

The Advent of ‘Corporate’ Limited Liability in Prussia 1843

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Abstract

While the debate on the adoption of limited liability for joint-stock corporations in Britain in the 19th century is comparatively well documented, little is known about the contemporary German debate. Hence, this paper aims to shed light on the debate within the Prussian Government which surrounded the Joint-Stock Act of 1843. After a short discussion of the assumed merits of limited liability in the light of recent historical evidence, I shortly review the existing literature on the Act as well as the historic background. Drawing on primary sources of the debate within the Prussian administration in the course of the legislative process, the article examines whether limited liability was indeed seen as a prerequisite for the existence of joint-stock companies as its supporters claim. I find that in line with British experience limited liability was not universally seen as a necessary condition for joint-stock companies. In fact, the course of the debate suggests that limited liability was finally introduced not because of the notion of a separate corporate legal identity, but because of the nature of joint-stock capital. In doing so, the administration wrongly assumed that shareholder constituency always consisted of a large number of shareholders with little equity each, being obviously unaware of the possibility of joint-stock companies being dominated by large shareholders and institutional investors.

Introduction

Many economists have argued that one of the reasons for the Financial Crisis of 2007/2008 was the lack of personal liability and hence the massive occurrence of moral hazard on financial markets.¹ In the absence of liability, which is meant to internalise the full costs of private actions (Carney, 2000, p. 665), institutions and private agents alike became ever more risk prone (see for example Blankenburg et al., 2010, pp. 823-824). Especially in Germany with its 'ordoliberal' tradition which highlights the importance of liability for the functioning of free and competitive markets (Eucken, 1990), several economists have pointed to the widespread lack of liability as the main design flaw of the current financial architecture (Michler and Thieme, 2009; Ilgmann and van Suntum 2008; Sinn, 2009). But even before the crisis hit, beginning in the 1980s, more and more scholars have argued against the widespread adoption of limited liability also from a theoretical perspective (Blumberg, 1986; see also Meyer, 2000, p. 2-3). Especially, the extension of this doctrine to parent corporations and majority shareholders in particular was criticised as it led to a shift of risks and thus a socialisation of losses (see for example Ireland, 2010, pp. 838-839; Eucken, 1990, p. 282-283; Blumberg, 1986, pp. 623-626; Grossfeld, 1968, pp. 110-111).

Despite this mounting criticism, limited liability will most likely continue to be an important part of the institutional architecture of modern market economies. While there are today numerous types of business forms that limit owner liability,² for more than 100 years, the limited liability joint-stock corporation has been without doubt the most prominent business entity of the modern world. Traditionally scholars have hailed it as a cornerstone of industrial development (Johnson, 2010, p. 108; for a review of the literature see Taylor, 2006, pp. 7-11). The conventional wisdom is that joint-stock corporations allowed businesses to raise huge sums of capital, which were needed to finance costly investments in infrastructure and machinery and that investors were more likely to offer funds if the investment could be recovered via liquid secondary markets. It also facilitated the advent of professional managers as it decreased transaction costs due to standardised internal governance structures and an increase in size of companies in order to exploit economies of scale and scope (Chandler, 1977; 1990).

Against this background, limited liability is often regarded as the 'conditio sine qua non' of the joint-stock corporation for it reduces the agency costs of separating ownership from control because it decreases the need of shareholders to monitor managers and other shareholders

1 The 'jingle loans' where homeowners were only liable with their homes, the 'originate and distribute' business model of mortgage banks, in which banks were no longer liable for the loans granted, and finally the massive bail out of distressed credit institutions by governments around the world.

2 Examples include the 'Gesellschaft mit beschränkter Haftung' (GmbH) in Germany, Limited Liability Partnership (LLP) and the Limited Liability Company (LLC) in the U.S.A (Carney, 1995).

(Easterbrook and Fischel, 1985, pp. 93-103). Hence, limited liability fosters economic growth as it encourages investors to take risks, allows the efficient distributions of risk between investors and creditors, and it avoids the litigation costs associated with seeking recovery from a large amount of shareholders (Carney, 2000, pp. 669-670). Finally, it is regarded as a prerequisite for liquid security markets for there are high transaction costs associated with the trading of shares with unlimited liability (see for further references Hickson, Turner, and McCann, 2005, p. 460). Hence, President Butler of Columbia University famously argued that 'the limited liability corporation is the greatest single discovery of modern times [...] even steam and electricity are far less important than the limited liability corporation' (Butler, 1912 p. 82).

This widespread endorsement might distract one's attention away from the fact that limited liability has a rather contentious history and its free availability is a relatively young phenomenon (Perrot, 1982, p. 83). In the United States as well as in Great Britain contemporary scholars and public sentiment were often set against it because it was widely believed that limited liability companies would be more prone to risk, default, and fraud. As late as the 1830s the joint-stock limited liability company was seen as a 'legally suspect and morally dubious' business form (Johnson, 2010, p. 2, see also Carney, 2000, pp. 662-664). Consequently, Britain generally allowed limited liability only as late as 1855 at a time when the country had already industrialized (Forbes, 1986) and in the U.S. the adoption of limited liability by the various states during the 19th century was rather gradual (Chausovsky, 2007, pp. 54-55). Moreover, recent scholars of the effects of limited liability have found ample evidence in various industries that many of the widely held beliefs concerning the effects of limited liability cannot be upheld without ado. Thus, it seems unlikely that limited liability corporations were a prerequisite for industrialisation and economic development as its supporters claim. Indeed, until the mid-19th century, limited liability was not seen as being an integral part of joint-stock companies, but rather the result of contemporary positive law making (Grossfeld, 1968, p. 105). Hence, the historical genesis of corporate limited liability was determined by specific historical, sociological and political circumstances 'rather than [being] the outcome of an orderly optimal institutional selection' (Johnson, 2010, p. 2). This judgement supports Blumberg's (1986, p. 576) statement that 'limited liability is a statutory development that represents the triumph of the rising political power of business interest'. Indeed, given that most large corporations today are dominated by institutional investors (El-Shagi and Ilgmann, 2010) with a large influence over business strategy (Ireland, 2010, p. 848), the traditional story of the need for limited liability seems to be unsatisfactory.

Against this background it seems worthwhile to revisit the historical debate surrounding the advent of the modern joint-stock corporation as this might improve our understanding of its origins

(Hillman 1997, p. 627). Indeed, the existing literature leaves little doubt that legal personality, joint-stock and limited liability are three distinct legal principles that were sometimes combined during the early modern period (Harris, 2000, pp. 22-25). Based on the recent literature on the subject, the article attempts to summarize the development of the joint-stock corporations in Britain. It also contrasts the perceived benefits of limited liability against the available historical evidence. Moreover, while the debate on incorporation and limited liability for joint-stock corporations in 19th century Britain is comparatively well documented, little is known about the contemporary German debate. Therefore, this paper also aims to shed light on the debate within the Prussian Government which surrounded the Prussian Joint-Stock Act of 1843 that laid the foundation of German corporate law. Drawing on primary sources from the debate within the Prussian administration in the course of the legislative process, it tries to examine whether limited liability was indeed seen as a prerequisite for the existence of joint-stock companies. I find that in line with British experience limited liability was not universally seen as a necessary feature of joint-stock companies. Moreover, the course of the debate suggests that limited liability was finally introduced not because of the notion of a separate corporate legal identity, but because of the nature of joint-stock capital. This is due to the fact that the Prussian administration assumed that joint-stock capital would always be dispersed among a large number of passive shareholders with little equity each on whom unlimited liability would have placed a large burden.³

Incorporation and limited liability: a historical survey

Origins of the corporation and transferable joint-stock capital in Britain

While seemingly a modern invention, in its origins the corporation is a very old and unique European concept⁴, which is already visible in revived Roman and Canon law by the 13th and 14th century. According to Harris' (2009, p. 613), a corporation is an association of individuals with a distinct legal entity. It may own property, contract with third parties, and has a hierarchical and centralized governance structure. Corporations were initially used for various administrative purposes such as church entities, universities, guilds, etc., and thus limited liability was of little importance to its members (Harris, 2000, p. 127). Consequently, many members of medieval

³ In the case of widely dispersed shareholding the problem of limited liability and moral hazard is shifted to management level of the corporation due to Principal-Agent issues (see for example Hicks, 1982, p. 17-21; Grossfeld, 1968, p. 111), which are not part of the present analysis. There is however a large literature on the subject, especially with respect to the optimal design of management contracts.

⁴ Concerning the above given definition of corporations, Harris (2009, p. 613) states: 'As a conception that embodies all these features, even those that were present as early as the 14th century, the corporation is a unique European conception.'

corporations tended to fall under unlimited liability, as in the case of most European Universities (Djelic, 2010, p. 6). However, beginning with the high phase of the industrialization, what was once a privileged organisational form for public bodies quickly became the dominant organizational form of big business in the United States, Great Britain, France and Germany (Horn, 1979, pp. 125-126). In its modern legal form, the business corporation combines the legal personality with the decoupling of ownership and management. It also offers limited liability for its shareholders who cannot be held liable for the corporation's debt and liabilities – and vice versa. Hence corporation shares are easily transferable on securities markets (Djelic, 2010, p. 2).

It is intuitively easy to imagine that having a legal personality is a huge advantage in terms of organisational or transaction costs for a large group of individuals in comparison with traditional partnership law, where all individuals are required to consent to each contractual arrangement. Thus, it constituted a privilege and prior to the codifications of the 19th century, the legal personality of the joint-stock corporation was a concession of the King – or Parliament in the English case – to some of his subjects. It was granted for projects that served the King's and Kingdom's and hence the public's interest (Djelic, 2010, p. 4), and required no other justification (see for Common Law Harris, 2000, p. 18; for continental Europe Cordes and Jahntz, 2007, pp. 15-17). This medieval legal concept was then used for new economic purposes during the mercantilist era, at a time when trade policy became an elementary part of public policy (Harris, 2000, pp. 39-59). Hence, by the second half of 16th century, maritime long-distance trade was increasingly organized in corporations, regulated⁵ and joint-stock (see, Harris, 2000, pp. 40-46). This is due to the fact that the corporations of the earlier modern era had considerable fiscal and administrative functions, especially concerning the rule of colonies (Cordes and Jahntz, 2007, p. 22). Against this background, the business corporation acquired its second characteristic: the financial innovation of transferable joint-stock.

The economic rationale behind joint-stock is undisputedly its capacity to raise enormous sums of capital from a large number of investors, who themselves are not necessarily involved in running the company. While the first mercantile corporations also used ad-hoc per voyage capital or capital for a limited amount of years, joint-stock capital became ever more permanent during the mercantilist era, thereby giving perpetual life to corporations. This in turn allowed ever more complex long term business projects. Consequently, entry and exit and thus widespread public participation in these endeavours became possible by purchase or sale of stock on liquid secondary securities markets. In response to this innovation, joint-stock companies began to develop internal governance structures, e. g. bookkeeping, dividend payments and managerial hierarchies. There was

⁵ Regulated companies had joint-stock that was used to pay for common infrastructure such as embassies, convoys. Members could use that infrastructure but still traded on their own account (Harris, 2000, pp. 32-33).

however no linear trend towards permanent joint-stock. Rather, many English joint-stock trade companies returned to the status of regulated companies in the course of the 17th century. In England, it was the influential East India Company that determined the development of joint-stock capital from ad-hoc per voyage capital to capital for a limited period of time to permanent stock at that period and also helped to develop the necessary internal governance structures (Harris, 2000, pp. 24-25). On the continent, most joint-stock companies of 17th century were already permanent in stock as for example the Dutch East India Company, but governance structure were also slowly evolving, with most shareholders being more or less passive investors without voting rights as business policy was made by the state and the influential investors (Cordes and Jahntz, 2007, pp. 17-22). Only in the late 18th and earlier 19th century – as the public nature of joint-stock corporations slowly faded – became the internal governance more and more democratized.

The capacity to raise enormous amounts of capital was also the reason for scepticism towards joint-stock corporations. Even without the privilege of limited liability joint-stock companies were capable to restrict competition and yield previously unknown private economic power by their sheer size and perpetual existence. Therefore, in Britain in the 1820s and 1830s, both major parties – Whigs and Tories – agreed that incorporation was a privilege to be given only to those large scale enterprises, which were in the public interest (Johnson, 2010, p. 119). Moreover, the authorities – also in the U.S. and in several German states – tried to restrict their influence by requiring a state concession. Furthermore, if such a concession was granted, it often included clauses limiting the lifespan of the corporation or limiting its business activities to a certain area (Grossfeld, 1968, pp. 110-131). Regulations that controlled the mergers and acquisitions and precluded companies to own stock in another were also enforced (Bakan, 2004, p. 14). Thus, the combination of corporation rights and joint-stock capital – even without limited liability – was heavily contested during 19th century – mainly out of a concern for competition due to the concentration of economic power.

As the joint-stock corporation became an ever more sought after business form in the course of 19th century, in Britain incorporation transformed from a special privilege to a freely available business form and previous regulation was step by step dropped.⁶ With the repeal of the Bubble Act 1825, incorporation outside an Act of Parliament became available through royal charter but without limited liability (Harris, 2000, p. 265). Incorporation became then freely available in 1844 under the

⁶ Similar developments took place elsewhere in the world. In the U. S., existing regulation on state level was worn down in a race to the bottom as individual states – New Jersey being the most prominent example – tried to attract large companies and their tax revenue by passing relatively liberal incorporation laws (Grandy 1989, p. 681; see also on Chatermongering Grandy, 1993). In Germany, the Joint-Stock Act of 1870 allowed for free incorporation for any lawful business, based on a naïve belief in the self-regulating forces of markets. Following Adam Smith's verdict on the inefficiency of large joint-stock companies vis-à-vis individual entrepreneurs, companies were not perceived as a threat to competition by the German authorities (Grossfeld, 1968, pp. 136-143).

Joint-Stock Companies Act, mainly to facilitate legal proceedings (Carney, 2000, pp. 662-664). This was, as Johnson (2010, pp. 119-120) points out, not only to the benefit of the newly incorporated firms, but also to the public if they had to litigate against the corporation.⁷ Within fourteen months some 1,639 joint-stock corporations with full personal liability for shareholders were registered at the Registrar of Joint-Stock Companies, tripling their total number compared to two years earlier (Harris, 2000, pp. 282-282).⁸

Hence in Britain, corporate rights and joint-stock matched for good in the 19th century as the perceived public benefits seemingly outweighed the negative aspects. What had been a privilege, had become a status to be achieved by conforming to certain legal requirements. Once incorporation was freely available, corporate shareholders and managers began lobbying for limited liability as an additional feature. At least for the British case, we know that they met fierce resistance by various social groups, dedicated to preserving the full liability paradigm, but the advocates of limited liability prevailed. Many of their arguments however, which are still put to frequent use by today's advocates of limited liability, have been refuted by recent historical research on the issue.

Limited liability in 19th century Britain

The desire for limited liability is probably as ancient as trade and commerce itself (Hilman, 1997, p. 615) and different forms of limited liability are known in Indian, Islamic, and Chinese law. The roots of limited liability in contracts can at least be traced back to the Commenda (Hilman, 1997, pp. 621-622), which can be found on the Arab Peninsula as early as the late 9th century BC and consequently migrated to North-western Europe and to the Far East (Harris, 2009, pp. 611-612).⁹ The Commenda was mainly used for risky sea trade, where a passive, non-seafaring partner would invest in the voyage of a seafaring partner. Obviously, for the partner that did not participate in the voyage itself, there was a mismatch between ownership and control and it might well be argued that these passive partners were uneasy to accept full liability for actions they did not participate in. Such contractual arrangements, sanctioned by the law, were known around the world already in pre-

⁷ Because British law required all partners to be named in a law suit against a partnership, which was difficult, if not impossible, in case of large joint-stock companies, creditors of those large firms were effectively denied justice. Thus, incorporation allowed them to sue the respective firm directly without having to find all partners.

⁸ See for details on these requirements Johnson (2010, p. 121). While this increase in the number of corporations is usually seen as a sign for the need for and acceptance of this new form of business organization, its significance might be overstated. For example, Johnson (2010, pp. 122-123) argues that 1,149 of those were railway undertakings, caused by the on-going 'railway mania', while normal businesses retained their mainly traditional organizational forms.

⁹ Lately, Malmendier (2009) argued that even the Roman Republic had an early form of a shareholder company, the *societas publicanorum*, which offered its shareholders limited liability.

modern times, with the notable exception of England where the existence of lawful Commenda contracts is in doubt.¹⁰

Similar to corporate status, limited liability outside Commenda contracts was a special privilege granted by Crown (or Parliament). If granted, it was meant to subsidize risky, but politically desirable undertakings (Deutsch, 2007, p. 63; Santini, 1982, p. 74; Grossfeld, 1968, pp. 108-110). Consequently limited liability was generally justified if the public interest was involved, which – besides colonial companies – was the case mainly in banking, insurance, and transport (Minchinton, 1982, pp. 146-153) or in cases where huge sums of capital had to be raised from the public (Johnson, 2010, p. 139). While French and British charters often explicitly included limited liability, German and Dutch charters did not contain such clauses. Nevertheless, their shares had de facto limited liability because contemporary 18th century German legal scholars argued that stock was rather a debenture than a share in the company (Cordes and Jahntz, 2007, p. 20), because Dutch joint-stock companies, on which many German companies were modelled, did not foresee shareholder participation in the affairs of the company. Thus, limited liability is not a modern concept. Its combination with legal personality and joint-stock in the modern business corporation and their free availability for private economic activity however is a recent and uniquely western concept.

In Britain, this development can be explained mainly on historical grounds (Santini, 1982, p. 73). Once free incorporation became available in 1844, a fierce economic policy debate erupted that centred on the question whether the privilege of limited liability was to be granted to all corporations (Johnsons, 2010, p. 139). This debate was mainly driven by practitioners and politicians and not by theorists as company law and limited liability never became a major issue in neo- and classical economics (Amsler et al., 1981, p. 792). On the con side, there is not much scholarly debate about the contemporary arguments against limited liability. Generally opponents of limited liability argued that it would create excessive speculation, create difficulties in securing credit as risk would be shifted to creditors, and encourage fraud (Carney, 2000, p. 663). Moreover, it would privilege corporations over more traditional business organisations, especially in the context of raising capital (Djelic, 2010, p. 16). These arguments are thus very much in line with today's criticism of the principle as pointed out above. By contrast, there are substantial differences in opinion as to why the principle of limited liability became an essential part of British joint-stock corporations.

To begin with, it is interesting to note that limited liability was also advocated by social reformers, Christian socialists and John Stuart Mill. In short, they argued that limited liability would allow the middle and working classes to combine their efforts in common projects and it would

¹⁰ 'It is impossible to reach a conclusive assessment whether the common law recognized the limited liability of the investing partner or subjected him to a full joint and several liabilities towards creditors similar to the case of partners in general partnerships' (Harris, 20009, p. 612, fn 21).

encourage the rich to lend to the poor. Moreover, in an environment where limited liability was granted in an 'opaque' manner by Crown or Parliament, its free availability would democratize the economy. Finally, it was argued that only very risk prone investors would invest in a full liability joint-stock company, hence – contrary to contemporary and modern economic thinking – limited liability would actually increase prudence and decrease the risk of fraud and mismanagement (Djelic, 2010, 13-15). Given that many of these claims seem implausible in the light of modern economic theory as well historical developments, they were – to best of my knowledge – never empirically tested by modern scholars. Nevertheless, they point to the fact that there is more than one story behind the advent of limited liability.

Another strand of thought sees the acceptance of limited liability as being caused by developments in legal theory. According to Blumberg (1986, p. 577) limited liability became undisputed because of the acceptance of entity theory. As they were created by a state action, prior to entity theory corporations were treated as 'legal fiction' or 'artificial entity' by French, English, U.S. and German legal theory and required regulation due to their privileges and size (Horwitz, 1985, p. 180). Only by the end of the 19th century had entity theory asserted itself as prevailing doctrine: the idea that a corporation is a separate legal person with its own rights and obligations similar to those of a natural person and distinct from its shareholders (Blumberg, 1986, p. 577). Hence, what had once been created as a legal fiction to decrease transactions costs now became personalized and acquired the same individual rights as a natural person. According to Horwitz (1985) this principle asserted itself amongst other reasons because it was capable of justifying limited liability more convincingly than partnership theories. Hence the privilege created a doctrine ex-post to justify its own existence. Furthermore, Hovenkamp (1991, p. 42) argues that entity theory asserted itself because it addressed two related problems: how to protect the property of shareholders in the face of claims against a single shareholder and how to assign the power to assert constitutional rights in corporately owned assets. Nevertheless, from a legal perspective limited liability was sanctioned by turning corporations from partnerships of individuals with an artificial legal personage to an entity itself, whose rights were to be safeguarded by the law.

Then there is the argument that without limited liability investors would be deterred from investing if such an investment could mean personal bankruptcy (Diamond, 1982). Similar to the Commenda argument, shareholders that did not participate in running the company were reluctant to accept unlimited liability stemming from somebody else's decisions (Kregel, 1992, p. 32; Grossfeld, 1968, pp. 109-110). Since joint-stock corporations became increasingly perpetual companies, liability was potentially permanent. Thus, Kregel (1992, p. 36) argued that perpetual existence was only achieved by shareholders forfeiting their direct control over business matters in exchange for limited

liability and secondary trading of share. Furthermore, the ‘cruel contemporary laws of debt and bankruptcy’, which involved personal imprisonment, made the concept even more attractive (Harris, 2000, pp. 131-132). As long as bankruptcy laws favoured creditors over debtors, the latter would seek limited liability in order to avoid harsh personal sanctions.

Recent research has refuted that argument. For example, Hickson, Turner, and McCann (2005) and Acheson and Turner (2008b) find evidence that British bank shares with unlimited liability were frequently traded and the introduction of limited liability neither increased trading nor liquidity. In fact, even when limited liability was granted to incorporated companies in 1855/1856, British firms in general were slow to adapt limited liability organizational forms, as Forbes (1986) and Nosal and Smart (2007) point out. A prime example in this respect is the British banking sector. Banks were free to incorporate under the Banking Copartnership Act of 1826, but were not granted limited liability. By 1836 there were 118 joint-stock banks in England (Turner, 2009a, pp. 169-170). These unlimited liability banks continued to dominate English banking least until the City of Glasgow failure in 1878, even after consecutive legislation in 1857, 1858, and 1862 had allowed for the incorporation of limited liability banks at (Acheson and Turner, 2008a, p. 237). Scholars working on the history of U.S. corporations have come up with similar evidence.¹¹

The main argument of contemporary advocates of limited liability was that full liability would be a paper tiger. Full liability would either attract investors of little wealth or lead to the use of straw men by wealthy individuals, which would make litigation impossible and liability de facto limited. The later argument has become known as the Bagehot Hypothesis (see Hickson and Turner, 2003, p. 933-935, for details) and played a decisive role in the debate – at least in the banking sector (Turner, 2009b). However, recent research into 19th century British banking has so far found little evidence for this argument (Hickson and Turner, 2003; Acheson and Turner, 2006, 2008a; Turner, 2009a). For example, Turner (2009a, pp. 190-191) suggests that prior to the arrival of limited liability, new shareholder were successfully vetted by the existing ones and that shareholder constituencies’ quality deteriorated only after the introduction of limited liability as the incentive for peer screening was removed. Hence, the Bagehot Hypothesis was largely a propaganda tool used by the advocates of limited liability.

11 The development in the United States was similar and limited liability was only adopted gradually state by state in the course of the nineteenth century (Chausovsky, 2007, pp. 54-56). Indeed, California only abandoned pro-rate liability of shareholders in 1931 without any notable effects on share prices (Weinstein, 2003). American Express Company in fact had unlimited shareholder liability until 1965, although its shares were publicly traded with little notable effects on either price or trade volume (Weinstein, 2008; see also Grossman, 1995). Carney (2000, p. 664) suggests that it was the threat of catastrophic tort and regulatory liability rather than contractual liability which led to the adoption of limited liability in the United States.

Finally, there is the ex-post 20th century argument of Butler which was upheld by many prominent economists of outstanding reputation. For example, Hicks (1982, p. 12) stated that because economic growth at least partially depended on economies of scale, 'it must be regarded as a major achievement of limited liability that it has made much of our economic progress possible. The argument runs from limited liability to capital accumulation to firm size and economic growth, a view that can be contested for various reasons. First, free incorporation for limited liability joint-stock companies became only available at a time when Britain as the world's foremost economic power had already industrialized. Second, for 19th century Britain, the need to raise huge sums of capital alone does not justify the spread of incorporated firms. Most corporations raised only small sums of capital and/or forbade public trading of their shares by statute (Johnson, 2010, pp. 123-127). Third, non-limited liability joint-stock corporations – as demonstrated above – seemed to have performed much better as the prevailing 20th century zeitgeist was prepared to acknowledge. Thus, the limited liability corporation might not be the prerequisite for industrialisation as its advocates claim – at least in the British case. While most scholars have taken the fact that corporations became the dominant organisational form of big business as self-evident proof for that claim, there might be other reasons for that dominance, e. g. the use of joint-stock corporations for external growth and the restriction of competition (Horn, 1979, p. 166). Hence, there is little reliable empirical evidence of the corporation's strong driving role regarding economic growth in the 19th century, and its importance may have been gravely overestimated.

In sum, it turns out that many of the arguments in favour of limited liability – be it contemporary or modern – do not hold in face of the historical evidence. Limited liability was the last common feature of joint-stock corporations to develop and it was definitely not the driving force behind their creation (see also Grossfeld, 1968, pp. 102-104). It never has been a prerequisite for neither incorporation, nor joint-stock and liquid security markets, nor economic industrial development. Furthermore, limited liability was never unanimously seen as a necessary feature of corporations by contemporaries (Diamond, 1982, p. 34; Johnson, 2010, p. 110). Rather it was recognized as a special privilege – or subsidy to investors – to advance undertakings that were in the public interest. From the investors perspective, incorporation was sought after not out of some overruling economic necessity, but because owners were thus able to 'hide behind the veil of corporate personality', distancing themselves from the legal obligations of other forms of business (Johnson 2010, pp. 135-136).

Such a necessity would have only existed if shareholders had been in fact been passive investors – which they were not. While many of the modern features of capitalism such as corporate groups and institutional investors were either not yet existing or of little prominence, in practice

there were powerful individuals or groups of that had full control over business policy, albeit shielded from the full costs of their decisions. Hence, the review of the arguments in favour of limited liability against the recent historical research on the matter supports both contemporary and recent criticism on the perceived benefits of limited liability. Nevertheless, in the course of the 19th century, for a variety of reasons, somehow incorporation, joint-stock and limited liability became freely available for private business. Thus, 'the control of the grantor, the state, or the judge or registrar on its behalf, over the body which seeks incorporation and limited liability is reduced to a mere formality: what was, historically, an exception is now a rule' (Santini, 1982, p. 74).

The Prussian Joint-Stock Act of 1843: historical background and previous research

Joint-Stock Companies and Limited Liability in Prussia before the Joint-Stock Act

Joint-stock companies were well established in Prussia prior to the Act of 1843 and the beginning of the industrial revolution. In fact, the Prussian 'Brandenburgische-Afrikanische Kompagnie' – founded in 1682 for over-sea trade with Africa – is believed to be the oldest German joint-stock company (Grossfeld, 1979, p. 236). Although it did not explicitly include limited liability, shareholders were generally treated as creditors, not investors, also to protect the company's assets against claims against individual shareholders (Meyer, 2000, p. 213). Commodities and food industry, infrastructure as well as insurance companies were other sectors that required huge amounts of capital in pre-industrialised times and were therefore often organized as joint-stock companies (Martin, 1969, p. 501). Hence, before the enactment of the Joint-Stock Act there were numerous incorporated companies, although there is no comprehensive contemporary statistic on Prussian joint-stock companies (see Moll, 1908, pp. 14-50, for detailed analysis of contemporary statistics). The first attempt to collect data on the issue is undertaken by Engel in the 1870s, who complained about the lack of official data, stating that thus his compilation may not cover all existing joint-stock companies (Engel, 1875, pp. 457). Adding up the 20th century statistics given by Bösselmann (1939), Thieme (1960), and Martin (1960), it results that prior to 1843 there were 90 joint-stock companies in Prussia, absent road companies ('Chausseeegesellschaften'). From the data follows that there were two periods of increased founding activities that in the first half of the 19th century: first the period of 1821-25 with twelve start-ups and a share capital of 10.6 million Talers and 1836-40 with twenty-five start-ups and a share capital of 25.3 million Talers (Martin, 1969, p. 502).

The possible reasons for this development have been debated extensively in the literature. According to the generally accepted view, the need for the joint-stock company's ability to raise huge amounts of capital was only felt from the 1830s onwards with the construction of railways and the subsequent development of large scale coal, iron and steel industry (Wehler, 1987, p. 103). In fact, railway companies required private capital on a previously unknown scale and thus some scholars even argued that it was their development that is ultimately responsible for the widespread introduction of joint-stock companies (Pierenkemper, 2000, pp. 93-96). This is backed up the empirical evidence. Up until 1850, 28 railway companies were set up with a share capital of 103 million Talers (Hopt, 1980, S. 137) and although railway companies made up one only third of all joint-stock companies by 1850, they were responsible for almost 80% of raised capital (Kießling, 2007b, pp. 124-125). Moreover, railway stock was normally issued as transferable shares while most other stock were registered securities and their possessions was linked to further contractual obligations (Bösselmann, 1939, pp. 46-49).

Hence, there is little doubt that the necessary amount of capital was constantly increasing with the onset of industrialization in Prussia, but the role of joint-stock companies in financing these developing industries may have been exaggerated. As in Britain, many industrial companies were able to finance their activities by traditional means, e. g. private credit, self-financing (Wehler, 1987, pp. 95-98; Pierenkemper, 2000, S. 124), also because the early stage of industrialization required comparatively little amounts of capital.¹² Hence, Martin (1969, p. 515) proposes a more nuanced view in concluding that the joint-stock company was not only necessary for major projects, but also for the development of backward regions with under-developed capital markets, where traditional means of finance were scarce. Here, only joint-stock companies were capable of collecting the necessary capital for the region's industrial catch-up. Nevertheless, even if one puts into perspective the importance of joint-stock companies, they remain an efficient institution for the collection and administration of large amounts of capital, which helped entrepreneurs to effectively tap available capital resources¹³.

The increasing demand for joint-stock companies visible in the numerous Octroi and Concession requests put pressure on the Prussian authorities to unify its joint-stock laws. Due to the Napoleonic Wars and the subsequent annexation of the Rhine provinces, the newly acquired western provinces were subject to the French Code de Commerce, which had become law in 1807, and remained in power even after the French defeat (Baums, 1981, p. 26). Concerning the establishment

¹² Borsig for example needed only 65,500 Talers for the creation of his work in Berlin in 1837, of which 10, 500 came from his own resources (Wehler, 1987, p. 97).

¹³ That a lack of capital caused the comparatively late Prussian industrialization has been refuted by the modern literature because because of the low interest rate on government bonds (Wehler, 1987, p. 95).

of joint-stock companies, the French law had already made the step from a system of special privileges to the concession system (Hopt, 1980, p. 135). Under the later, the rights and the laws governing a joint-stock company were no longer subject to special privileges, but were given by a general, abstract norm. A granting of special rights by individual 'Octroi' was no longer foreseen, although companies still had to apply for state permission in order to be granted corporation rights. According to the Code de Commerce, the local authorities had to establish whether at least two thirds of the initial capital had been paid in, whether the shareholders would be able to pay the rest of the capital, and whether the firm's business activities were sound. In addition, the local authorities had to submit a report to the responsible minister that made a statement on the benefits and the perceived prospects of a particular business (Baums, 1981, p. 24).

The eastern provinces of Prussia were governed by the General state laws for the Prussian states ('Allgemeines Landrecht'/ALR) of 1794. By contrast and similar to British Common Law, the ALR treats private firms as partnerships ('Societäten') and public institutions as corporations ('Corporationen und Gemeine'), a distinction that can be traced back in its origin to Roman law (Hadding and Kießling, 2003, p. 160). While the later are eligible for both limited liability and corporate body, the non-privileged companies lack both qualities (Baums, 1981, p. 22). Hence, it cannot contract in its own name and claims against the company are executed against the private property of the owners – and vice versa (Hadding und Kießling, 2003, p. 162). Under the 'Octroi'-system corporation rights are only granted by individual privilege (Baums, 1981, p. 22). From a legal theory perspective, the Octroi therefore exempts the privileged company from the application of the ALR, the extent of which depending on the individual Octroi. Consequently, non-privileged joint-stock companies are therefore treated as private partnerships, in which personal liability is both the necessary condition for credit as well as sound business conduct (Hadding und Kießling, 2003, p. 163). Moreover, without prior consent of all shareholders, such a company could not make any contractual arrangements. That especially the latter posed a real problem to contemporary stock companies is well documented in the contemporary literature (Hadding and Kießling, 2003, p. 162; Hopt, 1979, p. 138; Baums, 1981, p. 34).¹⁴

Within the jurisdiction of the ALR the grant of privileges depends on the company's perceived benefit to the public¹⁵. Besides a short liberal intermezzo after Prussian reforms in the wake of defeat at Napoleon's hands, the public authorities assumed that profit seeking private

¹⁴ As in the British case this needs to be somewhat put into perspective. In the first half of the 19th Century companies without or with limited privileges are repeatedly founded in order to avoid the strict state control associated with Octroi (Kießling, 2007a, pp. 194 -195).

¹⁵ 'Die Rechte der Coporationen und Gemeinen kommen nur solchen vom Staate genehmigten Gesellschaften zu, die sich zu einem fortdauernden gemeinnützigen Zweck verbunden haben' (II 6 § 25 ALR quoted after Baums, 1981, p. 27).

companies do not automatically fulfil this requirement. Hence, the need for joint-stock companies to prove their public benefit led to an on-going bureaucratic feud between the applicants and the authorities. Indeed, it is this petty paper war in combination with an increasing number of petitions of newly founded joint-stock companies, but also the experience with the developing railway sector with its previously unseen need for capital (see Kießling, 2007a, pp. 194-202) that drove the authorities towards a general solution (Martin, 1969, pp. 528-537).

Summing up, until the advent of the Joint-Stock Act in 1843, there were two distinct legal systems governing the rights of joint-stock companies: the Octroi system of individual special privileges granted by the state and the Concession system. In reality, this distinction had a rather limited impact (Hopt, 1980, p. 135), given that in both systems the establishment of a joint-stock company depended on positive action by the authorities. However, contrary to the Octroi system, in the concession system joint-stock companies may be formed on private initiative (Söhnchen, 2005, p. 217), although in reality the continued petitions by companies seeking such privileges had a very similar effect. Nevertheless, the Prussian Joint-Stock Act of 1843 does not only mark the transition from a system of special privilege to a system of abstract norm, but it also implemented the transition of joint-stock companies in German Law from private partnerships to companies with a distinct legal personality and limited liability with respect to both their internals as well as external relations (Kießling, 2007a, p. 219).

Previous German literature on the adoption of limited liability 1843

The contemporary German debate surrounding the adoption of limited liability by the Prussian Joint-Stock Act of 1843 is nearly completely ignored by the international literature on the genesis of modern corporations. For example, Marchazina (1982, p. 48), in his review of corporate forms and limited liability in Germany, hardly mentions it. Indeed, until recently even German scholars of legal history have treated the Act with benign neglect and even contemporary scholars of the German Empire seldom mentioned it (Martin, 1969, p. 513). This rather inglorious treatment by the academic community is astonishing, given that the Act introduced limited liability as a general norm into Prussian law and unified the Prussian legal system in an ever-more important domain of economic activity. For first time in Germany there exists a legally sanctioned corporate structure that is directed only at the private interests, but limits the liability of its shareholders to the capital raised (Kießling, 2007a, p. 225). The Act also had considerable influence on the first general commercial code in Germany ('Allgemeines Handelsgesetzbuch'), which was passed in 1861 (Kießling, 2007a, p. 194). Nevertheless, if one leaves aside 19th century literature,¹⁶ there remains a comparatively small

¹⁶ See for review of 19th century literature Reich (1969, pp. 255-256).

list of exclusively German studies on the Prussian Stock Act, which will be shortly reviewed in the following as they have received little attention by international scholars.

For the interwar period, there are the works of Schumacher (1937) and Bösselmann (1939), both of which delineate the legal history of the joint-stock company in the 19th century. In the postwar period, Blumberg (1960) elaborated on the importance of stock issue for financing firms in the 1850s and Thieme (1960) compiled data on the concession of joint-stock companies. Martin (1969) worked on the early genesis of the Act and the underlying economic necessities in particular. Baums (1981) edited the primary sources on the legislative procedure, including a short introduction into its development. The Act is furthermore referred to in the works of Reich (1969), Hopt (1980), and Grossfeld (1968; 1979) as well as in Wehler's seminal work on the history of German society (1987). Since the turn of the century, interest in the matter seems to have increased considerably. Söhnchen (2005) treated the Stock Act in his work on the history of the prerequisites required by law for the formation of joint-stock companies and Meyer (2000) referred to the Act extensively in his overview over the historic origin of limited liability in the German commercial law. Moreover, Hadding and Kießling (2003) and Kießling (2007a) elaborated on the Prussian Stock Act of 1843.¹⁷ Especially the recent publications focus on the developments in the history of law and on the transition from a system of special privilege ('Oktroi'¹⁸) via the concession system to today's normative regulations, where corporate rights are granted to all entities that fulfil specific legal requirements.

Given that the question whether to grant limited liability to shareholders aroused most controversy during the legislative proceeding (Hadding and Kießling, 2003, p. 185), the arguments made in favour of limited liability have already been covered by the literature to some extent. Indeed, most of the afore mentioned works refer to the contemporary feud between the advocates and opponents of limited liability, but come to different conclusions regarding the ultimate cause of its acceptance. To begin with, the standard argument is summed up in Wehler (1987, pp. 103-106) who argues that limited liability, though controversial, raised the attractiveness of limited liability shares for investors, and that the limitation of liability stemmed from the corporation's legal personality – as opposed to being a special privilege. However, there are more nuanced views which reject the automatic combination of corporate status and limited liability. Hadding and Kießling (2003, pp. 185-187) and Kießling (2007a, pp. 223-226) portray the debate within the administration, suggesting that the final reason for the introduction of limited liability was the possibility for wealthy shareholders to sell their share to destitute individuals, thereby avoiding regress to their property.

17 To a large extent the work of Kießling (2007a) seems to be a revised version of Hadding and Kießling (2003).

18 An 'Oktroi' is the document that notifies the special privileges of a company, e. g. limited liability, that are granted to all participants and their legal successors (Primker, 1881, quoted after Baums, 1981, p. 13).

According to this argument, which is similar to the Bagehot hypothesis, only the joint-stock capital will ultimately protect creditors in the case of default.

Finally, Meyer (2000, p. 262) argued that it was the idea of share ownership as a simple contribution of capital that led to the introduction of limited liability. Grossfeld (1968, pp. 109-110) came to the same conclusion, based on his reading of contemporary scholarly work but without reference to the Prussian administration. This notion is also upheld by Hopt (1980, p. 151) who, by reference to the contemporary works of Pöhls (1842) and the report made by the Berlin mercantile community, tries to demonstrate that limited liability is seen as protection for unskilled investors. Such an interpretation builds thus on the old 17th and 18th century German law tradition that regarded shareholders more like creditors rather than investors. This is somewhat puzzling, given that majority rule and majority shareholding were – at least in Germany – two very contentious issues as there were many cases of fraud by directors who quiet often also held large proportions of the shares (Grossfeld, 1968, pp. 119-120). Hence the notion of shareholding as a passive contribution of capital seems awkwardly at odds with the historical evidence – at least in the case of Germany.

In sum, due to the legal history background of most authors, their works have mainly highlighted the decisive legal inventions of the Act: the transition from the Octroi to the Concession system. In this context, the main debate is therefore between those authors who assume that the Act of 1843 introduced the notion of the corporation as a legal fiction into the law (see for example Wehler, 1987, p. 106) or those that maintained that the corporation was simply a modified partnership, which was exempted from certain aspects of partnership law, e. g. liability (Baums, 1981, pp. 41-44). According to the former limited liability would follow automatically from the law while the later assumed it to be a special privilege born out of economic necessities connected to the nature of joint-stock. Unfortunately, the literature on the subject which draws on the debate within the Prussian administration – with the notable exception of Meyer (2000, p. 259-260), who included reports made by the former ambassador to Britain, the chief of the statistical office of Prussia and the president of the province of Prussia as well as the statement made by Savigny – has mainly concentrated on the motives of the Royal Commission that had been tasked with developing a Joint-Stock Act and that handed over the first version of the Act in January 1840. Given that legislative process continued to go on for more than three years and that the enacted final form varied substantially from the first draft, there is a debate which has so far been hardly covered by the existing literature.

The debate on limited liability during the legislative process

The legislative procedure

The proceedings to the Act start by Royal order on the 13th of July 1837, which instructs the 'VIII. Deputation on the Revision of Commercial Law' to consult external experts and to prepare a draft joint-stock act (Kießling, 2007a, pp. 195-196). In fact, the deputation had already been tasked in 1826 with the reform of joint-stock law in the wider context of general law revision. Against this background, a first draft (quoted as *Commission Draft*) including extensive motives (quoted as *Motives*) is submitted by the commission, which included members from the deputation, representatives from the Berlin merchants as well as delegates from the Ministries of the Interior, Finance, and Justice¹⁹ on 31th of January 1840. The draft is revised by the ministers Kamptz, Mühler, Rochow and Count von Alvensleben²⁰ (quoted as *Ministers' Draft*), discussed in two meetings of the Ministry of state and yet again reformulated. The later draft (quoted as *Ministry of State Draft*) together with a dissenting draft by Mühler and Alvensleben (quoted as *Dissenting Draft*), two protocols from meetings of the Ministry of State on the 29th of June and 10th of July 1841 (quoted by date) as well as the reports of Schön, Bülow and Hoffmann (quoted by name) were then transferred by Cabinet Order on the 31st of January 1842 to the State Council²¹ for revision. In addition, the King, who is known as being an advocate of joint-stock companies (Kießling, 2007a), hands over Pöhls' (1842) work on the law of joint-stock companies as well as the Dutch commercial code of 1838 to the State council (Baums, 1981, pp. 30-31).

The State Council's combined departments for finance and the judiciary then created a report (quoted as *Combined Departments Report*) and a further draft law (quoted as *Combined Departments Draft*), which is then handed over to the State Council. The council then deliberates on the issue in four sessions, which are documented in four protocols dated 14th, 17th, 21st and 24th of

¹⁹ For the structure of the Prussian administration and its key personal in the mid-19th century see Hubatsch (1978). More information including further references can also be found in Wehler (1987).

²⁰ For biographical information regarding the involved ministers see the relevant personal entries in the *Deutsche Biographie* (2011) which includes information from both 'Allgemeine Deutsche Biographie' and 'Neue Deutsche Biographie'. A thorough discussion of their role within the administration as well as their political economy must be left to further research.

²¹ The Prussian State Council was a 'consultative body' which was founded in March 1817 and continued to exist formally until 1918. The chair was held by the king or an appointed president. In the pre-constitutional period to 1848, the State Council was an 'effective advisory body' (Lilla, 2005, p. 9 [my translation]). "His field of activity included all legislative and administrative norms, other administrative measures, jurisdictional conflicts between ministries, as well as advice on all issues brought before it by either law or by request of the King. Members of the State Council were: all adult royal princes, the Prime minister, the field marshals, the acting Minister of State, the state secretary of Ministry of State, the Postmaster General, Chief President of the 'Oberrechnungskammer', the leaders of the civil and military cabinet, commanding generals and 'Oberpräsidenten' present in Berlin, and other persons appointed because of special royal confidence" (Ibid, p. 9 [my translation]). See for the history of the State Council Schneider (1952).

June 1843 (quoted by date). In doing so, it refers to the *Combined Departments Draft*. The law is finally enacted by royal decree on the 9th November 1843 (Baums, 1981, pp. 30-31).

Were Prussian joint-stock companies really incorporated?

The *Motives* of 31st January 1840 state the rationale for the desired codification. In line with the empirical findings regarding the increase in founding activity, it explicitly mentions the increase in economic activity as well as the size of business as the reason for the growing demand for legal personality and limited liability. In granting these privileges the Ministry of Commerce was previously guided by public interest; otherwise they were denied to private enterprises. Given the increase in company size and the practical problems associated with the ALR for a large group of partners absent the status as a legal person, the administration opted for a middle way according to which several private companies received the status as a legal person but without limited liability. This in turn instigated a series of complaints by unsuccessful applicants, especially in those cases where newcomers were denied the same privileges as existing old joint-stock companies, which highlighted the need for a general provision (*Motives*, in Baums, 1981, pp. 54-56).

Even before the proceedings, the Ministers Mühler und v. Alvensleben in a series of letters agreed on the constitutive fundamentals of joint-stock companies. These include (1) widespread shareholding where each shareholder pays in just a small stake and does not participate in the daily business of running the company, which is done by appointed representatives, (2) the status of a legal person and limited liability for shareholders and directors alike, and (3) that shareholders may enter and exits the company without recuperating their paid in capital (*Motives*, in Baums, 1981, p. 56). This definition of joint-stock companies where investors have very little influences on the conduct of business remains unopposed in the course of the proceedings and reiterated many times over in the proceedings (see for example *Combined Departments Report*, in Baums, 1981, p. 137).

Against this background, both advocates and opponents of limited liability agreed that bestowing concessionary joint-stock companies with the quality of a legal person would greatly facilitate their daily business. According to §.13. Teil II Titel 6 ALR²², non-licensed joint-stock companies were unable to contract in their own name and were in particular unable to own land and capital (*Motives*, in Baums, 1981, p. 55). Such an arrangement apparently imposed considerable transaction costs on the companies as the consent of each and every shareholder for every transaction was needed (*Motives*, in Baums, 1981, p. 58-59). However, the Prussian administration never considered free incorporation as such. In §. 1. the commission asserted that joint-stock companies needed a state concession in order to become legally valid (*Commission Draft*, in Baums, 1981, p. 50). Indeed state concession as a prerequisite for founding a joint-stock company is

²² In the original: ‚Dergleichen Gesellschaften stellen im Verhältnisse gegen andre, außer ihnen, keine moralische Person vor, und können daher auch, als solche, weder Grundstücke, noch Capitalien auf den Namen der Gesellschaft erwerben.‘

undisputed during the legal proceedings.²³ This is due to the concern that the unchecked creation of joint-stock companies might endanger fair competition due to the large amount of capital involved,²⁴ even if this apprehension was put in perspective by the Smithian argument, according to which private entrepreneurs are favoured with respect to joint-stock companies because they do not have to bear administrative costs and are more free and flexible in their business decisions (*Motives*, in Baums, 1981, p. 66; see also *Combined Departments Report*, in Baums, 1981, p. 143). Nevertheless, incorporation of joint-stock companies, regardless of their liability regime, was to be checked by state confession in order to protect free competition as joint-stock companies were deemed to be capable to erect de facto monopolies because of their size (*Motives*, in Baums, 1981, p. 63).

In this context, it is interesting to note that there is in fact a debate below the surface on whether the rights of a legal person do stem from the conferment of corporate rights to joint-stock companies or whether these rights arise out of the nature of joint-stock capital. In fact, the primary sources are quiet contradictory in this respect. For example, the *Motives* (in Baums, 1981, p. 55) refer to the King's grant of 'corporate rights', a statement that is repeated throughout the proceedings (see for example *Protocol State Council 14th of June 1843*, in Baums, 1981, p. 171). The question is whether this points to an application of the ALR's²⁵ corporate laws or whether this is just a conferment of the same rights – those of a legal person – to joint-stock companies. Indeed, in the course of the proceedings 'corporate rights' and 'rights of a moral [legal] person' are used interchangeably throughout. At some points, the two are even explicitly equated (*Protocol State Council 17th of June 1843*, in Baums, 1981, pp. 175). This is most likely due to the fact that the rights of a legal person were explicitly denied to private companies according to ARL. Hence, corporate rights in the Prussian Stock Act would stem from the application of corporate law towards private joint-stock companies. Indeed, the *Report by Hoffman* (in Baums, 1981, p. 120) states that joint-stock companies should be privileged by being granted full corporate status, of which limited liability is an essential part. A similar argument can also be found in the State Council proceedings, where some members argue that limited liability stems 'eo ipso' from the corporate rights of a legal person (*Protocol State Council 17th of June 1843*, in Baums, 1981, p. 175). Such an interpretation would thus support the legalist view that limited liability originated in the corporate status of joint-stock companies.

Prussian joint-stock companies were however never incorporated in the strict sense. Rather, in the absence of special joint-stock legislation, privileged joint-stock companies whose Octroi

²³ See for example the statement of the Combined Departments Report (in Baums, 1981, p. 139) regarding incorporation.

²⁴ „Aktiengesellschaft vermöge ihres Uebergewichts an Kapital die einzelnen Gewerbe- und Handeltreibenden, [...], ganz zu erdrücken, jede Konkurrenz zu beseitigen, und so zum Nachtheil des Gewerbe- und Handelstandes wie des gesamten Publikums ein Monopol zu erlangen wissen möchten, [...]" (*Motives*, in Baums, 198, p. 57).

²⁵ §. 81. Teil II Titel 6 ARL: „Corporationen und Gemeinen stellen in den Geschäften des bürgerlichen Lebens Eine moralische Person vor".

included limited liability and legal personality, were only treated in analogy to corporations by the law. Nevertheless, joint-stock companies and corporation remained different legal concepts – at least for the majority of Prussian law makers. In several instances, legislators explicitly stated that joint-stock companies should not be established as corporations – which would require them to be of a particular interest to the state according to ALR – but to grant those rights and privileges to shareholders and directors that were absolutely necessary for their conduct of business (*Motives*, in Baums, 1981, p. 64).²⁶ Additionally, joint-stocks companies were granted limited liability for its members, a privilege that was regarded as characteristic for joint-stock companies but not for corporations (*Motives*, in Baums, 1981, p. 54).²⁷ In fact, Minister of Justice von Mühler und Minister of Finance Count von Alvensleben maintained that according to §. 96. Teil II Titel 6 ALR, members of a corporation may under specific circumstance be personally liable (*Motives*, in Baums, 1981, p. 67). Hence, according to the Motives limited liability and legal personality under an Octroi were not depended on being granted corporate rights, but were a special privilege granted to joint-stock companies. Because of these rights that were very similar to those of a corporation, under the ARL joint-stock companies were therefore treated in analogy with corporations. Nevertheless, the evidence suggests that the joint-stock company is not another corporation for Prussian law makers, but an organisational form of business ‘sui generis’.

This is also visible in the feud over the correct definition of joint-stock companies. While there are certain features that are considered to be characteristic of joint-stock companies such as dispersed shareholding, the rights of a legal person and perpetual existence (*Motives*, in Baums, 1981, p. 56), no agreement is reached on the legal nature of joint-stock companies. For example, the *Combined Departments Report* (in Baums, 1981, p. 137) proposes the following definition where joint-stock capital, raised from a number of shareholders, is recognised as a legal person by the law in its contracting with third parties. Furthermore, this joint-stock capital is represented by directors and shareholders who are not held liable for the company’s debts. Hence, shareholders are sleeping partners in accordance with §§. 651. 652. Teil II Titel 6 ALR. In this context, the *Combined Departments Draft* (in Baums, 1981, p. 160) attempts to define joint-stock companies as being of lawful purpose, whose end can only be achieved by collecting capital from a large amount of participants and whose founding procedure safeguards investors from fraud. However, this definition is regarded as unsatisfactory by many members of the State Council during the meeting. Since no

²⁶ ‘[...], da es sich eigentlich nicht davon handelt, die Aktiengesellschaften zu *Corporationen* im *Sinnes des Landrechts* [original emphasis] zu machen, sondern nur davon, ihnen diejenigen Eigenschaften zuzugestehen, ohne welche sie ihre Zwecke nicht erreichen können.’

²⁷ ‘Man hat sich auf diese Weise zu helfen versucht, daß für die Aktiengesellschaften die Verleihung der Rechte einer Korporation nachgesucht worden ist, damit dieselben in das Verhältnis einer moralischen Person treten., welche durch gewissen statuten-mäßig ernannte und erneuerte Beamte vertreten wird. Dabei ist in die zur Bestätigung vorgelegten Statuten zugleich die bestimmung aufgenommen worden, dass die Interessenten nicht über den Nominalbetrag der Aktie verhaftet seyn, damit auf diese Weise die bei Aktiengesellschaften für wesentlich erachtete, nach den Vorschriften über Korporationen aber nicht unbedingt eintretende Befreiung von der persönlichen Verhaftung begründet werden’ (*Motives*, in Baums, 1981, p. 54).

agreement is reached on the matter and joint-stock companies are believed to be sufficiently known to the public, any attempt to define their legal nature is dropped (*Protocol State Council 21st of June 1843*, in Baums, 1981, p. 187).

Another piece of evidence against the corporate origin of limited liability is the State Council's reply to the 'eo ipso' argument mentioned above. Besides §. 96. Teil II Titel 6 ALR, they argue that §§. 107. 108. 109. (ibidem) enforce personal liability for members even after their retirement from a corporation. Furthermore, it was considered to be doubtful whether all organisational forms that were granted the rights of a legal person could be treated as corporations, hence a simple reference to corporate law would not grant joint-stock companies limited liability (*Protocol 17th of June 1843*, in Baums, 1981, p. 176). Finally, Friedrich Carl von Savigny, one of the most prominent German 19th century jurists, argued in the first meeting of the State Council that joint-stock companies were rather partnerships with sleeping partners than corporations. He argued that while the Code Commerce recognized partnerships, limited partnerships and joint-stock companies, the ALR only deals with the first two forms. Hence, joint-stock companies had to be treated by the law according to analogous legal norms. These were thought to be the provisions concerning corporation, but Savigny argued that joint-stock companies bear more similarities with partnerships. This is due to the fact that partners already had access to limited liability, either by becoming sleeping partners or by restricting the procuration of managers, while legal personality was not obtainable under the ALR for private businesses (*Protocol State Council 14th of June 1843*, in Baums, 1981, pp. 170-171).

Hence, joint-stock companies were granted legal personality and limited liability not because they were treated as corporations; they simply received the same privilege, albeit for other reasons.²⁸ This fact was most likely obscured because prior to codification, joint-stock companies were treated in analogy to corporations in order to bestow them with a legal personality. That limited liability was however not a consequence of this treatment is visible not only in the debate about the nature of joint-stock companies, but also by the fact that limited liability of joint-stock companies was definitely more universal than that of corporation whose members could be held liable under specific circumstance. Thus, the evidence indicates that German joint-stock companies were never incorporated, but just bestowed with those privileges that were deemed necessary for their existence. Therefore the argument that limited liability was rooted in the corporate nature of joint-stock companies is invalid – at least in the Prussian case.

²⁸ Such an interpretation is actually also visible in the choice of words. Contrary to the English 'joint-stock corporation' the German 'Aktiengesellschaft' literally translates to joint-stock company.

The debate on limited liability: shareholders as 'sleeping' partners

While granting licenced joint-stock companies the quality of legal personality was not very controversial, limited liability was vehemently opposed by high-ranking officials in the Prussian administration, in particular by the Ministers Mühler and Count von Alvensleben. First, they believed that liability was meant to protect debtors from incurring large losses in case of bankruptcy. Second, they argued that limited liability encouraged the speculation in stocks.²⁹ Third, they pointed to the case of England, where shareholders in the absence of a charter were personally liable (*Motives*, in Baums, 1981, p. 66). The bottom line of their argument was that limited liability would alter the existing incentive structures, not only for shareholders but also for managers, who would become more risk prone and negligent in their conduct of business (*Motives*, in Baums, 1981, p. 67)³⁰. Hence, the Ministers suggested that shareholders should safeguard themselves from potentially unlimited risks by limiting the leeway of managers regarding their business decisions and making these restrictions known to the public. In this case, any contract beyond the power of representation would be void (*ultra vires*) – or at least leave the manager liable. Such a strategy was deemed to be a viable alternative to the widespread introduction of limited liability (*Motives*, in Baums, 1981, pp. 67-68).

Nevertheless, the two Ministers acknowledged that the existing legislation was rather restrictive to non-licenced joint-stock companies, because they were treated like partnerships. Thus, they argued that although not all joint-stock companies further the public good in the narrower sense, their creation was still economically desirable. For these firms, they recognized the provisions of the ALR as a considerable burden, because it assumed the identity of ownership and control and did not provide for the existence of managers and passive shareholders, (*Motives*, in Baums, 1981, pp. 57-58). Thus, Mühler and von Alvensleben proposed to grant these firms – given state concession – the rights of a corporation with respect to contracting, but to apply limited liability only to those companies which are in the country's interest and beneficial to the public (*Motives*, in Baums, 1981, p. 57). These privileges include: (1) the right to purchase and to own property in the company's name, (2) the executions into the personal assets of the shareholders only in those case where the company assets are insufficient, (3) a mandate for directors to conduct business with third parties, (4) representation in courts by the directors, (5) a provision that would allow for the exit of

²⁹ 'Zu einer Zeit, wo das Spekulieren auf Aktien ohne wirkliches Interesse für das Unternehmen selbst an der Tagesordnung sey, mache sich ein große Vorsicht nötig, bevor ein Privilegium für eine Aktiengesellschaft ertheilt werde'.

³⁰ 'Gerade in der persönlichen Verhaftung der Theilnehmer liege ein wirksames Mittel, dem Hange zum Aktienspiele entgegen zu wirken und die Interessenten zu veranlassen, daß Unternehmen im Voraus gehörig zu überlegen. [...] Die Theilnehmer möchten ihrerseits durch entsprechende Anweisung und Kontrollierung ihrer Vertreter dafür sorgen, daß letztere nur innerhalb des gemeinschaftlichen Vermögens Verpflichtungen eingingen. Würden diese Grenzen überschritten, so möchten die Theilnehmer die Folgen des mangelhaft verwalteten Unternehmens tragen, nicht aber das Publikum büßen lassen' (*Motives*, in Baums, 1980, p. 67).

shareholders from the company (*Motives*, in Baums, 1981, pp. 58-62). Hence, for private profit seeking economic activities the two ministers proposed a new business form with similar rights as corporations, but without limited liability, which they called privileged partnership ('privilegierte Societäten'). However, given that these privileged partnerships would still involve large amounts of capital and thus bear the danger of monopolies, their formation would have to be controlled by the state in order to avoid the formation of monopolies (*Dissenting Draft*, in Baums, 1981, p. 106). Still, Mühler and von Alvensleben acknowledged that limited liability would be the decisive distinction between the two types of companies (*Motives*, in Baums, 1981, p. 63): a business without limited liability would no longer qualify as joint-stock company, but would be a new form of partnership. Hence, even the opponents of a widespread introduction of limited liability assumed that it constituted a key feature of joint-stock companies. Nevertheless, the proposed privileged partnership emphasises the fact that Prussian joint-stock companies – with or without limited liability – did not develop out of the corporation, but were a business form sui generis.

Another argument for restricting limited liability to those companies which are beneficial to the public is made by the delegate from the Ministry of Commerce. By referring to the English case, he argued that joint-stock companies could not only exist without limited liability, but that it was full shareholder liability which made for the credibility of Scottish banks. Although he admitted that limited liability facilitated vis-a-vis the founding of joint-stock companies, this would lead to a considerable transfer of risk to the public. Given that shareholders participate in the profits, it seemed reasonable to him that they should also bear the risk. Moreover, the public shares a part of the potential losses under a limited liability regime, such a regime can only be justified by public benefits. Because it might be difficult to generally define when a company serves the public interest, the final decision on granting limited liability would therefore depend on administrative discretion. This public benefit argument explicitly involved the support of infant industries. He also stated that the notion that any company is in the public interest cannot be generally accepted and thus would not justify that joint-stock companies would be privileged in their contractual relations with third parties vis-à-vis private partnerships. Hence, the delegate suggested that joint-stock companies should be granted corporate status in order to facilitate business operations but without limited liability (*Motives*, in Baums, 1981, pp. 71-72).

However, the majority of the Commission is in favour of granting limited liability to all joint-stock companies. Consequently, the *Commission Draft* (in Baums, 1981, pp. 50-53) included limited liability for all joint-stock companies and consequently no shareholder was liable for the companies beyond the nominal value of his shares (§. 11). In addition, the executive directors are not liable to a third party for the company's deeds as long as their acts do not violate the provisions given by the act (§.16). The underlying rationale is that it would be quite difficult to determine whether a particular firm is in the public interest, also because the majority supports the classical notion according to

which all private firms also serve the general interest (*Motives*, in Baums, 1981, p. 65). In addition, they assume that a restrictive legislation would only lead to a flight of capital and to an increase in imports, as joint-stock companies will be founded abroad (*Motives*, in Baums, 1981, p. 65).

The majority of the Commission still favours limited liability for joint-stock companies, also because they maintained that to dispose of full liability would not have the negative consequences feared by Mühler and von Alvensleben. They argued that the success of firms is often determined by external factors outside the directors' control and hence managerial liability would not improve a firm's performance. In addition, any deeds by the management which are ultra vires or a violation of the law would render the directors fully liable (*Motives*, in Baums, 1981, p. 68). Moreover, the majority suggested the speculation in shares is best impeded by requiring shareholders to pay in the full capital of tradable shares (*Motives*, in Baums, 1981, p. 68). Then there is the idea of shareholders as passive partners. Indeed, the argument that investors have a marginal influence on the business strategy of a joint-stock company is not raised by the proponents of limited liability, but by Mühler and von Alvensleben themselves (*Motives*, in Baums, 1981, p. 58). This is due to what they call the most visible characteristic of joint-stock companies – dispersed shareholding where individual shares are just a marginal fraction of the capital stock – although it is not a constitutive property on its own (*Motives*, in Baums, 1981, p. 63). Consequently, the final argument in favour of limited liability is one of internal governance and risk and profit sharing. Without limited liability, the risk associated with being a shareholder ultimately depends on the respective personal wealth. However, the distribution of profits as well as property rights depends on the amount of shares held and thus do not reflect the economic risk taken. Under these conditions, joint-stock companies with a large group of shareholders would not be able to exist.³¹ This argument is however not universally accepted as the delegate from the Ministry of Commerce suggests that unlimited liability would set an incentive for shareholders to transfer shares only to solvent persons and would reduce the overall number of joint-stock companies while increasing their soundness (*Motives*, in Baums, 1981, pp. 70-71).

Consequently, the *Minister's Draft* (in Baums, 1981, pp. 80-83) by von Kamptz, Mühler, von Rochow und von Alvensleben states in §. 12. that shareholders are only liable up to the nominal value of their share. Moreover, §. 13. explicitly states that shareholders do not become debtors to

³¹ „Das Wesen der Aktiengesellschaften besteht darin, daß Viele zusammentreten, um ein bestimmtes, mit den Kosten und der Gefahr des Unternehmens im Verhältnis stehendes Kapital zusammenzubringen, dessen Ertrag nach dem Verhältnis der Antheilnahme getheilt werden soll. Hierdurch soll zweierlei erreicht werden; 1. daß ein Jeder weiß, welchen bestimmten Theil seines Vermögens er der Gefahr des Unternehmens hingiebt, und 2. daß ein bestimmter Maaßstab für die Theilung des Gewinns vorhanden ist. Dies eigentliche Charakteristische der Aktienvereine wird unmöglich gemacht oder gänzlich vernichtet, sobald man dieselben durch die Bestimmung, daß jeder Theilnehmer auch über den Betrag seines Einschusses hinaus haften solle, den gewöhnlichen Handelsgesellschaften gleichstellt. Der ganze Zweck der Aktienvereine wird damit vereitelt. Haftet der einzelne Aktionair auch über den Betrag der Aktie mit seinem ganzen Vermögen; so hört das Verhältnis der Aktionaire auf, ein gleichmäßiges zu seyn. Die Gefahr ist dann für die Begüterten groß, für die Unvermögenden gering. Auf solche Bedingung hin kann aber nicht eine große Anzahl von Mitgliedern zusammentreten“ (*Motives*, in Baums, 1981, p. 68).

the creditors of the company, but only a debtors to the joint-stock company in case of not paying-in the full amount of capital. The draft is then discussed on two meetings of the Royal Ministry of State on the 29th of June and 10th of July 1841. Especially in the first meeting the main arguments, as spelled out above, are repeated (*Protocol 29th of June 1841*, in Baums (1981), pp. 87). For example, von Alvensleben argues that granting large companies limited liability will endanger competition as these will have an advantage of smaller enterprises. This argument is countered by Kamptz who by reference to the necessary state concession points out that it is not in the state's intention to grant the privileges of joint-stock companies to all firms (*Protocol 29th of June 1841*, in Baums, 1981, pp. 87-88). In the concluding vote it was decided to include the requirement of a company being of public interest as a prerequisite for a concession, while the proposal of a privileged partnership made by Mühler and Alvensleben was rejected. However, the State Council asked the two ministers to come up a dissenting draft that would allow joint-stock companies to gain legal personality but without limited liability³² (*Protocol 29th of June 1841*, in Baums 1981, p. 89). The following meeting in July was then dedicated to technical matters (*Protocol 10th of July 1841*, in Baums, 1981, pp. 91-94). Consequently, the draft by the Royal Ministry of State followed the revised draft by v. Kamptz Mühler, v. Rochow und v. Alvensleben in granting limited liability to shareholders in §§. 13.-14, but included a clause in §.1. that only those companies that were in the public interest could form joint-stock companies with all ensuing rights (*Ministry of State Draft*, in Baums, 1981, pp. 96- 98).

The justification for limited liability slightly changes in the report drafted by the State Council's combined departments for finance and the judiciary, which is presented at the 16th of March 1843. For the first time it explicitly defined shareholders as sleeping partners in line with ALR §§. 651.-651. Th. II. Lit. 8³³ who are not involved in the daily business of running the company (*Combined Departments Report*, in Baums, 1981, p. 137). Consequently, it raises the question whether investors were not already capable of achieving limited liability via sleeping partnerships, in which only one destitute person becomes an official partner (*Combined Departments Report*, in Baums, 1981, p. 140). Given shareholders' voice in determining business policy and the prominent role of some shareholder-directors, such a judgement seems rather odd, especially because Oberregierungsrat Hoffmann, the only 'trained' economists involved in the proceedings, highlighted the shareholders involvement in business decision in his report. In fact, he argued for limited liability as means for facilitating joint-stock companies because shareholders were actively involved in the administration of the company as opposed to passive bond holders (*Report by Hoffmann*, in Baums, 1981, pp. 119-130). For Hoffmann, shareholders are a middle way between the 'active' business

³² See *Dissenting Draft* (in Baums, 1980, pp. 101-108).

³³ ,§. 651. Derjenige, welcher der Societät ein bestimmtes Capital mit der Bedingung anvertrauet hat, daß er, statt der Zinsen, am Gewinne oder Verluste nach Verhältniß dieses Capitals Theil nehmen wolle, wird ein stiller Gesellschafter (Associé en commendite) genannt. §. 652. Ist sein Name in der Firma nicht mit enthalten, noch er sonst als ein Gesellschafter ausdrücklich bekannt gemacht: so haftet er den Societätsgläubigern nur mit seinem in der Handlung stehenden Capitale; und kann ein Mehreres zu den Societätsschulden beyzutragen, nicht angehalten werden.'

owner and the 'passive' creditor, a view that is endorsed by the State Council's combined departments for finance and the judiciary (*Combined Departments Report*, in Baums, 1981, p. 143).

The *Combined Departments Report* then sums the previous discussion up and identifies two key questions: (1) whether corporate limited liability is to be restricted to enterprises that are in the public interest, and (2) whether there is the need for a further type of organization which allows for incorporation without limited liability (privileged partnerships) (*Combined Departments Report*, in Baums, 1981, p. 139). Concerning the first question, the report states that corporate limited liability should not be restricted to joint-stock companies that are in the public interest as long as these have registered shares. Only for companies with bearer shares, where the speculation in share is more frequent and hazardous, should the privilege of joint-stock companies be restricted to firms serving the common good (*Combined Departments Report*, in Baums, 1981, pp. 139-144; see also the *Combined Departments Draft*, in Baums, 1981, p. 160). Limited liability was justified once again with the asymmetrical risk and profit sharing already mentioned in the *Motives*. Indeed, it was seen as being characteristic of joint-stock companies and a necessary condition for their existence (*Combined Departments Report*, in Baums, 1981, p. 145).

Finally, all previous documents are handed over to the Royal State Council, which meets on the 14th of June 1843 for the first of four consecutive meetings. In the first meeting, the Minister of Law Revision, Savigny, argued not only that limited liability can be achieved under the ARL, but that it is the legal personality and not limited liability, which is the distinctive and necessary feature of joint-stock companies. For him, the ARL already provides several roads to limit liability via sleeping partners or the ultra vires doctrine. There is however no possibility for private associations to gain the status of a legal personality. Thus, limited liability is already a feature of existing forms of business organisation and not the decisive novelty. Therefore the plan of Mühler and Alvensleben of privileged partnerships does not address the real problem. (*Protocol State Council 14th of June 1843*, in Baums, 1981, pp. 170-172) and thus the idea of a privileged partnership with unlimited liability is finally dropped (*Protocol State Council 21st of June 1843*, in Baums, 1981, p. 185). In a nutshell, Savigny ends the debate on limited liability by pointing to its existing forms under the ALR, suggesting that risk prone agents looking for a limitation of their liability could simply use these forms of business.

Thus, it emerges from the debate that while there are other arguments for limited liability, especially the uneven share of risk and profits under a full liability regime, which are used especially in the beginning of the legislative procedure, later in the proceedings it is the idea of shareholders being similar to a 'sleeping' partner – or passive investors – that carries the day as these are already eligible for limited liability under the ALR. Given that this type of limited liability is already obtainable under the ALR, the debate then shifts to the quality of a legal person. Hence, the limited liability of the Prussian joint-stock company of 1843 stems not from incorporation, but from combination of the limited liability principle of the *Commenda* with joint-stock and the quality of a

legal person from corporate law into a new type of organisational form. This is also visible in §.1. of the finally enacted act which stated that 'Joint-stock companies with rights given to them by the present law can only be created with state concession' (*Joint-Stock Act 1843*, in Baums, 1981, p. 213 [my translation]). This provision was inserted into the law in order to clearly state – according to one member of the State Council – that joint-stock companies were given these rights 'ipso jure' (*Protocol State Council 21st of June 1843*, in Baums, 1981, p. 187), and not because of their corporate nature.

Conclusion

The present article on the advent of 'corporate' limited liability offers three new insights. First, what emerges from the review literature is that corporate limited liability has a long and contentious history, stretching back to the mid-19th century and beyond. Initially being hailed as one of the decisive legal inventions of our age, scholars have recently highlighted the negative effects of curtailing liability. During the 20th century, there was a tendency of scholars to highlight only the positive effects of limited liability without naming the negative side-effects. The past financial crisis has however highlighted the need to think about the negative consequences of an institutional design, where the costs of private action are not completely internalized. This in turn has inspired research in the historical origins of the joint-stock limited liability corporation in 19th century Britain. While many people believe that limited liability is the 'conditio sine qua non' of the modern corporation, this research has impressively demonstrated that such an impression does not match reality. In fact, there are many cases where large corporations with unlimited shareholder liability have operated very successfully for many years and their shares were tradable on liquid markets. Moreover, limited liability was debated rather contentiously by contemporary law makers in Britain as well as the US. Thus, many of the commonly held beliefs concerning the necessity of limited liability fall short of reality.

Second, the foregone discussion about the advent of limited liability in 19th century Prussia indicates that the majority of the Prussian administration as well as leading contemporary legal scholars considered the limited liability of a joint-stock company not being due to it being a corporation. Because joint-stock companies combined legal personality and limited liability, they were often treated in analogy to corporations within the jurisdiction of the ALR. As Savigny and various others pointed out, this did not turn joint-stock companies into corporations per se. In fact, what emerges from the sources is that the Prussian joint-stock company is not a corporation, but a form of business 'sui generis'.

Hence the third conclusion is that limited liability was seen as a distinctive feature of joint-stock companies, if not a necessary condition for its existence, but not of incorporation as such. Instead, this ever more popular form of business acquired those privileges deemed necessary for its existence. These necessary conditions were in turn derived from the nature of free-float dispersed joint-stock. Given that the Prussian law makers clung to the paradigm of dispersed shareholding by a large number of shareholders with little equity each, limited liability was justified – similar to the *Commenda* – by the divergence between ownership and control. Apparently, Savigny and others failed to see the difference in influence on business policy between shareholders and ‘sleeping’ partners, a somewhat puzzling fact. As was pointed out, even in the mid-19th century there were many cases where the dominating shareholder of a company was also its managing director. Hence, investors who were actively involved in determining business policy – if not on a day-to-day basis at least on a strategic level – were now protected from the negative results of their decisions. One can only speculate over the reasons for this misconception. Most likely, it was due to the fact that joint-stock corporation had indeed been ‘quasi’ public bodies, whose business strategy was more or less determined by the state via direct intervention and/or the appointment of trusted directors, but a final answer is yet to be found.

Finally, with respect to the present research, one first needs to point to the limitations of the present article as it probably raises more questions than it answers. Besides the printed and edited material that is available), there is a wide range of further potential material, e. g. personal correspondence between the ministers before and during the official legislative process. A thorough analysis of these handwritten documents, which are available at the Prussian State archives, is still missing. Also not considered in the analysis are those sources which are not directly related to the official legislative process. These are among other a report by the Berlin guild of merchants of 1829, various reports by the Minister Count von Alvensleben, the proceedings in Saxony in 1836/37³⁴ as well the French literature on the subject (Schumacher, 1937, p. 47). Also left out are the experiences made with the railway legislation (see Kießling, 2007a, pp. 197-202, for details), the British and Dutch legislation, and the legal situation and reform proposals in the other German states (see Bergfeld, 2007). Finally, there is a lot of more scholarly work to be done regarding the historical background in general, especially regarding the political economy in Prussia at the time, an issue that the present articles covers only very cursorily. A thorough analysis of these documents and issues must be left to further research.

34 See Bergfeld (2007, pp. 170-178)

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