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## The advent of corporate limited liability in Prussia 1843

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# ***The Advent of Corporate Limited Liability in Prussia 1843***

CAWM Discussion Paper No 46

April 2011 by

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Abstract:

Corporate limited liability has a long and contentious history, stretching back to the mid-19<sup>th</sup> century and beyond. Initially being hailed as one of the decisive legal inventions of our age, recently scholars have highlighted the negative effects of curtailing liability. This in turn has inspired research in the historical origins of liability. While the debate on the adoption of limited liability for joint stock companies in Britain and the United States in the 19<sup>th</sup> century is comparatively well documented, little is known about the contemporary German debate. Thus, this paper aims to shed light on the debate within the Prussian Government which surrounded the Stock Corporation Act of 1843. Drawing on primary sources of 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 as its supporters claim. I find that in line with British and American experience limited liability was not universally seen as a necessary condition for incorporated joint-stock companies. In fact, the course of the debate suggests that limited liability was finally introduced because the administration wrongly assumed that joint stock companies always comprised 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. Moreover, limited liability for shareholders was regarded as being similar to that of passive 'sleeping' partners, a justification that seems problematic in the light of today's virtually all powerful institutional investors.

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## ***Introduction***

Many economists have argued that one of the reasons for the current crisis is without doubt the massive occurrence of moral hazard on financial markets. In fact, in the last decade there were numerous examples for business models that were highly risk prone due to a lack of liability.<sup>2</sup> In the absence of liability that internalises the full costs of private actions (Carney, 2000, p. 665), institutions and private agent alike became ever more risk prone, a dilemma that was brought sharply into focus in the current crisis (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)

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 corporate forms that limit owner liability,<sup>3</sup> the most important one is the limited liability of shareholders and management of joint-stock companies. According to the standard view, limited liability is the condition sine qua non of the corporation, as it serves three economic goals: (1) it fosters economic growth as it encourages investors to take risks, (2) allows the efficient distributions of risk between investors and creditors, and (3) it avoids the litigations costs associated with seeking recovery from a large amount of shareholders (Carney, 2000, pp. 669-670). Another line of argument suggests that limited liability reduces the agency costs of separating ownership from control. For example it decreases the need of shareholders to monitor managers and other shareholders (see also Easterbrook and Fischel, 1985, pp. 93-103).<sup>4</sup> Finally, as mentioned above, limited liability is seen as a prerequisite for liquid security markets because there are high transaction costs associated with the trading of shares with unlimited liability. Thus limited liability is a necessary precondition for liquid and organized securities markets (see for further references Hickson, Turner, and McCann, 2005, p. 460), which allow for an efficient allocation of capital. Thus 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).

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2 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, which further reduced the already limited liability of shareholders and management for their business decision.

3 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).

4 Note that the existence of limited liability economizes on transaction costs, but does not enhance firm efficiency nor does it reduce the overall costs of capital for the corporation unaltered.

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 liabilities companies would be more prone to risk, default, and fraud<sup>5</sup>. In fact, Britain generally allowed limited liability 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 19<sup>th</sup> century was rather gradual (Chausovsky, 2007, 54-55). Thus it seems unlikely that limited liability corporations were a prerequisite for industrialisation and economic development as its supporters claim.

Indeed, beginning in the 1980s, more and more scholars have argued against the widespread adoption of limited liability also from a theoretical perspective (Meyer, 2000, p. 2-3), in particular against the extension of the doctrine to parent corporations (Ireland, 2010, p. 838-839). The historical genesis of corporate limited liability was in fact determined by specific historical, sociological and political circumstances 'rather than the outcome of an orderly optimal institutional selection' (Johnson, 2010, p. 2). 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 (see below). 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'.

Against this background it seems worthwhile to revisit the historical debate as this might improve our understanding on the origins of limited liability,<sup>6</sup> also because it was the 19<sup>th</sup> century that shaped the key institutions of today's economy (Johnson, 2020, p. 11). While the debate on the adoption of limited liability for joint stock companies in Britain and the United States in the 19<sup>th</sup> century is comparatively well documented, little is known about the contemporary German debate. Thus this paper aims to shed light on the debate within the Prussian Government which surrounded the Stock Corporation Act of 1843. Drawing on primary sources of 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 and American experience limited liability was not universally seen as a necessary feature of

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<sup>5</sup> In the 1830s the joint-stock limited liability company was seen as 'legally suspect and morally dubious' business form (Johnson, 2010, p. 2). See also Carney (2000, pp. 662-664).

<sup>6</sup> A similar point is made by Hillman (1997, p. 627) with respect to the debate in Great Britain during the first half of the 19th century: 'Specifically, in the 1837 Report in the Law of Partnership, [...] and in the 1851 prepared Report from the Select Committee on the Law of Partnership, [...], we can more than a century later find a level of inquiry, a quality of debate, and an awareness of history that is largely absent from contemporary discussions of limited liability.'

incorporation. Moreover, the course of the debate suggests that limited liability was finally introduced because the administration wrongly assumed that joint stock companies always comprised a large number of passive shareholders with little equity each, being obviously unaware of the possibility of joint stock companies being dominated by large shareholders and institutional investors. In fact, free-float of shares and passive shareholders similar to 'sleeping' partners were seen as the idiosyncratic trait of joint-stock companies and justified the privilege of limited liability for the investors.

## ***Incorporation and limited liability: a historical survey***

### ***Historical origins of the corporation***

For more than 100 years, the corporation has been without doubt the most prominent business entity of the modern world. Beginning with the high phase of the industrialization, it quickly became the dominant organizational corporate form of big business in the United States, Great Britain, France and Germany (Horn, 1979, pp. 125-126). However, in its origins it is a very old and unique European concept<sup>7</sup>, which is already visible in revived Roman and Canon law by the 13<sup>th</sup> and 14<sup>th</sup> century. According to Harris' (2009, p. 613) working definition, 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). Prior to the codifications of the 19<sup>th</sup> century, the legal personality of the corporation was a concession of the King to some of his subjects and required no other justification (see Harris, 2000. p. 18, for common-law; Cordes and Jahntz, 2007, pp. 15-17, for continental Europe). Because they were created by a state action, traditionally 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).

In Britain in the 1820s and 1830s, both major parties – Wiggs 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). Nevertheless, free incorporation outside an Act of parliament was introduced in 1844. British firms could incorporate under the Joint Stock Companies Act, but without being granted limited liability. Carney (2000, pp. 662-664) argues that in Britain free

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7 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.'

incorporation was granted to facilitate legal proceedings. However, as Johnsons (2010, pp. 119-120) points out, this was not only to the benefit of the newly incorporated firms, but also to the public. 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.

Even without limited liability incorporation became thus possible. Within fourteen months some 1,639 joint-stock companies were registered at the Registrar of Joint Stock Companies, tripling their total number compared to two years earlier (Harris, 2000, pp. 282-282). What had been a privilege, had become a status to be achieved by conforming to certain legal requirements (see Johnson, 2010, p. 121, for details). 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, Johnson (2010, p. 122) argues that 1,149 of those were railway undertakings, caused by the on-going 'railway mania'. Normal businesses retained their there mainly traditional organisational forms. 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. Thus, the question remains whether there is a causal link between the rapid economic growth of the 19<sup>th</sup> century and the development of the corporation.

In the literature the implicit assumptions, also visible in President Butler's comment quoted in the beginning, is that the development and use of corporations itself contributed to the rapid economic expansion of the 19<sup>th</sup> century (Johnson, 2010, p. 108). The conventional wisdom is that incorporation allowed companies 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. Moreover, it allowed the separation of management and ownership and enabled such the development of professional managers and business operations, as suggested by Chandler's (1977) work on the importance of professional managers in fostering economic growth.

However, there are two arguments against this uncritical endorsement. First, free incorporation became only available at a time when Britain as the world's foremost economic power had already industrialized. Thus, the corporation might not be the prerequisite for industrialisation as its advocates claim. There is little reliable empirical evidence of the corporation driving role regarding economic growth in the 19<sup>th</sup> century, although this is not to say that it played no role at all. While most scholars have taken the fact that corporations became the dominant organisational form of big business as self-evident proof for its causal role in economic development, there might be other



reasons for that dominance, e. g. the use of joint-stock corporation for external growth and the restriction of competition (Horn, 1979, p. 166). Moreover, for 19<sup>th</sup> century Britain, the need to raise huge sums of capital alone does not justify the spread of incorporated firms. Most joint-stock companies raised only small sums of capital and/or forbade public trading of their share by statute (Johnson, 2010, pp. 123-127). Consequently, Johnson (2010, pp. 135-136) argued that incorporation was thought after because owners were thus able to 'hide behind the veil of corporate personality', distancing themselves from the legal obligations of other form of business. It is in this context that shareholders of incorporated joint-stock companies sought to add limited liability to their privileges, a concept by far older than the corporation itself.

### ***Limited liability in 19<sup>th</sup> century Britain***

Indeed, contrary to conventional wisdom that regards limited liability as an idiosyncratic feature of corporations, the existing literature leaves little doubt that incorporation and limited liability are two distinct legal principles that were sometimes combined during the early modern period (Diamond, 1982, p. 34; Johnson, 2010, p. 108), in particular in the case of the early colonial companies. In fact, the desire for limited liability is probably as ancient as trade and commerce itself (Hillman, 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 9<sup>th</sup> century BC and consequently migrated to Northwestern Europe and to the Far East (Harris, 2009, pp. 611-612). Lately, Malmendier (2009) has argued that even the Roman Republic had an early form of an shareholder company, the *societas publicanorum*, which offered its shareholders limited liability.

If granted, limited liability was meant to subsidize risky, but politically desirable undertakings (Deutsch, 2007, p. 63; Santini, 1982, p. 74; Grossfeld, 1968, pp. 108-110). This is due to the fact that the first joint-stock companies of the earlier modern era also had considerable fiscal and administrative functions, especially concerning long distance maritime trade and the rule of colonies (Cordes and Jahntz, 2008, p. 22). 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 18<sup>th</sup> century German legal scholars argued that stock was rather a debenture than a share in the company (Cordes and Jahntz, 2008, p. 20), this most likely being due to the fact that the Dutch joint-stock companies did not know shareholder participation in the affairs of the company. Thus, limited liability in itself is not a new concept. Its combination with corporate rights in the joint-stock company and their free availability for private economic activity however is a recent and uniquely western concept, which can be explained mainly on historical grounds (Santini, 1982, p. 73), not by overruling economic necessities.

By the second half of 16<sup>th</sup> century, maritime long-distance trade was increasingly organized in corporations, regulated and joint-stock (see, Harris, 2000, pp. 40-46). Early trade corporations were created by state privilege and raised capital by issuing shares. The financial innovation of transferable joint-stock and liquid secondary markets allowed entry and exists mainly by purchase or sale and thus widespread public participation in these endeavours. In this context limited liability was the last common feature of joint-stock companies to develop during the 18<sup>th</sup> century and it was definitely not the driving force behind their creation (Grossfeld, 1968, pp. 102-104). Indeed, until the mid-19<sup>th</sup> century, limited liability was not seen as being an integral part of incorporated joint-stock companies, but rather the result of contemporary positive law making (Grossfeld, 1968, p. 105). It was generally seen as a special privilege which was justified if the public interest was involved, which was the case mainly in banking, insurance companies, transport companies, and colonial companies (Minchinton, 1982, pp. 146-153) or in cases where huge sums of capital had to be raised from the public (Johnson, 2010, p. 139).

Once free incorporation was granted in 1844, the economic policy debate in mid-19<sup>th</sup> century Britain focused on the question whether the privilege of limited liability was to be granted to all corporations (Johnsons, 2010, p139).<sup>8</sup> Opponents of limited liability argued that it create excessive speculation, create difficulties in securing credit, and encourage fraud (Carney, 2000, p. 663), while the contemporary pressure for limited liability came from different angles. For example, Harris (2000, pp. 131-132) argued that the 'cruel contemporary laws of debt and bankruptcy', which involved personal imprisonment, made the concept attractive. As long as bankruptcy laws favoured creditors over debtors, the latter would seek limited liability in order to avoid harsh personal sanctions. This line of argument is very similar to Johnson's (2010) hypothesis about the legal reasons for incorporation. According to Blumberg (1986, p. 577) limited liability became undisputed in the wake of the acceptance of entity theory that assume that corporations had the same rights and qualities as natural persons.<sup>9</sup> However, Horwitz (1985) argues that entity theory asserted itself amongst other reasons because it was capable of justifying limited liability better than partnership theories were, hence the privilege created its doctrine to justify its own existence: the chicken and egg principle. Then there was the argument that without limited liability investors would be deterred from

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<sup>8</sup> Interestingly, while a major policy debate, company law and limited liability never became a major issue in neo- and classical economics (Amsler, 1981, p. 792).

<sup>9</sup> By the end of the 19th century entity theory had asserted itself as prevailing doctrine: the idea that a corporation is a separate legal person with its own rights and obligations, distinct from its shareholders and limited liability. If a corporation was to be treated like a person in front of the law, claims against it would consequently be limited to the company's assets. Thus, limited liability was justified by turning corporations from partnerships of individuals to an entity itself (Blumberg, 1986, p. 577). Hovenkamp (1991, p. 42) argues that it addressed two related problems: how to protect the property of shareholders and how to assign the power to asserts constitutional rights in corporately owned assets.

investing if such an investment could mean personal bankruptcy (Diamond, 1982). Recent research has refuted that argument. 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.<sup>10</sup>

Finally, the main line of argument of contemporary advocates of limited liability was that full liability would attract investors of little wealth, 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). Turner (2009b) argues in his article on the contemporary debate in Britain that Bagehot Hypothesis was main argument for limited liability, at least in the banking sector.<sup>11</sup> However, recent research into 19<sup>th</sup> century British banking has so far found little evidence for this argument (Hickson and Turner, 2003; Acheson and Turner, 2006, 2008a; Turner, 2009a). 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).

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 never had been a prerequisite for either incorporation or liquid security markets. Even more, it was never seen as such by contemporaries. Rather it was recognized as a special privilege – or subsidy – to advance undertakings that were in the public interest. Nevertheless, in the course of the 19<sup>th</sup> century, for a variety of reasons, somehow the two privileges of incorporation 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).

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10 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 (Chauvaovsky, 2007, pp. 54-56). Indeed, California only abandoned pro-rata 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.

11 The other important argument was how the depositors could be assured of bank safety in the absence of liability.

## ***The historical background***

### ***Previous research on the Act of 1843***

The British and U.S. debate on the introduction of limited liability is well documented and some its implications have been empirically tested with surprising results. However, the contemporary German debate surrounding the adoption of limited liability by the Prussian Stock Corporation Act of 1843 is largely neglected by the literature. Indeed, until recently researchers 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 rather astonishing, given that the Act introduced limited liability as a general norm into Prussian. In addition, the law of 1843 was the first German general stock act and had considerable influence on the first general commercial code in Germany ('Allgemeines Handelsgesetzbuch'), which was passed in 1861 (Kießling, 2007a, p. 194). Indeed, if one leaves aside 19<sup>th</sup> century literature,<sup>12</sup> there remains a comparatively small list of exclusively German studies on the Prussian Stock Act.

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 19<sup>th</sup> 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 genesis of the Act, especially the economic necessities that led to its passing. Baums (1981) edited the primary sources on the legislative procedure, including a short introduction into its development and nature. Moreover, the Act is referred to in the works of Reich (1969), Hopt (1980), and Grossfeld (1968; 1979). In all cases the Act is mentioned in the wider context of economic and legal developments.

However, 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 commercial code in Germany. Moreover, Hadding and Kießling (2003) and Kießling (2007a) elaborated on the Prussian Stock Act of 1843.<sup>13</sup> Especially the recent publications focus on the developments in the history of law and on the transition from a system of special privilege ('Oktroi'<sup>14</sup>) concerning the foundation of

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

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

14 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).

joint-stock companies via the concession system to today's normative regulations, where corporate rights are granted to all entities that fulfil the legal requirements.

Given that the question whether to grant limited liability to both shareholders and directors aroused the most debate during the legislative proceeding (Hading and Kießling, 2003, p. 185), the arguments made in favor of limited liability have already been covered by the literature to some extent. Hopt (1980, p. 151), 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. Meyer (2000, p. 262) denotes the idea of share ownership as a simple contribution of capital responsible for the introduction of limited liability. Hadding and Kießling (2003, pp. 185-187) and Kießling (2007a, pp. 223-226) portray the debate about limited liability, arguing that ultimate reason for the introduction of limited liability was the possibility of wealthy shareholders to sell their share to destitute individuals, thereby avoiding regress to their property. According to this argument, which is similar to the Bagehot hypothesis, only raising and maintaining the required capital will protect creditors against default and thus the Stock Act of 1843 is the birth of the principles of capital raising and maintenance. The reason why joint-stock companies still required state concession was given by Grossfeld (1968, pp. 120-126) who argued that one economic policy goal of the concession system was to protect free competition as joint-stock companies were deemed to be capable to erect *de facto* monopolies because of their size.

Summing up the results of the previous research, due to history of law focus of most authors their works have mainly highlighted the decisive legal inventions of the Act, because not only does it mark the transition from a system of special privilege to a system of concession, but with the Prussian Stock Corporation Act of 1843 for the first time in Germany there exists a legally sanctioned corporate structure, which is directed only at the private interests of its owners, but limits the liability of its shareholders to the capital raised (Kießling, 2007a, p. 225). Neither of them has attempted to provide a comprehensive picture of the debate, especially with respect to the arguments against limited liability.

Moreover, the recent literature on the subject, 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 stock corporation 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. Consequently, there is still a lack of research concerning the economic

policy goals and various motives behind the Act of 1843. This article therefore aims to close this gap by not only referring to the motives, but also by extensively covering the later proceedings in order to give a full view on the contradicting views within the Prussian administration.

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

Joint-stock companies were well established in Prussia prior to the Act of 1843. In fact, the Prussian 'Brandenburgische-Afrikanische Kompagnie' – founded in 1682 – is believed to be the oldest German joint-stock company (Grossfeld, 1979, p. 236). Before the enactment of the Stock Corporation 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 (1875), who complains about the lack of official data, stating that thus his compilation may not cover all existing joint-stock companies (Engels, 1875, pp. 457). Adding up the 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 ('Chausseegesellschaften'). Indeed, in the first half of the 19<sup>th</sup> century there are two periods of increased founding activities: 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 hypothesis that joint-stock companies become ever more important for financing large scale industries, especially rail ways, is supported by the fact that about two-thirds of the total capital invested in shares, about 33 million Talers, falls in the period 1836-43, a time when the construction of railways took off in Germany.

The possible reasons for this development have been debated extensively in the literature. Most scholars agree that it was not a lack of capital that hampered financing in Prussia, an argument which is supported by a constantly low interest rate on government bonds. Indeed, most 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.<sup>15</sup> According to the standard view, 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

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<sup>15</sup> 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).

responsible for the widespread introduction of joint-stock companies (Pierenkemper, 2000, pp. 93-96).<sup>16</sup> Moreover, insurance companies were another branch that required huge amounts of capital and were therefore often organized as joint-stock companies (Martin, 1969, p. 501).

A slightly different view is proposed by Martin (1969, p. 515), who concludes that the joint-stock company is not only necessary for major projects in leading industrial sectors, but also for the development of backward regions with under-developed capital markets, where traditional means of finance are scarcely available. Only the joint-stock corporations are capable to collect the necessary capital for their industrial catch up. Nevertheless, in both views the joint-stock companies is an efficient institution for the collection and administration of large amounts of capital, which helped entrepreneurs to effectively tap available capital resources (Wehler, 1987, p. 95).

Turning to the legal background, due to the Napoleonic Wars and the subsequent annexation of the Rhine provinces, the laws and provisions concerning Prussian joint-stock companies were not uniform. Indeed, the eastern provinces were governed by the General state laws for the Prussian states ('Allgemeines Landrecht'/ALR) of 1794, but the newly acquired western provinces were subject to the Napoleonic Code de Commerce, which had become law in 1807, and remained in power even after the French defeat (Baums, 1981, p. 26). Given that the contemporary legislation had evidently a huge impact on the legal proceedings, the Code de Commerce is presented and contrasted against the General state laws for the Prussian states in the following.

Concerning the establishment 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 possibility of success of a particular business (Baums, 1981, p. 24).

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<sup>16</sup> Up until 1850, 28 railway companies are set up with a share capital of 103 million Talers (Hopt, 1980, S. 137) and although railway companies constitute one third of all public companies by 1850, they were responsible for almost 80% of raised capital (Kießling, 2007b, pp. 124-125). Moreover, railway stock were 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).

By contrast, 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. Thus such a company can neither make business transaction in its own name (Blum, 1981, p. 22), nor is the liability of its shareholders limited. Indeed, these companies have joint and several liability and claims against the company are executed against the private property of the owners (Hadding und Kießling, 2003, p. 162). Under the 'Octroi'-system corporation rights are only granted by special privilege, and sometimes these rights are only partially granted (Baums, 1981, p. 22). From legal theory, the Octroi exempts the privileged company from the application of the ALR. 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). That such an arrangement is rather time consuming and costly for a large group of partners is obvious because without prior consent of all shareholders, such a company could not make any contractual arrangements. That this posed a real problem to contemporary stock companies is well documented in the literature.<sup>17</sup> As will be shown below, this was also seen by the authorities, and consequently the regarded corporation rights as a considerable competitive advantage over non privileged companies.

Thus, according to the ALR the grant of privileges depends on the companies benefit to the public<sup>18</sup>. 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 companies do not automatically fall into this category and expected stock companies who seek privileges to prove their benefits to the public. Moreover, already established privileged joint-stock companies are now ex-post legitimized by their presumed public benefits. Hence, the need for joint-stock companies to prove their public benefits leads to an ongoing bureaucratic feud between the applicants and the authorities. Indeed, it is this petty paper war in combination with an increasing number of petitions and newly founded stock companies, but also 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).

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17 See Hadding and Kießling (2003, p. 162); Hopt (1979, p. 138); Baums (1981, p. 34). However, 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. See Kießling (2007a, pp. 194 -195.)

18 ‚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).



Summing up the afore said, until the advent of the Joint-Stock Act in 1843, there were two distinct legal systems governing the rights of joint-stock companies: the system of individual special privileges granted by the state as well as a 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 a positive reaction by the authorities. However, contrary to the Octroi system, in the concession system joint-stock companies may be initiated by 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 corporations with respect to both their internals as well as external relations (Kießling, 2007a, p. 219). Moreover, the Stock Corporation Act did also unify the Prussian legal system in an ever-more important domain of economic activity.

# ***The debate on limited liability during the legislative process***

## ***The legislative procedure***

The proceedings start by royal order on the 13th of July 1837, which instructs the VIII. deputation on the revision of commercial law to consult external expert and draw up a draft law on joint stock companies (Kießling, 2007a, pp. 195-196). In fact the deputation had already been tasked in 1826 with the reform of joint stock company law in the wider context of general law revision. The motives of 31<sup>st</sup> January 1840 state the rationale for the desired codification. In order to facilitate the business of joint-stock companies, the state previously could confer the status as legal person as well as the limited liability for shareholders and directors. In granting these privileges, the ministry of commerce was previously guided by public's interest. Given the practical problems associated with the ALR for a large group of partners absent the status as a legal person, some solely profit seeking companies received the status as a legal person but without limited liability. The increasing demand for corporate status and limited liability finally makes the King order a general codification (Motives, in Baums, 1981, pp. 54-56).

A first draft including extensive motives is submitted by a commission, which included members from the deputation, representatives from the Berlin merchants as well as delegates from the ministry of the Interior, Finance, and Justice, on 31 January 1840. The draft is revised by the ministers of state Kamptz, Mühler, Rochow and Count von Alvensleben, and by the Ministry of State. The draft of the Ministry, together with a dissenting draft by Mühler and Count von Alvensleben, and the reports of Schön, Bülow and Hoffmann is then transferred by Cabinet Order of 31st January 1842 to the State Council<sup>19</sup> 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.<sup>20</sup>

The State Council's combined departments for finance and the judiciary create a report and a further draft law, 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. In doing so, it refers to the draft by

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19 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).

20 A contemporary translation is available at Schumacher (1840).

the Ministry of State. The law is finally enacted by royal decree on the 9<sup>th</sup> November 1843 (Baums, 1981, pp. 30-31).

As I hope to demonstrate in the following, the motives and protocols are vivid testimony of a controversial debate with surprisingly level of inquiry, awareness of foreign developments, and understanding of incentive structure of directors, investors, and creditor. They provide evidence that parts of the Prussian administration did not perceive limited liability as the condition sine qua non of the joint-stock company, but rather as a special privilege that should only be granted by the state where there would be a considerable public benefits that would outweigh the negative consequences. Nevertheless, the perception that limited liability was necessary feature of shareholders with little equity each prevailed, although because the Prussian law makers failed to see the different implication of limited liability for ‘sleeping’ partners and active investors.

Besides the printed material that is available in Baums (1981), 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 1836/37<sup>21</sup> as well the French literature on the subject (Schumacher, 1937, p. 47). Also left out are the experience 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). A thorough analysis of these documents must be left to further research.

### ***The argument against the free availability of limited liability***

In §. 1. the first draft of the commission asserted that joint-stock companies needed a state concession in order to become legally valid (1<sup>st</sup> draft of the commission, in Baums, 1981, p. 50) Indeed state concession as a prerequisite for incorporation is undisputed during the legal proceedings.<sup>22</sup> This is due to the concern that the unchecked creation of joint-stock companies might endanger fair competition by creating monopolies due to the large amount of capital involved.<sup>23</sup> Also the fear that joint-stock companies might stamp out competition is put in perspective by the Smithian argument, according to which private entrepreneurs are favoured with respect to joint-

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<sup>21</sup> See Bergfeld (2007, pp. 170-178)

<sup>22</sup> See for example the statement of the State Council report (in Baums, 1981, p. 139) regarding incorporation.

<sup>23</sup> ‚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).

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 State Council report, in Baums, 1981, p. 143). Nevertheless, incorporation of joint-stock corporations, regardless of the liability regime, was to be checked by state confession. Thus, while bestowing licenced joint-stock companies with the qualities of a legal person was not very controversial, limited liability was vehemently opposed by high-ranking officials in the Prussian administration, the Minister of Justice von Mühler und Minister of Finance Count von Alvensleben

First, they believe that liability is meant to protect debtors from incurring large losses in case of bankruptcy. Second, they argue against limited liability because it encourages the speculation in stocks.<sup>24</sup> Third, according to Mühler und v. Alvensleben, under ALR shareholders of existing joint-stock can in certain instances still be personally liable, thus existing German law does not offer limited liability for corporations (Motives, in Baums, 1981, p. 67). Finally, the two ministers point out 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.<sup>25</sup>

Nevertheless, the two Ministers acknowledge that the current legislation is rather restrictive to non-licenced joint-stock companies that are treated like partnerships before the law. Although not all joint-stock companies do not further the public good in the narrower sense, their creation is still economically desirable. For these firms, the provisions of the ALR, which do not provide for the existence of managers and passive shareholders, are a considerable burden (Motives, in Baums, 1981, pp. 57-58). Thus, Mühler and von Alvensleben propose to allow for incorporation – given state concession – but to grant limited liability of 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 shareholders from the company (Motives, in Baums, 1981, pp. 58-62). Hence, for private profit seeking economic activities the two ministers propose a de facto corporation without limited liability, which they call privileged partnership ('privilegierte Societäten'). However, given that these privileged partnerships would still involve

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<sup>24</sup> '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' (Motives, in Baums, 1981, p. 67).

<sup>25</sup> '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).

large amounts of capital and thus bear the danger of monopolies, their formation would have to control by state in order to avoid the formation of monopolies (Dissenting draft, in Baums, 1981, p. 106).

Mühler and v. Alvensleben acknowledge that limited liability would be the decisive distinction between the two types of corporation (Motives, in Baums, 1981, p. 63): a corporation without limited liability would no longer qualify as joint-stock company, but would be a new form of business organisation. Hence, even the opponents of a widespread introduction of limited liability assume that limited liability is somewhat the key feature of joint-stock corporations. However, these forms of businesses are privileged against other firms and thus require not only state concession, but must also be in the public interest in order justify their status. They underline their position by referring to the example of England, where shareholders are fully liable, if limited liability is not granted by special charter (Motives, in Baums, 1981, p. 66).

Another argument for restricting limited liability to those companies which are beneficial to the public is made by delegate from the Ministry of Commerce. By referring to the English case, he argues that joint-stock companies can exist without limited liability. On the contrary, he insists that the full shareholder liability is responsible for the credibility of Scottish banks. Although he admits that limited liability will facilitate 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 seems reasonable to him that they should also bear the risk. Concerning the uneven distribution of profit and risk under a full liability regime, he argues that this would lead shareholders to transfer shares only to solvent persons, which would reduce the overall number of joint-stock companies but increase their soundness (Motives, in Baums, 1981, pp. 70-71).

Moreover, because under a limited liability regime, the public shares a part of the losses, such a regime can only be justified by previous public benefits, although it might be difficult to generally define when a company serves the public interest and thus it being granted will depend on administrative discretion. This explicitly involves the support of infant industries by granting limited liability. The argument that any company is in the public interest cannot be generally accepted. In particular it does not follow from it that joint-stock companies will be privileged in their contractual relations with third parties vis-à-vis private entrepreneurs. Such a widespread adoption of limited liability for joint-stock companies would favour them over other business entities. Therefore 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).

## ***The argument for limited liability: Shareholders as passive investors***

In the following I will demonstrate that it is the idea of many shareholders with little equity each that is the key argument in granting limited liability to all licenced joint-stock companies. 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 for justifying the privilege, later in the proceedings it is the idea of shareholders being similar to a 'sleeping' partner – or passive investors – that carries the day. This is due to the fact that the ALR already knows the concept of a sleeping partner, which effectively grants limited liability to passive investors.

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 United State Council report, in Baums, 1981, p. 137).

The majority is in favour of granting limited liability to all incorporated joint-stock companies, not only to those that of public interest. Consequently, the first draft Act 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). Their key argument is that in reality it would be quiet difficult to determine whether a particular firm is in the public interest because the majority supports the classical notions according to which all private firms also serve the general interest (Motives, in Baums, 1981, p. 65). Indeed, 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).

For the proponents of limited liability, the key argument in favour 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.<sup>26</sup> Indeed, the argument that investors have a marginal influence on the decision of a joint-stock company is not raised by the proponent of limited liability, but by Mühler and v. Alvensleben who see it as the most visible characteristic of joint-stock corporation, although it is not a constitutive property on its own (Motives, in Baums, 1981, p. 63).

Still, the majority argues that to dispose of full liability would not have the negative consequences feared by Mühler and Alvensleben, especially with respect to the incentive structure for managers and shareholders. It is 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 and any deeds by the management which are ultra vires or a violation of the law render the directors fully liable (Motives, in Baums, 1981, p. 68). Finally the majority argues that Mühler and von Alvensleben's key argument against limited liability – 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).

Consequently, the revised draft by von Kamptz Mühler, von Rochow und Graf 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 the creditors of the company, but is only a debtor to the firm in case he has not paid in the full amount of capital. The draft is then discussed on two meetings of the Royal Ministry of State on the 29<sup>th</sup> of June and 10<sup>th</sup> of July 1841, in which the main arguments, as spelled out above, are repeated (Protocol 29<sup>th</sup> of June 1841, Baums (1980), pp. 87-89).<sup>27</sup> In the concluding vote it is decided to include the requirement of a company being of public interest as a prerequisite for a concession in §. 1., while the proposal of a privileged partnership made by Mühler and Alvensleben is rejected. However, the council tasks the two ministers with drafting a dissenting draft that would include incorporation without limited liability<sup>28</sup> (Protocol 29<sup>th</sup> of June 1841, Baums (1980), pp. 87-89). The following

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<sup>26</sup> „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).

<sup>27</sup> For example, v. Alvensleben argues that granting large corporations limited liability will endanger competition as these will have an advantage of smaller enterprises. Kamptz by referring to the necessary state concession responds that it is not in the state's intention to grant corporate status to all joint-stock companies. The decision whether to licence a firm should thereby not be based on rules, but on discretion, a proposal v. Alvensleben refutes because it would lead to the state being accused of arbitrary decision making

<sup>28</sup> See the draft prepared by Mühler and v. Alvensleben, in Baums (1980, pp. 101-108).

meeting in July is then dedicated to technical matters (Protocol 10<sup>th</sup> of July 1841, Baums (1980), pp. 91-94). Consequently, the draft by the Royal Ministry of State follows the revised draft by v. Kamptz Mühler, v. Rochow und v. Alvensleben in granting limited liability to shareholders in §§. 13.-14 (draft by the Royal Ministry of State, in Baums, 1981, p. 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 16<sup>th</sup> of March 1843. For the first time it defines shareholders as sleeping partners in line with ALR §§. 651.-651. Th. II. Lit. 8<sup>29</sup> who are not involved in the daily business of running the company (United State Council report, in Baums, 1981, p. 137). Indeed, it raises the question whether investors are nor already capable of achieving limited liability via sleeping partnerships, in which only one destitute person becomes an official partner (United State Council report, in Baums, 1981, p. 140). Given shareholders' voice in determining business policy, 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 facilitation incorporated joint-stock companies because the 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 owner and the 'passive' creditor, a view that is endorsed by the State Council's combined departments for finance and the judiciary (United State Council report, in Baums, 1981, p. 143).

The State Council report then sums the previous discussion up and identifies two key question: (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) (United State Council report, in Baums, 1981, p. 139). Concerning the first question, the report states that corporate limit liability should be not be restricted to joint-stocks companies that are in the public interest as longs as these have registered share. Only for companies with bearer share, where the speculation in share is more frequent and hazardous, should the privilege of corporate limit liability restrict to firms serving the common good (United State Council report, in Baums, 1981, pp. 139-144; see also the draft by the United State Council, in Baums, 1981, p. 160). Limited liability on the other hand is then justified once again with the asymmetrical risk and profit sharing already mentioned in the motives (United State Council report, in Baums, 1981, p. 145).

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<sup>29</sup> ,§. 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.'



Finally, all previous documents are handed over to the Royal State Council, which meets on the 14<sup>th</sup> of June 1843 for the first of four consecutive meetings. In the first meeting, the Minister of Law Revision, v. Savigny, argues in line with the combined departments that limited liability can be achieved via the ALR by posing as sleeping partners or by endowing a manager only with limited authority, which restricts his freedom of contracts to predetermined amount. Consequently, argues that it is incorporation and not limited liability, which is the distinctive feature of joint-stock corporations. Therefore the plan of Mühler and Alvensleben of privileged partnerships does not address the real problem (1<sup>st</sup> Protocol State Council, in Baums, 1981, pp. 170-172). Consequently, the idea of incorporation with unlimited liability is finally dropped (3<sup>rd</sup> Protocol State Council, in Baums, 1981, p. 185).

Apparently, Savigny and others fails to see the difference in influence on business policy between shareholders and 'sleeping' partners. While sleeping partners have no say in the running of the company, shareholders do determine a joint-stock corporations business conduct quiet strongly, albeit indirectly. Moreover, the extent of their influence depends on their share of stock they possess. Indeed, in realty there are many cases where the dominating shareholder of a company is also the managing director. Thus, Savigny's argument that limited liability was available in Prussia even before 1843 is only half true. If you were a passive 'sleeping' investors in a partnership, liability was indeed limited to the investment, albeit without any control over the firm. The new quality of corporate liability that Savigny and his colleagues failed to see was that investors who were actively involved in determining business policy were now protected from the negative results of their decisions.

## ***Conclusion***

While many people believe that limited liability is the condition sine qua non of the modern corporation, previous research has impressively demonstrated that such an impression does not match reality. In fact, there are many cases where large corporation with unlimited shareholder liability have operated quiet successfully for many year and their shares were tradable on liquid markets. Moreover, from a theoretical perspective, there is 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 no longer internalized. Thus many of the commonly held believes concerning the necessity of limited liability fall short of reality.

The foregone discussion about the advent of limited liability in 19<sup>th</sup> century Prussia indicates that at least parts of the Prussian administration considered limited liability not as a prerequisite for incorporation, but rather as special privilege to be granted in order to subsidies enterprises that were perceived to be in the public good. Limited liability was seen as a distinctive feature of joint-stock companies, but not of incorporation or partnerships with many investors as such. Consequently the joint-stock corporation was to be reserved for firms that served the common good beyond the usual economic benefits of economic activity. The majority of the administration did not follow this line of argument. It rather saw limited liability rather as a distinct feature of joint-stock corporation that is indeed a necessary condition for its existence. This is due to the misconception of a joint-stock company consisting of many investors with little equity each. In addition, without limited liability, there would be an uneven distribution of risk and profit. This argument is refuted by the opponents of limited liability by stating that such incorporations would have to allow only wealthy persons to become their shareholder and by referring to the case of England.

In to counter this argument, its proponents argue that shareholders may gain limited liability by becoming a sleeping partner in existing partnerships. Thus, limited liability is already a feature of existing forms of business organisation and not the decisive novelty. Hence, the idea of allowing incorporation without limited liability is finally dropped from the agenda. They key problem with that line of thought is that shareholder, even with free-floating shares, have influence on the company's conduct as opposed to sleeping partners. Worse, given that today shareholders consist mainly of institutional investors (El-Shagi and Ilgmann, 2010) and that these shareholders have a large influence over the business strategy (Ireland, 2010, p. 848), it might worthwhile to reconsider the role of limited liability in the economy.

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