BUSINESS DEVELOPMENT IN THE AMERICAN ENVIRONMENT

EVOLUTION OF THE LEGAL FRAMEWORK FOR GOVERNMENT REGULATION OF COMMERCIAL BANKING

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The early state governments inherited from the legal tradition of England and from their colonial experience the implied power to grant charters of incorporation.[1] This right, which was made explicit in some state constitutions,[2] was a monopoly power which state legislatures shared only with the federal government.

The extension of the Bubble Act to the colonies in 1741 set a precedent for requiring that the corporate form of business organization possess a charter. Since no more than 10 charters were granted before the Revolution,[3] colonial administrators gained minimal experience with respect to business corporations. An appropriate body of law had not developed beyond a remedial state. After the Revolution, the number of business corporations increased rapidly, reaching 317 by 1800.[4] By 1830, the New England states, which formed the most commercially developed section of the country, had created about 1900 business corporations.[5] Since the growth of corporations occurred after independence, the accompanying legal developments assumed a unique character based upon American experience.[6]

The framework for government regulation of commercial banking was established through the use of corporation law. By 1820, basic legal relationships between state governments and corporations had evolved. An important implication of these legal relationships is that they formed channels for the transmission of state policies designed to control commercial bank behavior.

Restraining Acts

Following such early profitable ventures as the Bank of North America,[7] the total number of chartered banks increased rapidly, reaching 28 in 1800, 102 in 1813, 327 in 1820, 381 in 1830, and 720 in 1837.[8] The Bank of North America's persistence in a struggle to be rechartered (1785-87) and charter applications by subsequently-formed banking associations

indicate a desire to benefit from the use of the corporate form of organization, or at least to possess a charter which represented approbation of a state government. Among its advantages, the corporation offered a means of pooling capital resources, permitted transfers of shares of ownership, and granted the right to sue and be sued as a legal entity. In addition, it provided shareholders with an opportunity to employ their funds without committing their time and energy to directly supervising the firm in which they invested.[9]

By 1800, there had been only a few unincorporated banks in operation. The three major examples, Bank of New York (1784-91), Essex Bank (1792-99), and Bank of South Carolina (1792-1800), eventually received charters of incorporation.[10] The privilege of operating a bank was considered a common law right unless it was specifically restricted by legislative enactment or constitutional provision.[11] State legislatures began to require the corporate form of organization for banking activities as early as 1785 by passing restraining acts which reserved for incorporated banks either the right of note issue or more extensive privileges, such as loan and deposit activity. (see Table 1) In some instances, as additional protection against unauthorized banks, charters for non-banking businesses carried provisions explicitly prohibiting banking activity. This was common in New York even after the passage of its restraining act in 1804.[12]

Restraining acts effectively required banks to acquire a franchise that was available in the form of a charter of incorporation. By 1821, nineteen of the twenty-four state governments had adopted restraining acts. The major exceptions were the southern states of Tennessee, Mississippi, Alabama, and Louisiana. The only other state without a restraining act was Connecticut, which adopted one in 1830. North Carolina and South Carolina prohibited issue of bank notes by unincorporated businesses but did not restrict other banking activities. Indiana, Missouri, Rhode Island, and Vermont had similar provisions. All other states had declared unchartered banks illegal by 1820.

The restraining acts shifted the procurement of a charter from a highly desirable accomplishment to a necessity. At the same time it presented the possibility of economic gains from monopoly power depending upon the policies of legislatures in granting charters. Many state legislators were bank stockholders and most state governments either held bank stock or had options on a specified percentage of shares.[13] It is

TABLE I

STATE LAWS RESTRICTING UNINCORPORATED BANKING, 1781-1843

State	Date of Enactment	Type of Prohibition	Prescribed Penalty
Alabama	February 2, 1838	Bank notes of unchartered corporations.	Fines from $100 to $500 for each offense of issuing and from $20 to $100 for passing unauthorized notes.
Connecticut	June 5, 1830	Unauthorized bank notes.	Fines from $100 to $600 for issuing and $20 to $100 for passing unauthorized notes.
Delaware	February 4, 1811	Unincorporated banks.	$2000 fine for managers of unauthorized banks; $500 fine for subscribing to shares.
Florida	December 22, 1824	Illegal to bring private bank notes into Florida.	Fine of $50 for each offense.
Georgia	December 19, 1816	Unchartered banks not to issue notes larger than $2.	Fine of 25% above face value.
	December 19, 1818	Unauthorized banks.	$1000 fine for each person involved; each day to count as a separate offense.
Illinois	1818	Unauthorized banks.	
	February 8, 1821	Unauthorized note issues.	$10,000 fine and loss of charter if violator is a corporation not authorized to issue notes.

TABLE I - Continued

State	Date of Enactment	Type of Prohibition	Prescribed Penalty
Indiana	1816	Unauthorized banks.	$10,000 fine for participating in such banks; fine of three times nominal amount for passing notes issued by such banks; loans contracted void.
Kentucky	February 8, 1812	Unincorpprated banks.	
Louisiana	March 13, 1837	Partnership form of organization for banks.	
Maine	March 13, 1821	Unincorporated banks.	Notes void.
Maryland	December 24, 1810	Unchartered banks.	$2000 fine for managing; $100 fine for subscribing to shares.
Massachusetts	June 22, 1799	Unincorporated banks.	
Michigan	November 4, 1815	Unincorporated banking.	$1000 fine for each subscriber and proprietor.
	April 12, 1827	Unincorporated banks.	Notes void.
Mississippi	February 15, 1840	Unchartered banks.	$1000 fine for subscribing; notes void.
Missouri	December 20, 1820	Private bank notes.	$50 fine for each note issued.
	December 10, 1824	Private bank notes.	$100 to $300 fine for issuing and $50 fine for passing.

TABLE I - Continued

State	Date of Enactment	Type of Prohibition	Prescribed Penalty
New Hampshire	December 18, 1799	Unincorporated banks.	Fines from $400 to $1000 for proprietors; notes void; bank notes issued recoverable.
New Jersey	February 15, 1815	Unincorporated banks.	$20,000 fine.
New York	April 11, 1804	Unincorporated banks.	$1000 fine.
	April 2, 1818	Private individuals excluded from banking.	
North Carolina	November 18, 1816	Unauthorized bank notes.	$250 fine and jail sentence up to six months.
Ohio	February 8, 1815	Bank notes of unincorporated banks.	One year prison and fine less than $5000 for issuing.
	January 27, 1815	Unincorporated banks.	$1000 fine for acting as a bank without a charter.
	February 8, 1819		$1000 annual tax on unauthorized banks.
Pennsylvania	March 19, 1810	Unincorporated banks.	$100 fine for each offense of issuing, lending, or receiving deposits; loans void.
Rhode Island	June 14, 1805	Bank notes of unincorporated banks.	$100 fine for each offense of issuing.

TABLE I - Continued

State	Date of Enactment	Type of Prohibition	Prescribed Penalty
South Carolina	December 21, 1814	Bank notes of unchartered banks.	Fine of ten times face value for issuing.
Tennessee	December 14, 1827	Private banks (gives time to close).	$500 annual tax to begin 1829.
Vermont	March 4, 1797	Unauthorized notes.	Fine of three times nominal value for issuing; two times nominal value for passing.
Virginia	December 2, 1785	Private bank notes	Fine of ten times face value for issuing.
	January 25, 1805	Bank notes of unchartered banks.	
	February 24, 1816	Lending by unchartered banks.	Loans void.

not surprising then that the dominant motive behind the passage of the restraining acts appears to have been protecting existing banks from added competition. State legislators controlled issuance of new charters and thereby could effectively insure such protection.

Although a liberal policy of granting charters could be used to destroy the monopoly power of existing banks, the background of experience with British chartering policy led to a confusion between granting a charter of incorporation and creating a monopoly. For example, it was fear of monopolies that defeated a proposal that the United States Constitution contain a clause explicitly empowering Congress to grant charters.[14]

Hildreth records that the restraining act in Massachusetts was a deliberate effort to shield monopolies.[15] Virginia passed a restraining act in 1805 to protect the monopoly of the Bank of Virginia which had been chartered in 1804.[16] In New York, the restraining act contained political overtones, but again the intent was to restrict competition. In this case, the Democratic-Republican legislature sought to destroy the Merchants' Bank, which was operated by key members of the Federalist Party. The restraining act was passed in 1804 in the legislative session following the one in which the state denied the Merchants' Bank a charter.[17] The restraining act gave the Merchants' Bank one year to wind up its affairs.[18] It finally received a charter, however, after a "liberal use of money" influenced the legislature.[19]

Bray Hammond in discussing restraining laws stated that the early legislative intent of these laws "had been to complete the ban on note issue, which they forbade for unincorporated banks and which was impossible for incorporated banks so long as the legislature incorporated none."[20] This statement holds for only four states. Restraining acts preceded incorporated banking in Virginia, Vermont, Michigan, and Florida.

In states with restraining acts, banking was effectively limited to corporations specifically chartered to carry on banking. Although there is some evidence of unincorporated banks operating in violation of the laws, when such violations were flagrant, they were remedied through additional laws or eventual enforcement of existing laws. In Virginia, after passage of the restraining act of 1805, unincorporated banks still operated in the western counties. Enforcement of a more stringent law passed in 1816 solved this problem by forcing

the banks to close or apply for charters.[21] A loophole in the New York restraining act by which unfranchised private banking could take place was discovered.[22] This unintended occurrence was corrected in subsequent legislation.[23]

Restraining acts were either so well enforced, or so willingly obeyed, that in 1831 Albert Gallatin was able to note that, with only a few minor exceptions, "the currency of the U. S. so far as it consists of notes, is strictly confined to bank notes issued by chartered companies."[24] Walter B. Smith states that "the nuisance of unincorporated banks had ceased to be important by 1817."[25] There were exceptions; the Girard Bank of Philadelphia, a notorious hold-out, finally obtained a charter of incorporation in 1832.

State Regulation through Charters of Incorporation

Restraining acts performed a crucial role in directing the development of commercial banking regulation. State legislatures enacted this provision to control the number of firms in the banking industry, not to regulate the activities of those banks which had been granted charters.[26] The charter requirement, however, established an explicit legal relationship between state governments and commercial banks. A major consequence was the creation of a direct channel for control.

Studies concerned with government regulation within individual states usually cite restraining acts but do not consider their role in establishing a means for state control of banking.[27] Bray Hammond and Fritz Redlich, in works that draw conclusions about the conditions of banking for the entire country, do not indicate the extent to which restraining laws existed among the individual states.[28]

Although another result of the restraining acts was to provide state legislatures with the means to limit competition in banking, this paper does not investigate the record of legislatures in realizing that goal. The concern here is with the regulation of those banks for which legislatures actually granted charters and not with limitations on the number of charters granted. Some studies concerned with the number of charters granted by state governments committed a major oversight by failing to consider restraining acts.[29] Yet these acts added political obstacles to the existing economic barriers for entry into the banking industry.

The state legislatures' right to regulate was generally accepted as a condition of incorporation. Thus, charters went

beyond the tasks of conferring corporate status and prescribing internal organizational form to include regulatory clauses. The status of charter provisions in conveying legal rights of corporations and regulatory powers of governments evolved from the procedure of granting special charters. This system generated corporate charters which often contained provisions peculiar to particular firms. Because of increasing pressure on legislators' time, and because of the opportunity for political favoritism through grants of special privilege, an administrative machinery for granting uniform, general charters gradually replaced special chartering. Most states finally prohibited special chartering in the 1870's.[30] The First provisions for general bank charters appeared in the free banking acts of Michigan (1837) and New York (1838).[31] The contents of special bank charters within each state, however, had become quite uniform by that time. Nevertheless, the practice of granting special charters had promoted the idea that, for each corporation, all special privileges or restrictions had to be specifically mentioned in its charter. The creating law delineated corporate powers and described the circumstances under which the state could interfere in corporate affairs.

The ability of state governments to control corporations depended heavily upon the rights which it had reserved by declaration in the charters of incorporation. Examples of early violations of charter rights by state governments include the repeal of the charter for the Bank of North America in 1785 and the amendment of the charter for the Bank of Massachusetts in 1791.[32] In neither case did the original charter grant the state the right of amendment or repeal. Adjudication eventually served to re-enforce the sanctity of the charter. In Massachusetts in 1806, a general act which curtailed the charter-granted rights of a turnpike corporation was declared inapplicable: "The rights legally vested in this, or in any corporation, cannot be controlled or destroyed by any subsequent statute, unless a power for that purpose be reserved to the legislature in the act of incorporation."[33]

In the Dartmouth College case a similar ruling was given:

> . . . any act of a legislature which takes away any powers or franchises vested by its charter in a private corporation or its corporate officers, or which restrains or controls the legitimate exercise of them, or transfers them to other persons, without its assent, is a violation of the obligations of

> that charter. If the legislature mean to claim such authority, it must be reserved in the grant.[34]

The significant contribution in this decision was the application of the contract clause of the United States Constitution to the protection of chartered rights. The obvious outgrowth of this kind of interpretation was the inclusion of the reservation clauses, which reserved for the legislature the right to amend, alter, or repeal the charter being granted. It appeared in banking charters as early as 1795 and was commonplace by 1820. In fact, some states proclaimed the reservation clause through general acts or state constitutions for all subsequently granted charters of incorporation.[35] State governments recognized the need for a complete and flexible framework for the exercise of regulation from their first real experience in attempting to control banking activity during the suspension of specie payments, 1814-17. Prior to this period, attempts to regulate were limited. Early bank charters contained such provisions as authorizations for state inspection of banks, limitations on quantities of liabilities outstanding and prohibitions on non-banking activities; however, there was a general absence of punitive measures.

Conclusion

Guy Callendar observed that "Down to the Civil War, except in the case of the banking industry, the powers of government were used to encourage and assist private enterprise, not to restrict it."[36] The framework which developed for transmitting restrictive powers of government to banking was founded on corporation law. State legislatures restricted banking activities to corporations. They controlled this form of business organization by charter provisions which established limits on specific activities. The right of legislatures to amend charters provided flexibility in setting the regulatory environment for banking. This framework, which was fully established by 1820, set a precedent for subsequent regulation of the banking industry by the federal government when it began issuing national bank charters.

Footnotes

[1]Joseph S. Davis, Essays in the Earlier History of American Corporations, II (Cambridge, Mass.: Harvard University Press, 1917), 9; James Willard Hurst, The Legitimacy of the Business Corporation in the Law of the United States, 1780-1970 (Charlottesville, Va.: University of Virginia Press, 1970), pp. 8-9.

[2]For example, see Connecticut (1818) and Pennsylvania (1776) in The Federal and State Constitutions, Colonial Charters, and Other Organic Laws of the United States, comp. by Benjamin Perley Poore (Washington, D. C.: Government Printing Office, 1877).

[3]Davis, American Corporations, II, 4, 5, 331.

[4]Ibid., p. 27.

[5]William C. Kessler, "Incorporations in New England: A Statistical Study, 1800-1875," Journal of Economic History, VIII (May, 1948), 46-47.

[6]Hurst, Business Corporation, p. 7; Edwin M. Dodd, American Business Corporations until 1860 (Cambridge, Mass.: Harvard University Press, 1954), pp. 13-14.

[7]The Bank of North America was a successful business enterprise yielding average annual dividends of 10 per cent on the par value of its stock from 1782 to 1800. Dividends for other early banks commonly ranged between 8 and 10 per cent. Davis, American Corporations, II, 104.

[8]J. Van Fenstermaker, The Development of American Commercial Banking: 1782-1837 (Kent, Ohio: Kent State University, Bureau of Economic and Business Research, 1965), p. 111.

[9]Shareholders of banking corporations were not always protected by limited liability. Even when limits appeared in charters, ". . . legislatures subjected corporate shareholders to enough liability through the span from 1810-1860 that we must doubt the inducement of limited liability as the prime explanation for the growing popularity of the corporate form of business." Hurst, Business Corporation, pp. 26-28.

[10]Davis, American Corporations, II, 103.

[11]Nance v. Hemphill, 1 Ala. 551 (1840); People v. Utica Insurance Co., 15 Johnson (N. Y.) 358 (1818).

[12]People v. Utica Insurance Co., 15 Johnson (N. Y.) 369 (1818).

[13]Davis R. Dewey, State Banking Before the Civil War, National Monetary Commission, Vol. XXI, no. 1: S. Doc. 581, 61st Cong., 1st Sess., 1910, pp. 33-40.

[14]The Journal of the Debates in the Convention Which Framed the Constitution of the United States, May-September, 1787, as Recorded by James Madison, ed. by Gaillard Hunt, II (New York: G. P. Putnam's Sons, 1908), 373. The federal government subsequently granted charters of incorporation. The constitutionality of the first federal charter, issued to the first Bank of the United States, was debated at considerable length. Bray Hammond, Banks and Politics in America from the Revolution to the Civil War (Princeton, N. J.: Princeton University Press, 1957), pp. 118-22, 214-22.

[15]Richard Hildreth, History of the United States of America, V (New York: Harper & Brothers, 1851), 549.

[16]George T. Starnes, Sixty Years of Branch Banking in Virginia (New York: Macmillan Book Company, 1931), pp. 34-35.

[17]Jabez D. Hammond, The History of Political Parties in the State of New York, from the Ratification of the Federal Constitution to December, 1840, I (4th ed.; Syracuse: Hall, Mills & Co., 1852), 332.

[18]N. Y. Laws, ch. 117, sec. 2, 27th Assembly (1804).

[19]Dixon Ryan Fox, The Decline of Aristocracy in the Politics of New York (New York: Columbia University Press, 1919), p. 69.

[20]Bray Hammond, Banks and Politics, p. 184.

[21]Berkshire v. Evans, 4 Leigh (Va.) 223 (1833); An act more effectually to prevent the circulation of notes emitted by unchartered banks, Va. Acts, sec. 1, Nov. Sess. (1816).

[22]Bristol v. Barker, 14 Johnson (N. Y.) 207 (1816).

[23]People v. Bartow, 6 Cowen (N. Y.) 190 (1827); N. Y. Laws, ch. 236, 41st Assembly (1818).

[24]Albert Gallatin, Considerations on the Currency and Banking System of the United States, in The Writings of Albert Gallatin, ed. by Henry Adams, III (Philadelphia: J. B. Lippincott & Company, 1879), 265.

[25]Walter B. Smith, Economic Aspects of the Second Bank of the United States (Cambridge, Mass.: Harvard University Press, 1953), p. 59.

[26]Hammond, Banks and Politics, pp. 28-29; Oscar Handlin and Mary Flugg Handlin, Commonwealth: A Study of the Role of Government in the American Economy: Massachusetts, 1774-1861 (Rev. ed.; Cambridge, Mass.: Harvard University Press, 1969), p. 116; Dodd, American Business Corporations, p. 206.

[27]Milton S. Heath, Constructive Liberalism, the Role of the State in Economic Development in Georgia to 1860 (Cambridge, Mass.: Harvard University Press, 1954), p. 188; Handlin and Handlin, Commonwealth, p. 116 Howard K. Stokes, "Chartered Banking in Rhode Island, 1791-1900," in State of Rhode Island and Providence Plantations at the Eve of the Century, ed. by Edward Field (Boston: Mason Publishing Company, 1902), 280.

[28]Hammond, Banks and Politics, p. 184; Fritz Redlich, The Molding of American Banking, Men and Ideas (Reprint ed.; New York: Johnson Reprint Corp., 1968), Part I, 21, Part II, 81, Footnote 6.

[29]George Heberton Evans, Jr., Business Incorporations in the United States (New York: National Bureau of Economic Research, 1948); Louis Hartz, Economic Policy and Democratic Thought: Pennsylvania, 1776-1860 (Cambridge, Mass.: Harvard University Press, 1948); Wilfred S. Lake, "The History of Banking Regulation in Massachusetts, 1784-1860" (unpublished Ph.D. dissertation, Harvard University, 1932).

[30]Hurst, Business Corporation, p. 132.

[31]N. Y. Laws, ch. 260, 61st Assembly (1838); An act to organize and regulate banking associations, Mich. Laws, Jan. Annual Sess. (1837).

[32]Lawrence Lewis, Jr., A History of the Bank of North America (Philadelphia: J. B. Lippincott & Company, 1882), p. 66; Mass. Laws, ch. 65, May Sess. (1791).

[33]Wales v. Stetson, 2 Mass. 146 (1806).

[34]Dartmouth College v. Woodward, 4 Wheaton (U. S.) 518 (1819).

[35]Dodd, American Business Corporations, p. 141.

[36]Guy S. Callendar, "The Early Transportation and Banking Enterprises of the States in Relation to the Growth of Corporations," Quarterly Journal of Economics, XVII (November, 1902), 159.