Early American Banking: The Significance of the Corporate Form

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Today the corporation is known and accepted -- sometimes with varying mixtures of love and hate -- as a legitimate form of private, competitive business enterprise, a form available to Exxon or one's family physician. It was not always thus. Two centuries ago the corporation was much more a quasi-public, monopolistic privilege, sometimes of a non-business nature, and available only in a restricted manner as a specific grant from parliament or legislature. Historians of law, the state, and business have devoted much effort toward explaining how the modern concept of the corporation emerged during the past two centuries [7; 10, ch. 3; 15, ch. 4]. Less attention has been devoted to the question of why the transformation occurred. I suspect that a reason for this lack of attention to the "why" question is that the answer seems obvious. High on the list of the advantages of the corporate form of business organization are the related notions of mobilizing large amounts of investment capital and reducing the risks to the individual investor (shareholder) by means of limited liability.

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In the earlier times, however, these advantages of the corporation were not so obvious. When the modern concept of the corporation began to gain a foothold after 1800, the need for large aggregations of capital in a single enterprise was not apparent in most areas of economic life, a principal exception being transportation. Moreover, the notion of limited liability was suspect both among theorists steeped in the common law traditions of unlimited personal liability and among individual and partnership enterprises that saw corporate limited liability as an unfair competitive advantage. These were obstacles that the modern corporation had to overcome in order to establish itself.

I.

It is of interest for purposes of comparative economic history to ask when and where the transformation of the corporation from privileged monopoly to free, competitive enterprise first occurred. The answer, I shall argue, is that it occurred in the United States in the early decades of the nineteenth century, and, further, that the skirmishes, battles, and wars between the old and the new concepts of the corporation were fought primarily in one area, the business of banking. When the modern concept of the corporation triumphed in American banking, it spread easily and quickly to other sectors of the American economy. Later, in the second half of the nineteenth century, it spread to Great Britain, France, and other nations. Eventually the corporation spread throughout the world economy to become the dominant form of modern business organization. One could speculate, then, that the leadership of the United States in developing the modern corporation might have had something to do with the rise of the U.S. economy to its leading position by the late nineteenth century, just as the development of new manufacturing technologies in Great Britain a century before resulted in that country's becoming the workshop of the world during the first half of the nineteenth century.

The modern concept of the corporation took shape in the early nineteenth-century United States in the movement for free banking. Free banking has both specific and general connotations. These should be distinguished from one another. The specific meaning of free banking is that contained in the landmark Free Banking Law enacted by New York State in 1838. This law allowed "any person or association of persons" to form a bank of discount, deposit, and circulation. The capital stock of the bank had to be at least $100,000, and it had to maintain a specie reserve of 12.5 percent against its note circulation. The bank's notes had to be secured by bond securities of the United States or New York State and mortgages on land in the state. The law also stated that "no shareholder of any such association shall be liable in his individual capacity for any contract, debt or engagement of such association," which meant that the New York free banks were in fact limited liability corporations [19, App. A., pp. 69-79].

In tracing the origins of the New York Free Banking law of 1838, which paved the way for the spread of free banking to many other states before 1863 and to the whole country thereafter, the late Fritz Redlich said that the concept of free banking was not of American vintage.

> The thought that banking (with note issue as its characteristic feature) might be free, that is, "entire liberty be allowed to everyone to take up the trade of banking," had already been expressed by Sir James Steuart. But the idea was born even before the 1760's when Steuart published his book, for prior to this time it had been embodied in the Scotch banking system. Nevertheless the concept of Free Banking, that is de facto freedom of bank note issue, never gained much popularity or importance in the Old World, outside of Scotland [18, pt. 1, p. 187].

Redlich goes on to state that

> Adam Smith, the admirer and advocate of Scotch banking, took up the notion and elaborated it as follows: "If banks are restrained from issuing and circulating bank notes or notes payable to the bearer for less than a certain sum; and if they are

> subjected to the obligation of an immediate and unconditional payment of such bank notes, as soon as presented, their trade may, with safety for the public, be rendered in all other respects perfectly free." This conviction of Adam Smith probably stemmed from his experiences with Scotch banking [18, pt. 1, p. 188].

Redlich clinched his argument for the British origins of free banking by noting that David Ricardo, in his *Proposals for an Economical and Secure Currency* (1816), had recommended that bank notes be backed by deposits of "funded property or other government security" with government or its agency [18, pt. 1, p. 191].

The problem I see with Redlich's interpretation is that it ignores the crucial concept of limited liability as embodied in the New York law of 1838. The Scottish banks familiar to Sir James Steuart and Adam Smith were (with a few exceptions) large or small partnerships with unlimited liability. In addition, the English banks familiar to Ricardo were (with one exception, the Bank of England) small partnerships with unlimited liability. What distinguishes the New York Free Banking law from European practice is the concept of the limited liability corporation.

The general connotation of free banking in the United States was in the "free trade in banking" tradition espoused by Sir James Steuart and Adam Smith. But it pushed the limits of freedom a step beyond European ideas and practice to allow freedom of incorporation for banks. This could be accomplished by a general incorporation law for banks such as New York's of 1838, which made incorporation of banks a routine administrative function of state government instead of a specific, case-by-case function of the state legislature. Or it could be accomplished by the practice of state legislatures -- as in Massachusetts and other New England states which by the 1820s routinely granted requests for specific incorporations of banks without any provision for bond-secured bank notes.

In a comparative context, then, what was unique about American banking in the early nineteenth century was the emergence of free incorporation of banking enterprises, and not free entry into banking (a Scottish idea) or the government-bond-secured bank note (a Ricardian idea). Since free incorporation spread from American banking to other sectors of competitive enterprise, and also eventually to Scottish and English banking and, in general, to European business enterprise, the American innovation combining the corporation with free banking deserves scrutiny. How did free banking incorporation gain a foothold in the United States in the early nineteenth century? What were the arguments -- often powerful -- against the corporate form in banking? And why did these arguments dissolve in experience, thereby leading to general incorporation laws for business enterprise nearly everywhere?

II.

The issue of how free banking incorporation developed in the more progressive states of the United States in the early decades of the nineteenth century has been ably documented in the work of American historians. I refer here to some of these works, summarize their key points about free banking incorporation, and lend some economic perspective that they tended to ignore.

The early United States, we now know, was a rapidly growing economy, perhaps the most rapidly growing economy in the world of the late eighteenth and early nineteenth centuries. All of the developing economies of that period experienced a rising demand for money to accommodate their economic growth. The problem of satisfying this growing demand for money was compounded in the United States by the unusually high rate of economic growth in conjunction with major changes in the monetary system. There were no banks in colonial America; instead the colonies relied on specie, a variety of forms of private credit instruments, and governmental fiat paper issues to meet monetary requirements. The unprecedented Revolutionary War inflation coupled with threats of renewed inflation as the states turned toward more fiat paper issues in the 1780s led the Founding Fathers to the Constitutional prohibition of state paper money issues in 1787. By that time the first banks had appeared -- three of them -- and had begun to issue their bank notes as money.

The first American banks were chartered corporations, but in the old sense of privileged, monopolistic entities [6, ch. 2]. In return for the franchise privilege of banking under corporate charters, they served the governments that chartered them in a variety of ways, and they served their local economies by providing discount and deposit facilities, mainly for merchants, and bank note currency for the public at large. Given rapid economic development and the accompanying demand for banking services and paper currency, the early banks were highly profitable. This led to an increasingly popular view that the privileges of incorporated banking ought to be more widely shared, a view that ultimately triumphed in free banking.

Historians Oscar Handlin and Mary Flug Handlin and legal scholar Edwin Merrick Dodd trace this process of institutional change and development in Massachusetts, the most commercial of the early states [13, 7]. The Massachusetts Bank was chartered in 1784 as a quasi-state institution. Its franchise monopoly came under attack in 1792, and the legislature responded by chartering the Union Bank, with the state taking $200,000 of the stock, paid for with a loan from the new bank [13, pp. 115-17]. Demands from non-Bostonians for bank facilities and currency led to eight more charters between 1795 and 1803, but the legislature permitted no more than one bank in any town, except Boston, despite petitions for competitive charters. "The legislature remained reluctant to grant new charters, partly from fear that competition would lower the returns on the Commonwealth's own investment, mostly because it regarded such corporations not as business enterprises but as special agencies set up to create a currency" [13, p. 116]. Indeed, to protect its corporate creatures from competition, the state in 1799 passed a law prohibiting unincorporated banks from operating or issuing bank notes. In 1819, there were many more banks, and the courts settled in the affirmative, based more on public opinion than legal precedents, the notion that corporations possessed limited liability. Limited liability of corporations quickly became "a matter to be taken for granted" in Massachusetts law [13, p. 147; see also 7, p. 90]. The state ceased investing in banks in 1820, which removed a conflict of interest that had earlier acted against competitive charters [13, p. 163]. Charters increased from 29 during 1811-1820 to 51 during 1821-1829 and 48 during 1830-1835 [13, p. 166]. After 1820, Massachusetts had essentially free banking in the general sense of that term, and the state remained a leader in terms of numbers of incorporated banks and capital invested in banking enterprises for several decades.

Louis Hartz's study of Pennsylvania and Anna Schwartz's essay on Philadelphia demonstrate that a similar move toward liberalizing banking incorporations took place in the Keystone state, although at a slower pace than in Massachusetts [14, 20]. In Pennsylvania antebellum bank charters often required that the banks make stock subscriptions in, or grants or loans to, transportation enterprises; these were "sectional concessions" to the state's several geographical areas [14, pp. 46-71]. Unincorporated enterprises, glorified in most fields, were actually crusaded against in banking, as Pennsylvania passed restraining laws against private bankers similar to those of Massachusetts [14, p. 67]. The state also invested in the early chartered banks until 1837 when it decided to liquidate these investments. These state investments created the same conflicts of interest over competitive chartering that had been experienced by Massachusetts. In 1803, for example, a legislative committee reported unfavorably on the charter application of the Bank of Philadelphia because it might work against the "public interest," by which was meant the State's investment in the Bank of Pennsylvania! The Bank of Pennsylvania offered to pay the state a large sum of money to deny the charter to the rival Bank of Philadelphia, but the public interest apparently was served better by granting the new charter in return for a substantial bonus payment by the Bank of Philadelphia to the state [20; 4, p. 54]. Such bonuses became an important part of state revenues. They reached a peak in 1835-1836 when the Second Bank of the United States, having lost its federal charter, received one from Pennsylvania in return for a bonus of $2 million, temporary loans to the state of $1 million annually, and a permanent loan of $6 million [14, p. 55]. Bonus payments favored more liberal chartering, especially after the conflict of interest was removed by liquidation of the state's investments in banks in 1837. By 1842 more modest fees for chartering replaced the bonuses of earlier years [14, p. 56]. The "economic rents" that the state could extract in return for granting bank charters were nearly gone by the 1840s. Pennsylvania chartered 168 banks between 1790 and 1860 under special acts of the legislature. As in Massachusetts, limited liability for banking corporations was attacked, but it nonetheless became firmly established in law [14, pp. 38, 256-58].

Ronald Seavoy's recent study of New York State indicates a progression of events related to bank chartering that was similar to the experiences of Massachusetts and Pennsylvania [21]. As in these states, the first banks in New York were chartered to provide a bank note currency, short-term credit to merchants, and loans to the state. Also as in Massachusetts and Pennsylvania, New York protected its corporate banks against the competition of unincorporated banks with restraining laws in 1804 and 1818 [21, pp. 75-76, 87]. New York differed from the other two states, however, in making the chartering of banking corporations an extremely political matter. The so-called Albany Regency of the Republican Party ruled New York politics for much of the third and fourth decades of the nineteenth century. It subscribed rather explicitly to a policy of political management of banking. That is, banks were chartered by special acts of the Regency-controlled state legislature, and franchises were granted only to Republicans who agreed to support a disciplined party [21, p. 90]. In these circumstances it is not surprising that many requests for charters were turned down by the legislature, or that many of the banks that were chartered were frequently managed in a poor manner. During the 1820s New York experienced more bad banking than either Massachusetts or Pennsylvania. One response to political chartering was the introduction of bills in 1825 and 1826 to repeal the earlier restraining statutes outlawing private, unincorporated banking; these bills, which would have increased competition in banking and thereby reduced the political power of the Regency, were defeated by narrow margins. Another response was a call for unlimited liability in banking, but the Regency staved off moves in that direction, too, its leader, Martin Van Buren, arguing that "unlimited liability for bank stockholders would contribute to an unstable currency because it would tend to put the banking business into the hands of irresponsible men" [21, p. 118]. By the end of the 1820s, however, public criticism of the Regency's banking policy and its banks led to enactment of the Safety Fund, a measure for insuring bank liabilities akin to modern deposit insurance. The clamor for more liberal granting of bank charters nonetheless continued. When the Regency went into eclipse as a result of the New York legislative elections of 1838, the victorious Whigs immediately enacted the celebrated Free Banking Law. This law, which took politics out of bank chartering, was later embedded in the New York Constitution of 1846, and it paved the way for general incorporation laws to be enacted in New York for virtually all business and public service organizations. Seavoy lists 28 general incorporation laws enacted by New York state from 1847 through 1854 [21, pp. 191-92].

The emergence of free banking incorporation in Massachusetts, Pennsylvania, and New York in the first half of the nineteenth century is a story with wide ramifications. Why the first American banks were founded as corporations rather than as individual or partnership enterprises is uncertain. Part of the reason probably is that whatever familiarity American leaders had with European banking was with its exceptions, like the venerable Bank of England, rather than with its rule, which was the relatively small, unincorporated partnership with unlimited liability. The point of interest, however, is not what the first American corporate banks were at the time of founding -- namely, franchise monopolies -- but rather what they became. In the late eighteenth and early nineteenth centuries, Seavoy argues, "Corporations were the legal and moral exception to the accepted standard of business ethics, which required personal liability, but everyone recognized that they had their place in the community because of the public services they performed" [21, p. 257]. In Massachusetts, Pennsylvania, New York, and elsewhere in the

United States, the question quickly became one of whether the public services performed by these exceptional creatures, which not incidentally were highly profitable to their owners, should be a restricted, monopolistic privilege open only to aristocratic leaders, politicians, and their friends, or whether they should be open on equal terms to anyone or any group willing to undertake them. The issue was settled in the development of free banking incorporation, and from there free incorporation spread to encompass other areas of business enterprise.

An issue remains. Was the move for free banking incorporation primarily one of democratic equity, of transforming the privileges of the few into the rights of all? Or was there also a gain in economic efficiency from the new corporate form of competitive enterprise? If so, what was the nature of this gain?

III.

The distinctive feature of the early American banks is that they were corporations with limited liability. Their counterparts in the Old World were, with few exceptions, partnerships with unlimited liability. What were the pros and cons of the two systems? Today, limited liability is far more accepted than it was 150 years ago, but the unlimited-liability sector of business is still very large. Each system, therefore, must have its advantages. Some arguments from the past, however, saw the issue more in "either-or" terms. One of the arguments used by early Americans who were opposed to corporations was that limited liability was a privilege that gave its holders an unfair economic advantage over unincorporated competition. On the other hand, when British bankers were given the opportunity to avail themselves of limited liability in the 1860s, many refused to do so on the grounds that it would put them at an unfair competitive disadvantage. These arguments, of course, are diametrically opposed.

Even those who had thought more deeply on the subject of liability in banking came to opposed conclusions. To James W.

Gilbart -- Englishman, practical banker, and prolific writer on the subject of banking -- it was obvious for several reasons that unlimited liability was superior to limited liability in banking. Unlimited liability, said Gilbart in 1837, gave greater security to the public: "It is not necessary to prove that the paid-up capital and remaining property of the partners form a larger fund than the paid-up capital alone." Further, "unlimited liability is, to a certain extent, a guarantee for prudent management. As the directors are liable to the full extent of their property, they will take care not to incur such risks as will place their property in jeopardy" [12, p. 78].

Gilbart dismissed the argument that limited liability would attract "a more respectable class of persons," that is, the rich, to invest in banks: banks would be no safer when owned by rich men if the owners' liability was limited to the amount of capital actually invested. Finally, to the charge that "unlimited liability has been tried and failed, the private banks in England were all founded on unlimited liability, and yet large numbers of them have failed," Gilbart replied, "Has not limited liability been also tried and failed? Are the one hundred and sixty-five chartered banks that have failed in America to go for nothing?" [12, pp. 80-81].

Gilbart's reference to bank failures in the United States was based on failure data contained in an 1831 work of Albert Gallatin [11]. On the American side of the Atlantic, contemporary views concerning the very same data and the whole question of unlimited versus limited liability could be quite different. In volume 2 of his *Principles*, published in 1838, the American economist, Henry Charles Carey, performed a more extended analysis of Gallatin's failure data, compared his results with data on bank failures in England, and reached the following conclusion: "From the first institution of banks in America, to the year 1837, the failures have been less, by about one fourth, than those of England in the three years 1814, 1815, and 1816, and the amount of loss sustained by the public bears probably a still smaller proportion to the amount of business transactions" [2, p. 24]. Carey also noted that most of the losses resulting from bank failures in the United States had been borne by the stockholders and not the banks' creditors. Carey followed his discussion of bank failures in the two countries with an extended discussion of limited and unlimited liability, holding that the former was a natural right that had been severely restricted on both sides of the Atlantic; but a right that was, in his era, being restored in the United States. In Carey's view, English banks -- because they lacked limited liability -- were less safe, not safer, than American banks. Unlike American banks, "the joint stock banks of England do a large business upon small capitals, and make their dividends chiefly out of the profits of their circulation and deposites [*sic*]" [2, p. 252]. By implication, the English banks were undercapitalized because they lacked limited liability, and their high profits cited by Carey were taken by him to be a sign of high risk, "because if the business were safe competition would reduce the rate of profit" [2, p. 252].

Who was right? The English banker, Gilbart, or the American economist, Carey? History suggests that Carey must have been right because today banks almost everywhere are corporations, and the general right of incorporation with limited liability for business enterprise is common. But was Carey right at the time he wrote? If so, why?

IV.

Limited liability would have had the salutary effects that H.C. Carey described if two related consequences had followed from its adoption. The first consequence is that corporate banks would have relatively more equity capital and relatively less debt in their capital structures than would unincorporated banks. The second consequence, which could be expected to follow from the first, is that corporate banks would be less likely to fail.

In Table 1 are gathered some data on the banking systems of England and Wales, Scotland, and the United States for years near the middle of the nineteenth century. The data, especially the

English data, are rough but nonetheless suggestive. The ratio of bank liabilities to bank capital in the three systems is as follows: England and Wales, 2.5 (1.79 for Bank of England, and 3.63 for the rest of the system); Scotland, 2.85 (2.76 for the three public, that is, incorporated, banks, and 2.89 for the unincorporated joint stock banks); and United States, 1.19 (1.07 for the incorporated state banks, and 2.73 for the private, unincorporated banks, which probably were more significant numerically than economically). These data support the thesis that limited liability in banking, as Carey argued, attracted much more capital in relation to liabilities than was attracted to unlimited-liability banks. It is

Table 1
Banking System Data, Mid-Nineteenth Century

Institutions	No.	Branches	Capital Assets	Circulation	Deposits
England & Wales, 1844					
			(£000)	(£000)	(£000)
Bank of England	1	12	18,118	20,176	12,275
Private banks	336	71	(?)	5,153	(?)
Joint stock banks	105	486	9,488	3,478	(?)
TOTAL	442	569	(44,000?)	28,807	(81,000?)
Scotland, 1850					
			(£000)	(£000)	(£000)
Public banks	3	82	4,491	1,024	11,380
Joint stock banks	14	308	8,944	2,201	23,662
TOTAL	17	390	13,435	3,225	35,042
U.S.A., 1860					
			($m)	($m)	($m)
State incorporated banks	1,579		422.5	211.6	239.4
Private banks	1,108		33.0	--	90.1
TOTAL	2,687		455.0		541.2

Sources: England and Wales [5, p. 22, supplemented, where data are missing, by 1, ch. 2]. Scotland [3, p. 426]. U.S.A. [22, p. 41].

difficult to believe that refinements to the data would change the conclusion that banking in the United States was significantly different in this respect from banking in Great Britain.

The remaining issue, then, is whether the heavier relative capitalization of American corporate banks resulted in a safer, more failure-proof system. The results of my investigations so far are preliminary, but they tend to be consistent with this interpretation. Lawrence H. White in his recent book reports failure rates (bankruptcies per thousand banks) for England and for Scotland during the period 1809-1830 [23, p. 48]. For England he finds an average annual rate of 18.1 bankruptcies per thousand banks for the period, and a rate of 4.0 for Scotland. For the period 1782-1837 in the United States, my study of the detailed data on early American banks gathered and reported some years ago by J. Van Fenstermaker [8] indicates an average annual rate of 5.0 failures per thousand, which is slightly above the Scottish rate but well below the English rate.[1] The failure rate would be lower for the United States than for Great Britain.

Several points should be made in connection with these preliminary results. One is that the comparison, restricted as it is to the years before the late 1830s, is not altogether pertinent. The United States was moving toward but was still far from free banking in this period, and in England the six-partner rule, which prohibited large joint stock banks, was not relaxed until 1826. Another point is that the preliminary calculations are for the whole United States, not for the states where freedom of incorporation was greatest for banks. I suspect, pending further investigation, that failures in relation to bank numbers in these "progressive" states were less than for the rest of the country. Along these lines, Scotland probably ought to be compared with,

[1]Fenstermaker's long Appendix A [8, pp. 111-84] contains a fairly complete listing of every bank chartered by an American state government between 1782 and 1837, and includes a brief description of what, if anything, caused the bank to disappear before 1837. I am analyzing these data in order to determine true failure rates, as opposed to disappearances for other reasons.

say, New England rather than with the whole United States. Refinements of the data and the analysis -- the agenda for future research -- will permit stronger conclusions.[2] But the preliminary indications are that early American corporate banks had more capital in relation to their liabilities than did British banks and that -- perhaps as a consequence of heavier capitalization -- they were less prone to failure.

Finally, how can our estimates indicating a comparatively low failure rate for American incorporated banks be reconciled with all the discussions of reckless banking in early US history? In part these discussions resulted from banking being a newer, more suspicious business to Americans than to the British. In part it was because banking was much more tied up with politics in the United States than in Britain. And, of course, very few of the American writers who took a dim view of banking troubled themselves to compare their systems with those across the Atlantic; H.C. Carey was an exception. I have found, using Fenstermaker's data, that estimates of failures among American banks are often exaggerated. Some "failures" were merely temporary suspensions of convertibility, and the banks soon recovered. Sometimes banks disappeared because charters were suspended or revoked. Some banks disappeared by closing voluntarily, and some that appeared on the records as receiving charters of incorporation never opened. There are many pitfalls in estimating accurately the extent of bank failures from extant data, but it seems likely to me that many accounts of early American banking exaggerate both the frequency of bank failures and the extent of the resultant losses to bank creditors.

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[2]Naomi Lamoreaux in discussions and correspondence has pointed out to me that Rhode Island bank charters, after granting limited liability to bank stockholders until 1833, then changed to unlimited liability until 1872. Her recent contribution in these proceedings [17, p. 172] suggests a possible effect of this change: banks became very "personal" institutions, lending the bulk of their resources to their own directors.

V.

Imitation, it is said, is the sincerest form of flattery. It is also a form of learning behavior. According to James Jeffreys, "between 1846 and 1857 about 100 banks, private and joint stock, failed with liabilities totaling almost 50,000,000" [16, p. 17]. That was in Great Britain. The British began to introduce the possibility of limited liability corporations under laws passed in the late 1850s, and these laws were consolidated into general company law in 1862 [4, 241-50]. From that time forward most *new* banks in Britain adopted limited liability, but many of the old ones remained unlimited rather than converting to the new order. However, the failure of the City of Glasgow Bank in 1878 changed all this. The shareholders of this unlimited bank had to pay about £2,750 on each £100 shares that they held. With this example in front of them and with the assistance of special legislation in the following year, shareholders and the general public now readily accepted the idea of limited banks [16, p. 102].

In France, after much debate and with the English example in view, a general free incorporation law was passed in 1867. One historian writes in a recent book, "Other European countries shortly followed the lead of France and England in providing free incorporation; Spain in 1869; Germany (North German Confederation) in 1870; Belgium in 1873; and Italy in 1883," [9, p. 144].

The true leaders of the movement for free incorporation were, of course, not from England or France after the middle of the nineteenth century. They were from a different place and an earlier time. In the early decades of the United States, legislators and bankers transformed the concept of the corporation from one of privileged franchise monopoly to one of competitive enterprise. It was not an easy battle. Powerful economic and political interests opposed the movement for competitive corporate banking. So did many thinkers who had no discernible vested interest in the issue. In the end, successful experiences with competitive corporate banking carried the day. In studying early American banking, one learns more than a little about how and why the economic and business organization today came to be the way it is.

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