Golden Silence: Why the Express Chose Not to Incorporate

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A profound legal change in the history of American business occurred after the Civil War when statutes in most states were altered to permit the wide establishment of limited liability corporations. Business and legal historians have correctly highlighted this development. As one has noted, the corporation was a "superior, if not almost indispensable, instrument for mustering and disciplining large amounts of capital and allowing dependable continuity of its use"[11, p. 34]. Most of the large business enterprises of the late 19th century were corporations. But not all. Some very sizable firms did not select this option even when they had the opportunity to do so. In one industry in particular, the railroad express, three of the four largest firms chose not to incorporate. These firms were large by the standards of the day.[1] By 1905 the combined revenues of the four principal express firms totaled more than $100 million [9].

All four express giants -- the American, Adams, Wells Fargo and United States express companies -- began as unincorporated joint stock associations, chartered under statutes of New York State. Their stock, which traded like that of corporations, carried unlimited liability. But the joint stock organizational form still proved advantageous in other ways. Most important, the form allowed managers and directors to control the dissemination of information about their companies. This, in turn, permitted the firms, first, to reduce entry attempts, and, second, to gain advantages in contract negotiations with the railroads. Unincorporated status also allowed managers and directors special personal benefits.

One firm, Wells Fargo, did choose incorporated status in 1866 under a private Colorado territory charter [7]. On the surface, this charter must have seemed ideal: it provided limited liability but allowed the company to

[1]For example, in the mid-1880s the Adams and American express companies each had revenues that may have been comparable to those of the Baltimore & Ohio Railroad, which grossed $11.57 million in 1883 [5]. While no contemporaneous revenue reports for the two express companies could be located, (and indeed may never have existed [3]), the magnitude of express revenues is estimated by the author to have been comparable based on an extensive examination of available archival data [2, 6].

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maintain information control. Yet as we will see, Wells Fargo's choice had distinct disadvantages and must have reinforced the industry bias against incorporation even on favorable terms. Some express executives were so convinced of the overall benefits of remaining unincorporated they considered that status their "most valuable asset" [9, p. 183].

This paper shows that while incorporation laws were important to the rise of large industries in the 19th century, they did not serve all enterprises alike. The express story suggests that full appreciation of business history of the era requires an understanding of how entrepreneurs were able to exploit the variety of institutional arrangements that were available.

The Nature of the Express Service and Industry

The express, in the second half of the 19th century, was America's principal financial courier service and package transport-delivery system. Though the post office competed with private firms for some classes of parcel transport, there was no government parcel post service. For many kinds of shipments, the express had a monopoly.

The decision by express firms to remain unincorporated was influenced by the characteristics of the industry. Unlike manufacturing companies, or even other transportation companies such as the railroads, the express had relatively low fixed capital costs.[2] An express needed wagons, horses, and agency offices, as well as a small amount of rolling stock. But the capital most crucial to its operation -- high-speed long-distance transportation -- was rented from the railroads and paid for out of cash flow. Consequently, the express had less need to gain access to capital markets, a major benefit of limited liability.

The express was mostly self-financing, and the firms possessed large internal resources. The four largest companies controlled about 80% of express traffic and together with the smaller Southern express formed a cartel that was, arguably, the most stable and successful in U.S. business history [8]. The firms consistently earned returns above market rates, and by the turn of the century, they had accumulated large surpluses in cash and stock. American Express executives, for example, estimated that the firm's capital and surplus -- available in highly liquid assets -- were greater than those of any bank in the country with the exception of the National City Bank of New York [2].

The Value of Organizational Form

The wealth of the express firms owed much to their unincorporated status. The New York State law of 1894 governing unincorporated joint stock associations was relatively simple and covered a little more than two pages

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[2]In 1910 Adams Express valued its capital at $6 million [3]; the company's revenues were about $40 million [2].

[12]; by contrast, the state's general law of incorporation of 1875 ran nearly eleven pages [13].

Under New York State law, an unincorporated joint stock company could issue tradeable stock and had a filing requirement in which the officers had to acknowledge their position in the company, certify the name of the organization and its place of business, and note the number of shareholders. Otherwise, New York State statutes treated joint stock associations like partnerships. Stockholders were entitled to a share of the profits, but there were no requirements regarding their right to information about the performance of the firm. Authority was delegated to the officers and directors. They did not need to publicize profits, reveal details of operations, or submit themselves to the shareholders for regular election [12].

Officers of incorporated firms in the late nineteenth century typically had a very different set of requirements. Reports of various financial details had to be made. Moreover, they faced restrictions on their behavior. Not only did they have to report paid-in capital, they had to maintain a certain level of it. Debt ratios, too, were subject to state statutes. Shareholder meetings and annual reports were mandatory [13].

Scholars have pointed out that many corporations of the period limited the scope of what they reported and made some important information costly to obtain [4]. Although by law stockholders had the right to information, often they did not gain a clear grasp of the firm's profitability or the level of its debt.

Nevertheless, far more information was available about the most secretive corporations than was known of the unincorporated express. These express firms reported no details of their business to anyone--including the U.S. Census Bureau and the New York Stock Exchange.[3] No one outside a small circle of senior managers really knew how profitable the businesses were. Directors and managers had learned early on that information control offered great advantages, and they were able to exploit this knowledge profitably for more than half a century.

Entry Barriers

The express cartel had developed a number of formidable barriers to entry [8]. Information control enhanced the effectiveness of these barriers. Since existing companies published no balance sheet information, potential competitors always remained uncertain as to the nature and magnitude of costs, revenues, and profits of incumbent firms. If express firms earned zero economic profits, or even small rents, there would be less incentive for outside firms to consider entry. This rationale was explicitly stated by an American

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[3]In 1890, after years of noncompliance, the express companies made limited reports to the Census Bureau. The firms provided information on traffic volume, operational mileage, the size of the labor force, and the value of "equipment and fixtures." However, no information was provided concerning revenues or profits.

Express board member in 1852 to justify withholding data from shareholders [9, p. 58].

Fear of entry was heightened after the Civil War. During the war, firms had not revealed profitability directly but they were earning enormous profits and had paid dividends to stockholders representing as much as a 40% annual rate of return. This sign of success encouraged entrants. While these attempts were defeated, incumbent firms prevailed only at high cost. It became clear that not only did balance sheet information need to be withheld, but all signals of profitability had to be controlled. As a result, dividends were kept at, or slightly above, market levels, and no large scale entry by an outside express firm was attempted after 1870.

Relations with the Railroads

Entry by one group--the railroads--remained possible (and was feared) after 1870. Indeed, the railroads controlled the transportation system the express used and so held a cost advantage in an important factor [8]. Had the railroads acted in unified fashion, they could have seized the express. The express industry was fortunate that railroad rivalry made a general expropriation impossible [1]. Railroads were able to enter the express only over their own lines, and their cost advantages could be wiped out by denial of low-cost access to the rest of the express system [8]. But even if the express could reduce an entrant's profits, the loss of routes through railroad entry would hardly be a positive turn of events. Without railroad lines to serve, an express firm would cease to exist.

Each express company therefore sought to pay the railroads a sufficient amount to persuade them not to enter, but not so much so that its economic rents would be excessively dissipated. A railroad, on the other hand, knew that it could extract at least as much as it thought it could gain from entry and perhaps a good deal more, potentially most of the rents. The question for a railroad was: just how large were the rents?

The exact size of express profits cannot be known since no reports were made and even the minute books of the directors meetings often left out profit figures [2]. Yet the information that exists in express and railroad archives suggests substantial profits. Through the late 1880s, annual net profits were probably in excess of 30% of revenues, and the return on capital at least 10%, and in some years 30% or more, for most of the industry.[4]

For an express company, the less a railroad knew of its profitability the better. A railroad had somewhat better information than most organizations about the express since it could monitor the volume of traffic over its own lines. But this provided less than perfect information about express profits. Some railroads asked express firms for a breakdown of profits on each route

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[4]These are the author's estimates based on archival data [2, 6].

but the express firms argued that such data did not exist.[5] Railroads also tried to estimate the size of express profits themselves, but because of the control of information that express executives exercised, the effort was costly. Moreover, as those who tried it found, after considerable expense, the estimates still contained a great deal of uncertainty. Archival records show that through the 1880s railroad executives were unsure even of the range of express profits, much less the actual value. Without that information they could not determine the maximum that could be extracted from the express for transportation services [6].

The problem for the railroads is illustrated by the case of the Chicago, Burlington & Quincy Railroad. The CB&Q had a contractual relationship with American Express spanning three decades. From the late 1870s until 1887, railroad officials tried to figure out the size of express profits. But after spending time, energy, and money on the effort, their profit estimates remained guesswork [6].

By 1887, after nearly a decade of research, the CB&Q, having gained only an inkling of the magnitude of express profits, nevertheless demanded a significantly larger share of them. The express agreed, increasing its lease payments by 60% in exchange for a longer-term contract [6]. Railroad officials still remained uncertain about how much more they could have hoped to extract, but the point had finally been reached where there appeared to be diminishing returns to searching further. At the same time, the settlement suggested that for the previous twenty years, the express had earned a net return on CB&Q routes as high as 40% of revenues.

Personal Benefits From Unincorporated Form

The firms benefitted from secrecy, but shareholders did not. Since managers were shareholders, they might appear to have been hurting themselves so the firm would gain. Indeed, to some extent this is true; managers let large liquid funds accumulate that they could have distributed to themselves and other shareholders as dividends. Instead, they chose an indirect and less public method of distribution -- a method that was possible only if the firms remained unincorporated.

Specifically, officers and directors gave each other loans. In corporations, officials typically could not borrow personally from company coffers. Unincorporated stock associations had no such strictures. Examination of the American Express archives shows that officials took direct advantage of this. The minutes of the directors' meetings, for example, note loans to directors, managers, and their friends. American Express underwrote

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[5]It was a believable claim given cost accounting at the time, and in one instance found in archival records (concerning American Express and the Chicago, Burlington & Quincy Railroad), the claim was not challenged [6].

one executive's personal foray into railroad ventures.[6] The board provided loans to officers for investment, for personal real estate purchases, or for unspecified purposes. Some of these loans were forgiven, effectively making them bonuses.

Directors and managers had little worry that their advantages would be lost. The reason was simple: joint stock companies made no reports to shareholders and did not have company elections; their boards were self-perpetuating. Regular shareholders' meetings were not required. According to company charters, a shareholders' meeting could be called only if representatives of a majority of the shares demanded it. To call meetings, then, was costly, and they occurred rarely. In the case of the United States Express, no shareholders' meetings were held from 1862 until the company's dissolution in 1914 [3]. Even increases in the company's stock could be authorized by directors alone.

Wells Fargo, by virtue of its 1866 Colorado corporate charter, was different. It had to have an annual shareholders' meeting, election of directors, and shareholder ratification of stock increases [7]. Within three years after incorporation, Wells Fargo's management forced a stock increase and found itself fighting a shareholders' lawsuit [10]. If a company fought its decisions in court (or even needed to defend them at annual shareholders' meetings), its ability to keep information private was threatened. Afterwards, the rest of the industry would have seen little gain in adopting an incorporated form.

Directors and managers of the other three firms more completely controlled those companies. They determined policy, distributed surpluses, and controlled the flow of information, unthreatened by shareholders, beholden only to each other. One measure of their success can be seen in the amazement, lawsuits, and muckraking articles that followed the revelation of express assets and pricing policies after the companies were put under the supervision of the ICC in 1906. The public had never known how profitable the express service was [3].

Conclusion

Before 1906, while stockholders of the express may not have seen profit statements, they actually did possess one bit of information: they knew express affairs were secret. Judging by the fact that the stock of all three unincorporated express firms traded actively, it must be assumed that their secretive behavior was itself considered an asset.

But the unincorporated form the express chose allowed a small group of managers and directors to obtain valuable information that they could keep

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[6]American Express helped executive William G. Fargo try to gain control of several railroads, including the New York Central. In the case of the Central, according to Minutes of the Board of Director's meetings, American Express invested $1 million in Central stock (2/13/65) and loaned Fargo $50,000 (5/13/67). According to various contemporary newspaper accounts, Fargo and two partners were temporarily successful in their takeover attempt, but within a year, they lost control of the Central to the Vanderbilts [2].

private. Other firms and individuals had an interest in obtaining that information, but they could gather only part of what they wanted to know, and that was obtainable only at high cost. In essence, the organizational form allowed firms to be silent about their affairs, and this advantage proved to be golden.

The case of the express demonstrates that entrepreneurs will take advantage of whatever rules exist in forming business organizations. Whether the form that was chosen by the express produced the most desirable social results is a question for further investigation. But clearly, with the aid of unincorporated status, a large industry was created -- an industry that played a vital role in nineteenth century American commercial life.

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