Legal Innovations, Long-term Investments and the Birth of the Corporation

Dari-Mattiacci, G.

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Giuseppe Dari-Mattiacci

Alfred W. Bressler Professor of Law at Columbia Law School.

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For the last several decades, organizational law has been predominantly viewed as a menu of default contractual clauses that, as with contracts more generally, can be adapted to the needs of each specific organization. This view, which originated in economics, has permeated legal scholarship and kept the focus on contracts rather than law. However, recent literature has stressed the role of the law in regulating claims on firm assets by creditors and owners, and has set the stage for a property-rights theory of business organizations.

In a recent article, Oscar Gelderblom, Joost Jonker, Enrico Perotti and I conducted an historical and economic analysis of the foundations of corporate law. We found that the world's first business corporations, the East India companies in England (EIC) and the Dutch Republic (VOC), heavily relied on the law to provide crucial innovations. In particular, the law provided enforcement for a previously unenforceable provision: the agreement among partners to keep the capital invested in the business over the medium (and possibly long) term.

Trading companies during the 15th and 16th century were financed as special-purpose partnerships. This meant that the company was dissolved at the return of the ships and profits were apportioned. Reinvestment was possible but depended on the unanimous agreement of all the partners. This system worked well while the capital needed to finance voyages could be supplied by a close circle of investors who were familiar with each other. The international banks that arose in Florence in the 14th and 15th century relied on family ties to ensure continuity of investments over long periods of time.

The onset of Atlantic trade with south-east Asia upset this equilibrium. The amount of capital needed to finance expeditions required a much larger investor base. The partnership model came under stress. In the beginning of the 17th century, the VOC and EIC were chartered to take up this challenge, but they did so in radically different ways. While the 1602 VOC charter included a clause that locked in capital for 10 years (and indefinitely after the 1612 amendment), the 1600 EIC charter inherited the traditional short-term financing model and continued to operate on the basis of a series of successive subscriptions until 1657, when its capital finally became permanent.

The EIC's half-century delay in embracing long-term equity was not without consequences. The economic performance of the two companies, and of the Asian companies in other European countries, shows clearly the Dutch dominance on all measurable indicators. What is even more telling is the way that the VOC organized trade, which suggests much heavier investments in long-term assets. To zero in on this issue, we looked at the duration of return voyages. The VOC operated much faster fleets than the EIC did. The reason was a specialization in trade operations: the VOC had a large fleet stationed in Asia (reaching 100 ships at the end of the 17th century), which took care of security and inter-Asian trade, and a separate fleet operating the return voyages. In contrast, the EIC had a much smaller Asian contingent and hence the trading fleets needed to remain longer in Asia.

The ability to invest for the long term in forts, trading posts, security, and diplomatic relationships depended on the longer maturity of equity in the VOC. The short maturity of the EIC equity meant that investments made would benefit partners in the following capital subscriptions, which created a common-pool problem and curbed the incentives to invest in long-term assets.

Why was the EIC not able to organize itself differently? The EIC adopted long-term capital only in 1657, when the Dutch had already established a dominant position in Asia. We argue that the delay in embracing a superior organizational model originated from a different constitutional setup. While the VOC operated in a republic where power resided largely in the hands of traders, the EIC was chartered by a powerful Queen with little parliamentary oversight. Holding on to the right to withdraw capital was a way for investors to protect themselves from the various ways in which the Queen and her successors could expropriate company profits. The change came after the civil war, when the Crown's power to tax and wage war was put under closer parliamentary scrutiny, which is in line with the view that constitutional constraints on the executive foster economic development and the institutions that support it.

Giuseppe Dari-Mattiacci is Professor of Law and Professor of Economics (by courtesy) at the University of Amsterdam.