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CORPORATE GOVERNANCE IN THE 19TH CENTURY: EVIDENCE FROM THE CHESAPEAKE AND OHIO CANAL COMPANY

Abstract: Presenting evidence from a 19th century corporation, the Chesapeake and Ohio Canal Company (C&O), the paper shows that issues of corporate governance have existed since the first corporations were established in the U.S. The C&O used a stockholder review committee to review the annual report of the president and directors. The paper shows how the C&O stockholders used this committee to supplement the corporate governance structure. The corporate governance structure of the C&O is also viewed from a theoretical structure as espoused by Hart [1995].

INTRODUCTION

The U.S. approach to corporate governance is being challenged due to corporate failures in the early part of this decade and the more recent decline in markets and the trading value of corporate equity securities. These recent episodes have raised public concern over corporate behavior in many areas such as compensation, performance measurement, and accountability.

While these corporate failures have diverse consequences and details, the conditions which enabled them can be related to corporate governance failures. Evidence and theory available to the investor show that managerial discretion combined with other incentives can cause managers to pursue personal interests at the expense of the investor. In their discussion of

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corporate governance, Shleifer and Vishny [1997] try to answer the question of why investors part with their money in the face of potential managerial misuse of the investment. Currently, investors theoretically control management. In the 19th century, stockholders were directly involved in the corporation and established governance procedures and policies for the protection of their investments.

Hart [1995] provides a theoretical framework for corporate governance, describing the problem of incomplete agent contracts and how corporate governance relates. Hart proposes that if the agency problem exists and contracts are incomplete, then the structure of corporate governance has a role and is important. Five issues of corporate governance raised by Hart are: cost of agent contracts; individual stockholders are too numerous to exercise control on a day-to-day basis; large stockholders; limitations of the corporate board of directors; and the potential that management will pursue its own goals at the stockholders' expense. Resulting from these issues, providers of capital have designed systems of corporate governance with checks and balances to protect their financial interests in the corporation.

With methods of corporate governance and the success of those methods today being questioned, this paper reviews corporate governance from an historical perspective. While several studies [Roe, 1993; Charkham, 1994] have compared corporate governance methods between countries, few have looked at corporate governance in history [Gallhofer and Haslam, 1993].

CORPORATE GOVERNANCE

Over the past several years, the structure of our corporate governance system has come into question. At Enron, the board of directors removed governance controls, allowing the CFO to operate off-balance-sheet partnerships that greatly obscured the true financial condition of the company. At Adelphia, the president ignored the economic entity assumption and used the assets of the company as his own. Before these companies faltered, some academics were already questioning our corporate governance system. Hart [1995] and Shleifer and Vishny [1997] published papers presenting evidence that there are flaws in the corporate governance system upon which investors rely. Both of these papers state the limitations of the corporate governance system and potential problems associated with those limitations. Issues mentioned in both papers include agency problems and large stockholders.

As previously indicated, Hart proposed a framework of corporate governance, maintaining that the market approach to monitoring corporate governance theoretically should create a good system of corporate governance that would work in all cases. Hart argues that a market view should not need a statutory corporate governance structure, but that the limitations of the market are not correcting all corporate governance issues. As an example, he regards the historical separation of chief executive and board chairman as a non-issue. However, one individual holding the position of both CEO and board chairman at a company can provide sufficient power to base business decisions on personal incentives. The recent failures of the market approach to corporate governance have led to statutory governance policies in the form of the 2002 Sarbanes-Oxley Act.

Shleifer and Vishny [1997] in their discussion of corporate governance make the observation that in lesser developed countries corporate governance is almost nonexistent. Undeveloped countries today have the advantage of the ability to observe and emulate the best practices of the developed world. By choosing the best practices of each country, these countries can create systems that are as good, if not better, than the systems currently used in the economically developed world.

However, what can be said about the origins of corporate governance? The earliest companies did not have the advantage of others to emulate. Using historical examples, we can review the development of our current corporate governance structures and obtain additional insights into these systems. This paper provides evidence that many of the current issues of corporate governance existed in 19th century corporations. The paper further illustrates how the issues raised by Hart are not new but have been related to corporate governance since the first corporations chartered in the U.S. by providing evidence from the Chesapeake and Ohio Canal Company (C&O). The paper also presents information about how the C&O addressed these issues of corporate governance.

BACKGROUND INFORMATION

On September 2, 1784, George Washington started a tour of the western territories. Washington had large land holdings in western Virginia, and the purpose of his trip was to examine his land holdings, collect some money due him from tenants, and other business dealings. Upon his return to Virginia, Washington wrote a letter to Benjamin Harrison, governor of Virginia, on October 10, 1784. In this letter, he noted that unless the colonies improved communication and trade with the western territories, the loyalty of the people settling these territories would switch to Spanish New Orleans. Washington suggested in this letter[1] that a method that could be used to improve communications was to improve waterways between the coastal region of the country and the Ohio Valley. Governor Harrison presented Washington's letter to the state legislature during that session. The legislature granted Washington a corporate charter.

The corporation formed was the Potomac Company (PC). Over the next three months, Washington worked to obtain a similar charter from the State of Maryland. The PC was a river improvement company and, as such, removed obstructions from the river and built canals circumventing major falls. The PC had exhausted its finances by 1820 with few improvements to show for the expenditures of time and money. The navigational improvements undertaken by the PC proved to be inadequate for the region and needs of the country.

During the War of 1812, communications and transportation needs became very apparent in the states. The State of New York started construction of the Erie Canal in 1817 [Shaw 1966]. Once again, the Potomac route to the west was seen as a commercial route. In 1823, a new group of individuals obtained a charter from Virginia, Maryland, Pennsylvania, and the federal government to form a new company. The new company, the C&O, absorbed the assets, liabilities, and stockholders of the PC. The goal of the new company was to build an artificial river (canal) from tidewater Potomac to the Ohio River at Pittsburgh. On July 4, 1828, the company broke ground in Georgetown (now part of the District of Columbia) and commenced construction paralleling the north bank of the Potomac River.

Congress appropriated funds for the Army Corps of Engineers to survey the route and prepare an estimate of construction for the canal in the amount of $22 million. The canal promoters believed that this sum was far too great an amount for the company to raise for construction. The canal promoters secured a new estimate that predicted the canal could be built for $4.5 million. The canal promoters accepted the lower number and proceeded with construction. Twenty-two years (1828-

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[1] From the sending of this letter, the canal movement in the U.S. was born. Individuals promoting the C&O and the Erie Canals [Shaw, 1966], as well as other canal promoters, quote the letter from Washington to Harrison. The letter presents Washington's fears that without communication and trade, the western territories could become Spanish by virtue of trading with Spanish New Orleans.

1850) and $18 million later, the company reached Cumberland, Maryland. The distance from Georgetown to Cumberland was 184.5 miles. This distance was less than half the original route planned to the Ohio River. Lack of funds for continued construction and the location of coal fields in the Cumberland area as a source of revenue convinced company management to stop at Cumberland.

Despite the fact that the C&O was never sufficiently profitable to pay off its corporate debt borrowed for construction and repairs, the company was able to survive for over one hundred years (including the predecessor PC). Although the canal did enjoy financial success during the 1870s and early 1880s, it was insufficient to pay off the corporate debt or to provide a return to the stockholders. During this time, the company administrators were successful in waging a political war[2] with the Baltimore and Ohio Railroad (B&O) [Dilts, 1993]. Severe flooding in 1877 and 1889 caused major damage to the canal works. After the 1889 flood, funding was not available to make repairs, and the C&O was forced into receivership.

Subsequently, the B&O emerged as the majority owner of the repair bonds, holding the mortgage on the canal, and assumed control of the company. Funding provided by the B&O allowed the canal to be repaired and returned to service in 1892; however, another flood in 1924 resulted in the canal's permanent closure. In 1938, the federal government purchased the canal assets from the B&O for $2 million [Sanderlin, 1946], and, in 1971, the canal was designated a national park.

At the time the federal government purchased the C&O canal assets (1938), the available corporate records were also transferred to the government and now reside at the National Archives in the suburbs of Washington. Included among these records were the Board of Director's minute books and the *Minutes of the Proceedings of the Subscribers to the Capital Stock of the Chesapeake and Ohio Canal Company*, referred to in this paper as the stockholder minute books. Financial statements were presented annually to the stockholders of the C&O during the period 1829-1889, with the number of copies produced ranging from 250 to 1,000 annually. However, the annual reports for

[2] The B&O and the C&O were both politically active. Both companies were attempting to gain favors in the Maryland State Legislature. The companies in their early histories were trying to obtain construction financing while later issues involved other advantages, such as rate changes. (Company toll rates were set by the legislature.)

only five of these years reside in the National Archives. Copies of the printed annual financial statements for all years except 1857, 1869, and 1888 were obtained from six sources (see Appendix 1).

The C&O, while never profitable for the individual investors, was economically valuable for the region it served. Ransom [1964] argued that economic historians have focused on the railroad as the most important factor in American economic growth. He concluded that this emphasis is misguided and that since canal construction in the U.S. predated the railroads, their contribution to American economic growth should be re-evaluated. Ransom further states that canals never constituted an integrated system and that their economic contributions should be evaluated individually.

ACTIONS BY STOCKHOLDERS TO EFFECT CONTROL

The 1784 charter of the PC required an annual meeting of the stockholders. The charter also included wording that at the annual meeting the "president and directors shall make report, and render distinct and just accounts of all their proceedings, and on finding them fairly and justly stated, the proprietors then present, or a majority of them, shall give a certificate thereof" [Virginia Act, 1784, ch. XLIII]. To accomplish this charter requirement at each annual meeting, the stockholders of the PC selected a committee of stockholders to review the annual report of the company. At the time of the founding of the PC, there were no corporations to emulate. The origin of the concept of using the review committee remains unknown. However, the Middlesex Canal Company also used the stockholders to perform the review function [Roberts, 1938].

The charter of the C&O was almost identical to that of the PC, including the above referenced phrase. In addition to absorbing the stockholders of the PC, the C&O also inherited many PC practices, including the corporate governance structure. The C&O continued to have a committee review the annual report presented by the company president and report back to the stockholders on their findings. A separate sub-committee was created to review (audit) the annual financial statements presented to the stockholders.

At the 1831 annual stockholders meeting, a resolution was passed to create the stockholder review committee at the current meeting to review *next year's* annual report. The resolution also states that the president and directors should have the annual report prepared two weeks prior to the annual meeting to allow the committee to review the report before the stockholders meeting. After completing the canal to Cumberland, Maryland in 1850, the review process was again modified. A committee of three or four stockholders present at the current stockholders meeting would be selected to review the next year's annual report, replacing the committee/sub-committee structure previously employed. The committee's main focus during these years was the examination of the financial records of the company. Additionally, other committees would be established as the stockholders felt necessary to examine particular issues of interest to the stockholders.[3] The annual review committee reports presented in the stockholder minute books provide insight into the functionality of the company's corporate governance structure.

WEAKNESSES OF CORPORATE GOVERNANCE

Hart [1995] explained the weaknesses and importance of corporate governance structures. He discussed the five weaknesses in corporate governance structures identified in the introduction and provided a theoretical framework for these weaknesses. The following discussion describes these five weaknesses and how they are illustrated by the C&O in operation.

The Cost of Agent Contracts: The costs and complexity of writing a comprehensive agent contract are such that organizations will only write incomplete contracts [Hart, 1995; Shleifer and Vishny 1997]. Shleifer and Vishny describe the incomplete contract issue with regards to the allocation of company funds. They remark that ideally a company would write a contract that specifies exactly how a manager would allocate company funding of projects, but future contingencies are impossible to foresee or describe. Hart [1995] argues that the potential costs of contracts are thinking of every potential eventuality, the cost of negotiating contracts, and the cost of writing the contract so that it is enforceable. In the case of the C&O, it was not possible to think of every possible contingency since its stockholders were entering an unknown area. The C&O did not even have a written contract with the corporate president. Company presidents were elected annually at the stockholders meetings, so there were no negotiations. The method of enforcing the stockholders' will on the company presidents was by replacing them at the next stock-

[3] An example is the committee established in 1869 to investigate the option of turning over control of the company to the bondholders.

holders meeting.

The stockholders imposed controls on the company management by passing stockholder resolutions. As illustrated by the changes occurring during the tenure of Arthur Gorman's presidency. Gorman was president of the C&O from 1873 to 1883. During his tenure, a corporate bondholder, Daniel K. Stewart, brought a lawsuit against the company for non-payment of bond interest. In this 1881 lawsuit [Stewart v. Chesapeake and Ohio Canal and others], the plaintiff alleged corporate mismanagement as the reason for the non-payment. The court, while not agreeing to place the company into receivership as requested by the plaintiff, did agree that the company was spending extravagantly on travel and entertainment expenses. In 1879, the stockholders had passed a resolution limiting the travel reimbursement expenses of the officers and directors of the company. Following the lawsuit, the stockholders further limited expenditures at the 1881 stockholder meeting. The stockholders passed a resolution that all salaries would be fixed by them and that the company would pay no expenses for travel or hotel bills [C&O, 1856-1889, p. 332].

Hart [1995, p. 680] further states that the "governance structure can be seen as a mechanism for making decisions that have not been specified in the initial contract." While the stockholder review committee did not identify the issue of excessive travel and entertainment expenses, the stockholders of the C&O acted to correct the issue of travel and entertainment expenses by setting limits on the amount of expenditure allowable.

Individual Stockholders are too Numerous to Effect Individual Control: The authors of the C&O charter attempted to protect small investors by including voting restrictions. These restrictions were one vote per share for the first ten shares held and one vote per every five shares above ten. It was felt that at $100 par, no one individual or organization would be able to gain control of the enterprise. However, in 1836, the State of Maryland purchased enough shares of stock to control over 50% of the voting rights [Sanderlin, 1946]. Thereafter, each change in the political party controlling the Maryland statehouse brought a change in the company president and the Board of Directors.

In 1825, Maryland created a Board of Public Works. The original purpose of the board was to oversee state investments in corporations and to locate additional opportunities for investment as the state set out to provide income for governmental operations without direct taxation. In 1850, Maryland created a new Board of Public Works whose job was simply to represent the state at stockholder meetings, not to exercise direct managerial control over its various investments [Wilner, 1984].

In 1850, Maryland held a constitutional convention, and the oversight of the various state corporate investments was an area of significant debate. Mr. Thomas, the representative from Frederick County, commented that there was a significant difference between Maryland and other states with respect to its canal investments. The difference was that the internal improvements companies in other states were owned, built, and operated by the states as non-profit entities. Canals in New York, Pennsylvania, and Ohio were all public enterprises. Mr. Smith of Allegheny County said that the state had no duty other than to attend the annual meeting and cast the state's vote. He further said that the state could have no supervision over the works as the charter gives entire control to the president and directors of the company [Wilner, 1984]. The Maryland legislature intended the company to be independently controlled, but the intent of the state legislature did not prevent the Board of Public Works from making political appointments to the company presidency. In spite of concerns about management weakness caused by political appointments, the C&O continued operating independently until 1889, when it was finally placed into receivership.

In 1841, the stockholders, recognizing the costs of continuous changes in company management, passed a resolution that the C&O was a national work and should not become a political engine, fluctuating with the vagaries of Maryland's statehouse politics [C&O, 1836-1841, p. 414]. By the 1870s, the offices of the company had become political perks bestowed by the political party in charge. Arthur Gorman was appointed president 1873 as a reward for services rendered the Democratic Party [Sanderlin, 1947]. In the year Gorman was nominated as president of the company, Maryland cast its votes for Gorman with all other stockholder votes against. Hart [1995] explains that when company management is sufficiently bad, dissident shareholders can initiate a proxy fight to remove the board, but that this course of action is usually ineffective. In the case of the C&O, it was impossible for the minority stockholders to bring about change.

The minority stockholders also made attempts to gain more influence in the company. The individual representing the stock held by the U.S. government presented a motion to change the method for electing members of the Board of Directors at the June 1879 annual meeting. The proposal was for the Board of Directors to consist of three members elected by Maryland and two members elected by the minority stockholders. The resolution was defeated because Maryland voted against the resolution although all other stockholders voted for it.

Corporate bondholders also recognized the limitations occasioned by the political nature of the company. In 1881, the bondholders presented a petition at the stockholders meeting noting that they had not received any payment since December 1876. The petition further explained that if the company were run as a business and free of political influences, the company would have been able to pay the debt [C&O, 1856-1889, pp. 336-337].

O'Sullivan [2000, p. 410], commenting on innovative organizations and corporate governance, argued that "a system of corporate governance supports innovation by generating three conditions – financial commitment, organizational integration and insider control." Financial commitment is defined as an institution's resolve to continue financial support of innovation. Organizational integration is the maintenance of human capital. Once an innovative process has started, the loss of human capital will cost the organization additional resources. Insider control requires that decision makers are involved in the learning/innovation process. The stockholders of the C&O were upset by the problems of continuously changing company officers. Subsequent to Maryland gaining control of the company, the minority stockholders were unable to exert enough control to force a change in policy. At the April 1841 stockholders meeting, the review committee made the following statement to protest the turnover of officers as a function of Maryland politics [C&O, 1836-1841, pp. 417-418]:

> The committee, from evidence given them, are satisfied that very valuable and faithful officers have been removed from the service of the company, and, in some cases, men not competent to perform the duties required have been appointed in their places, to the serious injury of the best interest of the company.
>
> Some of these removals have been as admitted by the president's report to the governor of Maryland, for political opinions sake which, as your committee conceive, no direct interest of the company either required or demanded.
>
> In addition to these views already presented, there are other matters which might be adverted to if the time allowed for this report would permit, which go strongly to induce this committee to believe that the affairs of the canal company have been most unfortunately managed.

The stockholders of the C&O were numerous with large blocks of stock held by the U.S. government, the State of Virginia, and the cities of Alexandria and Georgetown. Even with these large blocks of stock, the holders working together were still unable to affect changes in corporate management when it was deemed necessary.

Large Stockholders: In the presence of large shareholders, agency problems may be reduced but not eliminated. Shareholders with over 10% of the outstanding stock of a company have more incentive to monitor company management. A substantial minority shareholder has enough voting control to put pressure on or even remove management [Shleifer and Vishny, 1997]. A current example would be the California retirement system (CALPERS) that picks a few companies each year to contact about corporate changes. Unfortunately, CALPERS is the exception not the rule. Most large-block holders are free riders and do not monitor company management.

Large shareholders will under-perform the monitoring and intervention activities and may use their voting power to improve their own position at the expense of the other shareholders [Hart, 1995; Shleifer and Vishny, 1997]. One reason identified by Hart for the under-performance of large stockholders includes their using their voting power to improve their own position at the expense of the company. Also, large stockholders can be persuaded not to confront management in exchange for a promise to have their shares repurchased at a premium (greenmail). Hart mentioned one additional problem with large stockholders that more clearly relates to the C&O. The problem is that a large institutional shareholder must hire a representative to act on its behalf. As stated above, Maryland controlled more than 50% of the stockholder voting rights. However, aside from selecting company management each year, the state maintained a *laissez faire* attitude toward the operations of the company.

Information regarding a large stockholder working for reasons of self-interest was also illustrated by the C&O. In 1841, the Maryland legislature passed a bill to provide additional funding requested by the company for completion of the canal. Before the funding was made available to the company, the stockholders had to ratify the provisions of the bill. When the resolution was presented for a vote at the stockholders meeting, Maryland voted for the resolution with all other stockholders against. The bill thus passed included a clause that the other stockholders found objectionable. This section contained wording requesting that the state's attorney general begin proceedings against the company for failure to pay interest on previously loaned money. Since the previous loan included a mortgage of corporate assets, the stockholders were afraid that the state would foreclose on the company and leave them with nothing. The state ended up lending the company the money without taking legal action to collect amounts past due. Maryland used its voting power to further its own agenda. Politicians of the state also used the company to further personal political ambitions and agendas as indicated in the previous section of the paper.

Maryland held ownership control but did not exert it day-to-day. Rather, it limited its role to appointing members of the Board of Directors each year. At a constitutional convention, the delegates considered taking operational control of the company, but in the discussion of this issue, the delegates indicated that this was beyond the scope of state government [Wilner, 1984].

Limitations of the Corporate Board of Directors: Stockholders elect a board of directors to monitor corporate management. In his discussion of a board of directors, Hart [1995] lists four shortcomings of the board as a monitoring device. The first limitation is that some board members are corporate officers and that self-monitoring is not effective. The C&O did not have corporate officers as board members so there is no illustrative evidence of this issue present. The second limitation is that board members may not have a financial interest in the company and therefore have little to gain by the success of the company. In the beginning, the C&O board was populated by stockholders. All of these individuals had a vested financial interest in the success of the company. After Maryland acquired voting control in 1836, board members were selected by the state for more political reasons. Most of these individuals had no financial interest in the company. The third limitation is that board members are busy persons and have little time for company business affairs. In the 1800s when travel was more time consuming and difficult than today, this problem was a greater issue. The board members were paid a salary and travel expenses (limited in 1879), but these were political gentlemen more interested in political than financial gains. The last limitation is that directors may owe their positions to company management and may be more loyal to management than to the stockholders they are to protect. In the case of the C&O, the directors and the company president were political appointees, selected as much for their political party association as for their business savvy. These individuals owed their allegiance to the president far more than to the stockholders.

In the second half of the 19th century, the members of the C&O Board of Directors were all political appointees. None of the board members held company stock and, thus, had nothing to gain personally from company success. The only gain they would receive was political. All of these issues, in the case of the C&O, led to the company having a Board of Directors with little to gain by the company's success. It is apparent from archival evidence that President Gorman used the company to further his own political future. Gorman hired persons and chose contractors to gain favor with the individuals he needed in the future to reach higher political office [Lambert, 1953]. After eight years as president of the C&O, Gorman was elected to the U.S. Senate, representing the State of Maryland. The Board of Directors owed their allegiance to the political party more than to the C&O. For this reason, one could conclude that the board did not monitor the actions of the company president as closely as perhaps they should have. Without close monitoring by the board of directors, company management is free to pursue its own goals. The following section provides a discussion of this topic and the consequences that resulted in the case of the C&O.

Potential that Management will Pursue its Own Goals: As stated earlier, President Gorman used his office to further his political ambitions. Further evidence is demonstrated by the fact that many board meetings during his tenure were held in Baltimore, the home of the B&O, the C&O's chief competitor. The B&O was a rival for funding, route, and customers. Gorman spent company money on travel, hotels, and entertainment for himself and C&O board members to have its board meetings in Baltimore. Gorman was not a Baltimorean, the C&O offices were in Annapolis, and the City of Baltimore and its residents provided little, if any, support for the canal. However, Baltimore was the center of political power in Maryland.

Existing evidence indicates that Gorman used the C&O to further his personal ambitions. In 1880, the C&O was sued by a holder of mortgage bonds. The lawsuit [1881] alleged that Gorman was using his position as president to further his political ambition at the expense of the bondholders. The suit alleged that Gorman had political agents on the company payroll and employed numerous "worthless" persons to further his political ambitions [Lambert, 1953].

The corporate governance issues presented by Hart [1995] existed in a 19th century corporation. C&O stockholders identified and addressed these corporate governance issues. It is manifestly clear that agency problem existed.

Hart argued that in the presence of agency problems and incomplete contracts, corporate governance matters greatly. Therefore corporate governance would be vital at the C&O since the company did not have a contract with the corporate president and severe agency problems existed. The next section of this paper discusses how the C&O shareholders used a stockholder review committee to force corporate officers and directors to address the problems presented by the limitations on corporate governance.

STOCKHOLDER AUDIT

As mentioned previously, the C&O annually created a committee of stockholders to review the annual report of the president and directors. The Middlesex Canal of Massachusetts[4] also used stockholders to perform the audit function [Kistler, 1980]. In her article on the Middlesex Canal, Kistler revealed that the stockholders of that company appeared to have reviewed all transactions. However, she also noted that the review performed in 1830 was completed in only one week and commented that it is doubtful that much work could have been performed in such a short period of time, leaving doubt as to the thoroughness of the audit. The archive of the Middlesex Canal Company does not provide any additional information about the these audit efforts.

The C&O review committee left more detailed information regarding the thoroughness of its audit efforts. The C&O committee recognized the limitations of auditing. In 1838, the committee reviewing the annual report made the statement that it could not review all transactions in the time period allowed, but that this did not seem necessary since the board had approved all requisitions for payment. Therefore, the committee reviewed the requisitions issued for disbursements, examined the books of the treasurer and company clerk, and found these to be satisfactory [C&O, 1836-1841, pp. 176-177].

For the year 1839, the committee, in making comments about estimated figures on the financial statements, made this further observation [C&O, 1836-1841, p. 291]:

[4] The Middlesex Canal was a contemporary company of the C&O. The Middlesex was founded in 1793 and had a similar corporate governance structure.

> From these causes the statements may be found to require some variation but although not exact, the sub-committee are induced to believe, that they are at least proximately correct in the available basis that they exhibit for the demands of the current year.

This limited endorsement did not keep the sub-committee from admonishing the company officers when irregularities were encountered.

Over the life of the C&O, the stockholders reviewing the company finances made numerous observations and recommendations. The first recommendations for change came in 1834, when the review committee requested four changes in the manner in which the company kept records and reported to the stockholders. The first request was that requisitions for salaries and services state the time period for which the recipient was receiving pay and the capacity in which the person had served the company. The second request was that changes be made regarding the presentation of financial statements. Previously, for instance, the treasurer's report consisted of one statement showing total receipts and expenditures to date for the company. The recommendation of the committee was to present a separate column for the current-year information. The review committee also requested that expenses for repairs be accounted for and reported separately from expenses for canal construction. Finally, it requested that a statement showing the volume of goods transported on the canal be presented [C&O, 1828-1835, pp. 361-362].

In 1839, the committee observed that the clerk's statement showed other receipts in the amount of $11,175.58 arising from such things as tolls, rents, etc. collected by the several superintendents that had been subsequently used and accounted for in the service of the company. Consequently, these receipts had not passed through the books of the treasurer [C&O, 1836-1841, p. 289]. The review committee asked that this process be terminated and that all receipts and expenditures be passed through (entered into) the treasurer's books. The committee commented that the practice of allowing superintendents to spend money without an accounting of the money in the company records "seems irregular and inconvenient."

Two stockholders meetings were held in 1841. At the April meeting, the stockholder review committee admonished the company, claiming that the statement of debts and credits of the company presented by the president to the stockholders was incorrect and could not be relied upon. The committee then observed that it was unable to present any satisfactory view on the financial statements [C&O, 1836-1841, pp. 415-416]. The committee further claimed that the company bylaws required that the company treasurer present financial reports at each monthly board meeting and that this reporting had not been done since the current treasurer had been in office. The committee made several statements regarding individual transactions such as the sale of bonds issued by Maryland for stock subscriptions. The committee argued that the manner in which the sale was handled cost the company a substantial amount of money. As a result, the stockholders removed the company president, treasurer, and directors from office and replaced them with a new slate of corporate officers.

At the August 1841 stockholders meeting, the committee, after further review of the company records, presented additional problems with the records. The committee made the observation that several irregularities in vouchers were traced to a disregard of company policy by the former company president. The committee also stated that during the five months leading up to the change in officers, no accounting entries had been entered in the company books.

In 1845, the review committee made the following observation about the company's method of bookkeeping and requested that it be changed [C&O, 1842-1846, pp. 488-489]:

> They find that under the directions given to the treasurer, and in accordance with the custom, which has heretofore prevailed in the company, payments have been made for more than one purpose on the same warrant and the whole payment charged under the head of the principal item for which the warrant was drawn.
>
> In consequence of this circumstance the abstract of receipts into and payments from the treasury instead of exhibiting the actual condition of the affairs of the company in its items as well as in its final balances, only show the amount charged in the treasurer's books under each head in the abstract instead of the whole amount of expenses properly chargeable under that head. Thus under the head of pay of lockkeepers, it appears by abstract that the amount paid in 1845 was $627, whereas by reference to the accounts of the company it is found that the whole amount properly chargeable under this head is $7,801.00.

In 1855, the corporate office staff was fired and replaced with political appointees. The 1856 review committee disagreed with these organizational changes and stated so in their report to the stockholders. The review committee further averred in their report that the office staffers who had been fired were competent individuals and that their replacements were incompetent. In 1856, a new slate of corporate officers had been elected the prior year. The new corporate officers reinstated the former office staff and organization. The 1857 review committee commented that they were grateful to see the former organization of corporate officers restored.

After the canal construction was completed to Cumberland, Maryland in 1850, the review committee was less involved in reviewing the actions of the president and directors and more concerned with the review of the company finances. Subsequent to 1857, the review committee made no further admonishing remarks about the company operations or finances.[5]

Political Problems: As previously noted, the C&O became a politically controlled company. In this political environment, there existed the potential for political favors to override the stockholder reviews. In 1829, the stockholders established the process for the selection of committee members. The stockholder resolution stated that the review committee would be staffed with a representative from Virginia, Maryland, the U.S., and the cities of Alexandria, Washington, and Georgetown, each of which had purchased large blocks of stock in the company. The balance of the committee would include members selected from other stockholders in attendance.

This stockholder audit practice continued until the company ceased to exist in 1889. During the last 30 years of the company's existence, no review committee reported any error or misstatement.

In the 1881 bondholder lawsuit, the verdict provided stated that there were excessive expenditures for travel and entertainment but that the company should not be placed into receivership. For these reasons, one is left to assume that the review committee examined transactions to insure that the transactions were correctly documented. It appears that the committee did not consider the transactions to determine the legitimacy of the expenses. A statement made by the review committee in 1837 further illustrated this point. The committee reported that the magnitude of expenses paid and charged to the contingent fund

[5] An examination by the authors of the review committee reports subsequent to 1857 found no additional admonishing comment about the company.

(miscellaneous expense) far exceeded that of the previous year. After presenting the transactions that represented the greatest amount of these expenses, the committee made the comment that they were not charged with testing the legitimacy of the payments and, therefore, had no opinion to render regarding the necessity of the payments made. They further commented that the payments were authorized by the board [C&O, 1836-1841, p. 130]. This denial illustrates the shortcoming of the C&O's review committee's practice.

The practices of the review committee had the shortcoming of not identifying problems relating to the magnitude of expenditures, but the committees did reveal and recommend changes in internal control and company reporting practices. The individuals performing these financial reviews were not trained auditors, but they were still able to recognize problems and recommend changes which the corporate officers placed into service.

CORPORATE GOVERNANCE EVOLUTION

The model of corporate governance that existed at C&O was similar to other corporations during that era and beyond. Theoretically over time, capital-market investors required a reasonable accounting for the use of their capital. For example, in early 19th century development companies, such as the PC, individual investors were directly involved in both the supply of capital and in the management of companies. Corporate governance techniques for several of these early companies included assurance in the charter of the publication of an annual report and the agreement among selected shareholders to serve as members of an audit committee [Russ et al., 2006].

Railroads and later larger corporate entities drew from an expanding capital market made possible by communication improvements, such as the telegraph which linked cities and capital investors. Thus, individual and merchants served as "bankers" of investment funds. Interstate investment required the use of legal vehicles such as "trusts" to assure that accountabilities and "reasonable" control of information could be achieved. In the last quarter of the 19th century, industrial expansion, abetted by the creation of corporate holding companies and the rise of investment banking houses such as Morgan and Schiff, produced a greater concentration of funds and greater public concern regarding the management of those funds.

In states such as Massachusetts, the response was to form public railroad commissions, headed by leading citizens such as Charles Frances Adams of the famous presidential family. Adams and his brother Henry also introduced public commentary by writing about the abuses of corporate railroad management, such as their essay on the Erie Railroad and the alleged manipulations of this *laissez faire* era attributed to Gould, Fisk, and Drew. Public concerns were addressed, in part, by the notion of "disclosure" being required of transportation companies which operated interstate. The Massachusetts Commission, known as the Sunshine Commission, became the model for the Interstate Commerce Commission, established in 1887, which required the filing of information about the operations of carriers.

A new accounting profession launched with the passage of the CPA designation in l896 spread across the country in the next three decades. Disclosure, exemplified in the reports of U.S. Steel, sought to address public concern, and journalists paid extensive attention to corporate abuse. Collectively, these efforts were the response to public and private concerns that capital providers be given a reasonable accounting about the use of their capital.

The notion of boards of directors serving as the ultimate manager of corporations and representing individual owners, community members, merchant bankers, and capital providers while countering the power of professional management, became the mode as corporations in transportation and industry continued to grow in economic importance.

Chandler [1977] documents the rise of a professional management class in the early 20th century, describing how their power to allocate resources constituted a "visible hand" that often, if not effectively, replaced Smith's "invisible hand." With this era came a loss of proprietary involvement in major corporations and a rise of contractual management and investor relationships which can be called the "agency era" as documented by Berle and Means [l932].

Berle and Means' work began a modern era of public concern over the relationships among capital providers, proprietors, and managers, well documented in the writings of Shleifer and Vishny [1997]. From the beginning of the 19th century through the rise of agency governance concerns, a core theoretical concern remained to provide for a reasonable accounting for the use of their capital. During this time period, the corporate governance structure remained essentially the same. The greatest change over the 200 years of history was the increasing distance between the stockholders and management.

SARBANES OXLEY

In 2002, Congress passed the Sarbanes-Oxley Act (SOX) in response to corporate failures including, most prominently, Enron and WorldCom. SOX was designed to, among other things, strengthen corporate governance. While SOX has made some statutory changes to our corporate governance system and strengthened the board of directors, issues still remain. SOX does not eliminate the agency problem of corporate management, but it does make corporate management criminally liable for corporate reporting. Individual stockholders are still unable to exert control over the companies that they own, while large stockholders are not required to monitor the companies in which they hold stock. SOX has made improvements, but there is still much room for corporate governance issues to arise.

It will take time before it can be known if SOX has had an effect on corporate governance today. In the case of the C&O, there are some areas where SOX could have made a difference. In the later years of the company, the stockholder review committee did the job and made no comments. The largest corporate governance failure at the C&O appears to have been during the 1870s when President Gorman ran the company to feather his own nest as much as to enhance the well-being of the company. Gorman was elected to the U.S. Senate while serving as president of the company. The corporate bondholders sued the company in 1881, alleging that the company was being used to further his political ambitions. The corporate responsibility section of SOX requires company management to be held responsible for the company's financial statements. No one questioned the financial statements of the C&O; however, the bondholders did question the financial management of the company. If SOX had been in place in the 1870s, it could have encouraged the directors to a greater diligence in policing the expenditures of President Gorman.

CONCLUDING COMMENTS

Corporate governance as it existed in the early 19th century has not changed significantly from what exists today. While the distance between stockholders and management has increased over time, corporations have always been faced with managing absentee ownership and the related concerns surrounding the provision of proper assurance and disclosure.

This paper provides support for the theoretical framework of corporate governance presented by Hart [1995] by presenting evidence from a 19th century company. In this regard, the issues presented by Hart are not considered new, but were manifested and were acted upon in an early corporation. In this paper, a "modern" theory was applied to a 19th century company. A theory of this nature, or any other theory, should stand the tests of time, tested by both contemporary and historical data. If the concept stands up to the tests of time, then it gains in acceptance; when it fails the tests of time, it loses acceptance. Are matters relating to 19th governance comparable to the modern era? Theoretically, they are the same issues. The first corporations struggled with the idea of absentee ownership as corporations do today. The example used in this paper is of a company struggling to develop a corporate governance system that would be taken for granted today. The founders of this company did not have a roadmap to follow in starting the corporation. The PC/C&O was one of the first American corporations.

In summary, Hart states that agent contracts cannot be comprehensively written. The C&O did not have an employment contract with the president of the company. The stockholders controlled the president's actions by resolutions made at the annual stockholders meetings. As new issues arose, the stockholders adopted new resolutions to restrict or control the president.

Second, Hart felt that when individual stockholders are too numerous, a failure to exert control over the actions of corporate officers exists. In the late 1700s, the PC/C&O established a corporate governance structure similar in many ways to the structure used today. One difference between the C&O's and modern structures is the use of independent auditors to review the finances of the company today. The C&O used a committee consisting of stockholders to perform the audit function and to review the actions of the president and Board of Directors.

Third, Hart contended that large stockholders will "free ride" instead of actively participate in the monitoring of corporate management. In the case of the C&O's largest stockholder, Maryland, participation in corporate management was no greater than the participation of other stockholders, even with Maryland's much larger investment to protect. The state not only failed to monitor at a level associated with the investment at risk but allowed company management to pursue political gains at the company's expense. President Gorman was accused of using the company to further his own political career. In the lawsuit brought by a bondholder alleging mismanagement, the court did not find mismanagement but found only that the company was spending unnecessary money. The court did not give control to the bondholders but did appoint a court monitor to review future company spending.

Next, Hart [1995] presented four limitations of a board of directors. This paper provides support for three of the four limitations: board members may not have a financial interest in the company, board members have little time for company affairs, and directors may owe their position to company management. After Maryland gained controlling interest of the company, the C&O Boards of Directors were selected based on political party affiliation rather than for business reasons. Each subsequent change in the majority political party in the statehouse resulted in a new president and Board of Directors. For this reason, the board members were not stockholders and had no financial interest in the success of the company. The board was more loyal to the company president (a fellow political appointee) than to the company stockholders. The actions of the board, while not explored in this paper, were probably more politically than profit motivated for the reasons set forth above.

The last corporate governance issue presented by Hart is that the potential exists for managers to pursue their own interest at the expense of the company. In his paper describing Arthur Gorman as a political party boss, Sanderlin [1947] observed that Gorman used his position as president of the C&O for his own political gain. The 1881 bondholder petition provides additional support for the case that the presidents of the C&O used the office for political purposes. As stated, it is felt that Gorman used his position as the company president to assist in his election to the U.S. Senate [Sanderlin 1947].

Shleifer and Vishny [1997] write that most advanced market economies have reasonably solved the problem of corporate governance, but this does not mean that the current systems of corporate governance cannot be improved. The issues raised by Hart indicate weaknesses in the corporate governance structure used today. Examples of today's corporate failures provide evidence that improvements could and should be made. In the U.S., more requirements are being made for outside directors to strengthen corporate governance. Maybe we can learn from history and find additional solutions to corporate governance problems that have been lost in time. In the U.S., the distance between managers and providers of capital increases the agency problem [Shleifer and Vishny, 1997]. Managers have greater discretionary power over the allocation of corporate resources than might otherwise be the case if owners were actively involved in corporate affairs.

In the case of the C&O, the stockholder review committee gave the providers of capital, the stockholders, a more active involvement in corporate management. Since companies that draw on the experience of the stockholders will be more efficient [O'Sullivan 2000], the model of a stockholder review committee utilized by the C&O might well be utilized in corporate governance today.

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APPENDIX 1

List and Location of Annual Reports for the Chesapeake and Ohio Canal Company for the Period of this Study: 1829-1889

Number	Year	Location	Number	Year	Location
1	1829*	Library of VA	31	1859	UVA
2	1830	Library of VA	32	1860	UVA
3	1831	Library of VA	33	1861	MD Law Library
4	1832	Library of VA	34	1862	MD Law Library
5	1833	Library of VA	35	1863	MD Law Library
6	1834	Library of VA	36	1864	UVA
7	1835	Library of VA	37	1865	MD Law Library
8	1836	Library of VA	38	1866	NARA
9	1837	Library of VA	39	1867	UVA
10	1838	Library of VA	40	1868	UVA
11	1839	Library of VA	41	1869	Report not located
12	1840	MD Law Library	42	1870	U Mich
13	1841	MD Law Library	43	1871	MD Law Library
14	1842	MD Law Library	44	1872	MD Law Library
15	1843	Library of VA	45	1873	MD Law Library
16	1844	MD Law Library	46	1874	MD Law Library
17	1845	MD Law Library	47	1875	MD Law Library
18	1846	MD Law Library	48	1876	Madison
19	1847	MD Law Library	49	1877	MD Law Library
20	1848	MD Law Library	50	1878	Madison
21	1849	MD Law Library	51	1879	MD Law Library
22	1850	MD Law Library	52	1880	Madison
23	1851	MD Law Library	53	1881	Madison
24	1852	MD Law Library	54	1882	Madison
25	1853	MD Law Library	55	1883	Madison
26	1854	UVA	56	1884	Madison
27	1855	MD Law Library	57	1885	Madison
28	1856	UVA	58	1886	MD Law Library
29	1857	Report not located	59	1887	Madison
30	1858	UVA	60	1888	Report not located
			61	1889	NARA

NARA: National Archives and Records Administration, College Park, Maryland
MD Law Library: Maryland State Law Library, Annapolis, Maryland
Library of VA: The Library of Virginia, Richmond Virginia
UVA: The University of Virginia Library
Madison: Wisconsin Historical Society
U Mich: University of Michigan
* The C&O broke ground in 1828, and the first annual report was presented at the end of the first year of operations in 1829.