

CHAPTER Ch

Business Organization

Editor: Naomi R. Lamoreaux

BUSINESS ORGANIZATION

Naomi R. Lamoreaux

Before one can count the number of elements in a set, one has to be able to specify clearly how the set is defined and how its elements can be distinguished from those of other related sets. In the case of business enterprises, these are not easy tasks. Even if one accepts the apparently simple and commonsense notion that businesses are undertakings that have as their purpose the generation of profits, there are all kinds of knotty theoretical issues to be confronted – most obviously the question of whether the set of business enterprises is identical to the set of “firms.”

Theoretical Issues

When business history first emerged as a subdiscipline during the second quarter of the twentieth century, practitioners implicitly treated business enterprises and firms as if they were the same. Thus, N. S. B. Gras, the scholar generally regarded as the field’s founding father, stated boldly in 1934 that business historians should devote themselves to writing “the collective biography of firms, large and small, past and present” (Gras 1934, p. 385).¹ What exactly he meant by the term “firm” was not clear, however, and scholars who worked in this tradition sometimes misclassified enterprises. For example, James B. Hedges wrote about some of the early Brown family trading ventures as if they were formal partnerships, whereas they now appear instead to have been informal long-term relationships (Hedges 1968a, 1968b).²

¹ For a discussion of Gras’s founding role, see Sass (1986), pp. 41–6.

² This approach to business history has recently been criticized by Angel Kwolek-Folland, who found it necessary to extend the term “business enterprise” beyond relationships conventionally thought of as firms in order to include the activities of women (Kwolek-Folland 1998, p. 5). Intriguingly, Hedges’s focus on firms not only caused him to make classification errors but also, as the recent reprocessing of the Brown family’s papers (led by Joyce Botelho at Brown University) has shown, to miss the important economic role played by Brown women. See the extended discussion on H-Business, an Internet forum devoted to topics in business history, about whether the firm

Acknowledgments

Naomi R. Lamoreaux thanks the many colleagues whose comments helped her conceptualize this essay. These include Ruth Bloch, Lance Davis, Stanley Engerman, Louis Galambos, Stephen Haber, David Lamoreaux, Kenneth Lipartito, John Majewski, Gregory Mark, Jean-Laurent Rosenthal, David Sicilia, Kenneth Sokoloff, John Wallis, and Mary Yeager. She is grateful for the research assistance of Juliette Levy, Victoria Nayak, and Andrea

Gras’s injunction that business historians should study the operation and organization of firms received explicit theoretical grounding with the publication in 1959 of Edith Penrose’s *The Theory of the Growth of the Firm*. In this study, Penrose deliberately broke with the neoclassical view that essentially reduced firms to equation-solving entities that maximized profits by equating marginal revenue and marginal costs. As she pointed out, this conception of the firm “was constructed for the purpose of assisting in the theoretical investigation of . . . the way in which prices and the allocation of resources among different uses are determined” – that is, the way in which markets worked. Penrose postulated, by contrast, that firms were fundamentally different from markets and were, in fact, an alternative means of economic coordination. Whereas markets coordinated economic activity through the price mechanism, firms accomplished the same task administratively. The difference was an important one because administrative coordination was subject to improvement – firms could learn how to accomplish their tasks more efficiently. Moreover, as firms became better at coordinating economic activity, they could expand the scope of their responsibilities. The implication of Penrose’s theory, therefore, was that, over time, as the coordination abilities of firms increased relative to the price mechanism, more and more economic activity would move within firms (Penrose 1959, especially pp. 9–30).

Two decades later Alfred D. Chandler Jr. took this basic idea and made it the core of his synthesis of American business history. Chandler argued that Penrosian-type administrative capabilities provided coordination mechanisms that were superior to the market in certain important types of industries. As he saw it, in the most capital- and energy-intensive sectors of the economy, firms that were able to maintain a large volume of throughput had a competitive advantage. They obtained this advantage in part by building plants large enough to capture economies of scale, but more importantly, they learned to substitute “the visible hand of management” for the invisible hand of the market. By integrating vertically – backward into raw materials to avoid supply bottlenecks and forward into marketing to assure themselves an outlet

was a “fiction” that obscured as much as it revealed about business enterprises (begun on August 31, 1999, with the posting of Mary Yeager’s review of Kwolek-Folland’s book, archived on the EH-Net Internet site).

Maestrejuan; for the ongoing support and helpful comments of Susan Carter, Richard Sutch, Matt Sobek, and Monty Hindman; and for financial assistance from the All-UC Economic History Group. Fellowships from the National Endowment for the Humanities and the American Council of Learned Societies enabled her to take leave from teaching to pursue the research underlying this chapter.

for their product – and by investing in a managerial hierarchy that could coordinate the flow of product from raw material to final sale, they improved upon the workings of the market, captured the resulting efficiency gains, and reaped enormous competitive advantages. The only firms that could compete with them were ones that completely duplicated their vertically integrated structures and managerial hierarchies. Because of the enormous investment such duplication required, these kinds of industries came to be dominated by small numbers of very large firms (Chandler 1977, 1990).

Chandler's view of the dynamic of American business history obtained reinforcement from two new bodies of economic theory that emerged at approximately the same time. The one that was closest in spirit to what Chandler was trying to do was the evolutionary economics of Richard Nelson and Sidney Winter (Nelson and Winter 1982). Nelson and Winter took as their starting point the Penrosian notion that the essence of firms was the capabilities they built up over time. They argued that particular ways of coordinating economic activity – the term they used was “routines” – became embedded in the structure and culture of an enterprise. Routines became established in the first place because they worked. An enterprise innovated in a particular way, achieved good results, and then attempted to build on its success by expanding the same or similar practices to other areas. Firms that came to dominate their industries succeeded because their organization-specific capabilities had proved adaptive in an evolutionary sense. Moreover, because these capabilities typically depended on considerable firm-specific knowledge and attributes, competitors found them difficult to copy. Successful imitation involved replicating not only a product or production process but also the entire system in which it was embedded – something that it was extremely difficult for other firms even to learn about, let alone do. Thus, the learning – the routine building – that individual firms engaged in over time was an important source of sustained competitive advantage.

The second theoretical tradition that reinforced Chandler's synthesis was the so-called transaction-cost theory of the firm. This view harked back, not to Penrose, but to Ronald Coase's classic 1937 article, “The Nature of the Firm.” Coase's starting point was the question why all economic activity did not occur through market exchange – why some of it was “managed” within firms. He reasoned that certain kinds of transactions were difficult to conduct in the market because they involved writing contracts that anticipated a myriad of possible contingencies. In such cases, economic actors could reduce their transaction costs by entering into more general, long-term contracts that gave one of the parties discretionary authority over the others. These contracts, Coase argued, were the essence of those entities that we call firms. During the 1970s, a number of scholars began to reinterpret and extend this view. They retained Coase's observation that firms existed to economize on transaction costs, but they tried to give this insight more explicit content by exploring the particular kinds of exchanges that were likely to be characterized by high transaction costs.³ For example, Oliver Williamson analyzed exchanges where one party had to make investments that were highly specific to the transaction. Because the resulting assets could not readily be used for other

purposes, the party making the investment was susceptible to being held up – that is, to undue pressure to lower prices. Because it was extremely difficult to write contracts that would eliminate this risk, a straightforward way to elicit the desired investment was to integrate vertically – that is, to bring the asset within the bounds of the firm (see Williamson 1995, pp. 52–6). Williamson thought that this argument provided an effective theoretical underpinning for Chandler's view that, in capital- and energy-intensive industries, the visible hand of management provided a coordination mechanism that was superior to the invisible hand of the market, and in an article published in the *Journal of Economic Literature*, he undertook to translate Chandler's scholarship into the language of transaction costs (Williamson 1981).

None of these theories, however, offered a clear set of criteria for distinguishing firms from other kinds of business relationships. Any time economic actors are involved in a long-term relationship, whether it be organized formally or informally, they can engage in learning that makes them better able to coordinate their activities and expand the scope of their ventures. Should we include all such long-term relationships in the category of firms? Transaction-cost theorists like Steven Cheung have argued that logically there is no other choice. To illustrate the difficulty of the problem, Cheung posed the following question. Suppose an orchard owner contracted with a beekeeper to pollinate his plants. Did the contract create a new firm, or should the contract be conceptualized as binding two preexisting firms? Cheung argued that the question had no clear answer. Most economists, he suggested, would reply that there was one firm if the beekeeper agreed to work for wages but two if the contract took some other form – for example, an agreement whereby the orchard owner rented the hives. But he questioned whether this answer made sense – whether it was at all useful to make one's count of the number and size of firms dependent on the precise form of the contract between the parties involved. Furthermore, he pointed out, the count was likely to be different depending on whether the orchard owner rented the hives from the beekeeper or whether the beekeeper rented the orchard from the owner. Thus, Cheung concluded, “it is futile to press the issue of what is or is not a firm.” The important question is “why contracts take the forms observed and what are the economic implications of different contractual and pricing arrangements” (Cheung 1983, pp. 16–18).

The question of what is and what is not a firm, however, is not a purely economic one. Even if one accepts Cheung's claim that it is impossible to draw up a set of economic criteria that distinguishes firms from other kinds of contracts, one nonetheless has to recognize that the distinction is a very real one from the standpoint of the legal system. As Peter Behrens has pointed out, the law differentiates between those parties to a contract that are risk bearers and those that are not, and effectively defines a firm in terms of the former group (Behrens 1985, p. 73). That is, the law delimits the set of contracts that will bear the designation “firm.” More important, businesspeople do not in fact have complete freedom of contract when they organize their enterprises. The legal system effectively constrains the kinds of contracts that businesspeople can write by sorting them into categories – for example, ordinary contracts versus firms; and within the category of firms, partnerships, limited partnerships, corporations, and so on. Furthermore, the contracts that the legal system designates as firms have associated with them standard sets of terms, and these terms often dominate, even when they are contrary to the provisions that businesspeople actually

³ For a survey of the literature that developed from Coase's initial insight, see Eggertsson (1990), especially Chapter 6.

write into their agreements. For example, the corporate form entailed a governance structure based on majority rule by stockholders, even though members of small corporations with closely held shares might prefer another type of voting system. At least until the post-World War II period, however, there was substantial risk that agreements based on alternative governance structures would not be enforced by the courts. (For examples, see Schwartz 1965, pp. 66–7. See also Weiner 1929, pp. 275–7.)

For the purpose of counting business enterprises, there are a couple of important implications to draw from the preceding discussion. First, such counts as we can make of the number and types of business enterprises must be based on legal rather than economic definitions of firms. There is not (and never has been) any general requirement in the United States that contracts be recorded and preserved. Hence, even if one accepts Cheung's argument that firms are indistinguishable from other types of long-term business relationships, it is not possible to get a count (or even any reasonable estimate) of the number of such contracts in effect at any given point in time. For the nineteenth century, the only business enterprises that it is possible to count are those for which legislatures required some kind of public registration or notice. During the early years of the century, the grant of a corporate charter required a special act of the legislature, and the result was a paper trail that is fairly easy to track (see Table Ch380–391). Similarly, the general incorporation laws that state legislatures subsequently passed in large number enabled any group that met specified statutory requirements to obtain a corporate charter but required that the corporation register (and pay fees) at the office of the Secretary of the State. Scholars have used these records to compile figures on the number of corporations chartered over time (see Table Ch293–318). Moreover, it should be possible, though it has not been done, to establish for at least some states the number of corporations that were active on a year-by-year basis. Limited partnerships also had to register in order to secure their limitation on liability. Unfortunately, because the requirement applied at the county level, and because these registrations typically were interspersed in local record books with other, more voluminous types of contracts (like deeds), the limited partnership form is very difficult to track and little effort has been made to establish its incidence (for one attempt, see Howard 1934). Ordinary partnerships are even harder to count because their contracts did not have to be registered. The law did, however, require partnerships to publish notices in local newspapers announcing their dissolution and any changes in the identity of their members. In theory, it should be possible to use a combination of newspapers and city directories to obtain estimates of the number of partnerships in operation in particular localities, but again this work has not yet been done.⁴

The ratification of the Sixteenth Amendment to the Constitution (income tax) in 1913 made more complete counts possible (see, for example, Table Ch1–18) because Congress used the standard legal forms of organization to sort businesses into different tax categories. Thus, the Internal Revenue Service (IRS) taxes corporations and individuals at different rates. Although partnership

⁴ For studies using city directories alone, see Lamoreaux (1997). The manuscript Census of Manufactures can provide counts of the number of enterprises on an industry-by-industry basis, but breakdowns by organizational form are problematic because classifications have to be made on the basis of the firm's name (Atack and Bateman 1995). A potential source is the records of firms compiled by R. G. Bun & Co. (see Table Ch408–413).

profits are taxed as income earned by individual partners, the IRS requires partners to submit information about the firm and its expenses and revenues along with their individual returns. The income tax system has also made it possible to obtain estimates of the number of single proprietorships because individuals who operate their own businesses can deduct costs from revenues if they file a separate business schedule along with their returns. Unfortunately, many individuals who are full-time employees also file these schedules (university professors, for example, often report income from their writing as a separate business), and so these numbers are inflated by the inclusion of many such part-time activities.

The second important point to make is that the proportion of enterprises taking one or another of these standard legal forms has been affected over the years by government actions that have altered the relative desirability of these different ways of organizing business activities. The most obvious example is tax policy. Since World War II, changes in the level of corporate tax rates relative to the top individual brackets have stimulated businesses first to shift toward the corporate form and then away from it (see, for example, Petska and Wilson 1994; Petska 1996). But changes in the terms associated with the standard legal forms of organization have also affected businesspeople's choices. For example, until the late twentieth century, a business enterprise had to organize as a corporation in order for all of its members to obtain the advantage of limited liability. But organizing as a corporation meant perforce adopting other provisions that could operate to the disadvantage of some of these members. Take, for example, the case of a small business. If it organized as a partnership, members who were dissatisfied with the actions of the other partners could move to dissolve the enterprise, even if they were in the minority. Because such an action raised the specter of liquidation, an outcome that could impose serious costs on all the members of the firm, this threat provided an incentive for the parties to resolve their differences in a mutually satisfactory way. This incentive did not exist, however, in the case of small corporations. Because the corporate form concentrated power in the hands of the majority, minority stockholders who were disadvantaged by the way the business was proceeding could do little to remedy the situation. Nor typically could they exit by selling their shares because small firms' securities were not normally sold on the market and thus lacked liquidity, and because investors would not be eager to buy a minority position in a company where there was already dissatisfaction about the policies of the majority. Hence, until their legal options changed during the late twentieth century, participants in small businesses who were considering adoption of the corporation form had to weigh the advantages of limited liability against the risks associated with becoming minority shareholders (Lamoreaux 2004).

The sections that follow trace over the course of U.S. history the ways in which governments have affected the menu (and relative attractiveness) of the main organizational forms available to businesspeople. As will be shown, although governments have sought to reduce uncertainty in the capital markets by maintaining clear legal definitions for the various forms, from time to time these definitions have themselves become a source of uncertainty and thus an impetus for change. At other times, governments have acted to revise the choices open to businesspeople in response to political pressures. Although in the early period these pressures were mainly associated with democratization, more recently they have been generated by the search for favorable tax treatment.

Proprietorships and Partnerships

The dominant form of enterprise during the early nineteenth century was the single proprietorship – that is, a business owned by just one person. This form of enterprise is still numerically preponderant. In 1997, for example, the Internal Revenue Service reported that there were more than 17 million nonfarm proprietors in the United States, as opposed to fewer than 2 million partnerships and fewer than 5 million corporations. Single-owner businesses, however, accounted for a smaller share of total economic activity than either of these other two forms. In 1997, their total receipts were about \$870 billion as opposed to more than \$1,500 billion for partnerships and more than \$16,600 billion for corporations (see Table Ch1–18 as well as Figure Ch-A).

Proprietors enter into contractual relationships with other individuals or firms for a variety of purposes. For example, they often hire workers on wage contracts and borrow money from lenders on debt contracts. But proprietors are the sole residual claimants on the profits of their enterprise. Indeed, it is this characteristic that at law has distinguished proprietorships from partnerships, which have two or more residual claimants.

The partnership form of organization has a long history that can be traced back to Greco-Roman times (Lopez 1976, p. 74). Given all of these centuries of experience, one might think that the boundary between partnerships and proprietorships would have been well demarcated by the modern period, but in fact considerable confusion developed on precisely this frontier during the

early nineteenth century. Partnerships, of course, were contracts by which two or more individuals entered into a business relationship with each other, but individuals could unite their interests through many different kinds of business contracts, only some of which were considered partnerships. Determining which contracts were partnerships and which were not was generally a matter of common, rather than statutory, law until states adopted the Uniform Partnership Act during the early twentieth century, and so it is to the common law that one must look for the source of the difficulty.

At the beginning of the nineteenth century, the courts based their definition of the partnership form on two long-standing principles of English common law, both of which aimed to safeguard the rights of creditors (Lamoreaux 1995, pp. 52–4). The first was the idea that a contract might be deemed a partnership even if the parties to the agreement did not so intend. If two or more businesspeople stood in relation to each other as partners, then according to this principle, they could not escape the resulting liability to creditors merely by claiming that they had not entered into a partnership agreement. The second was the idea that an agreement among two or more people to share the profits of a venture was by its very nature a partnership contract. As Justice Putnam of Massachusetts explained in 1821, “He who takes a moiety of all the profits indefinitely, shall by operation of law be made liable for losses, if losses arise; upon the principle that, by taking a part of the profits, he takes from the creditors a part of that fund, which is the proper security for the payment of their debts” (*John P. Rice v. Nathaniel Austin*, 17 Mass. 197 at 204).

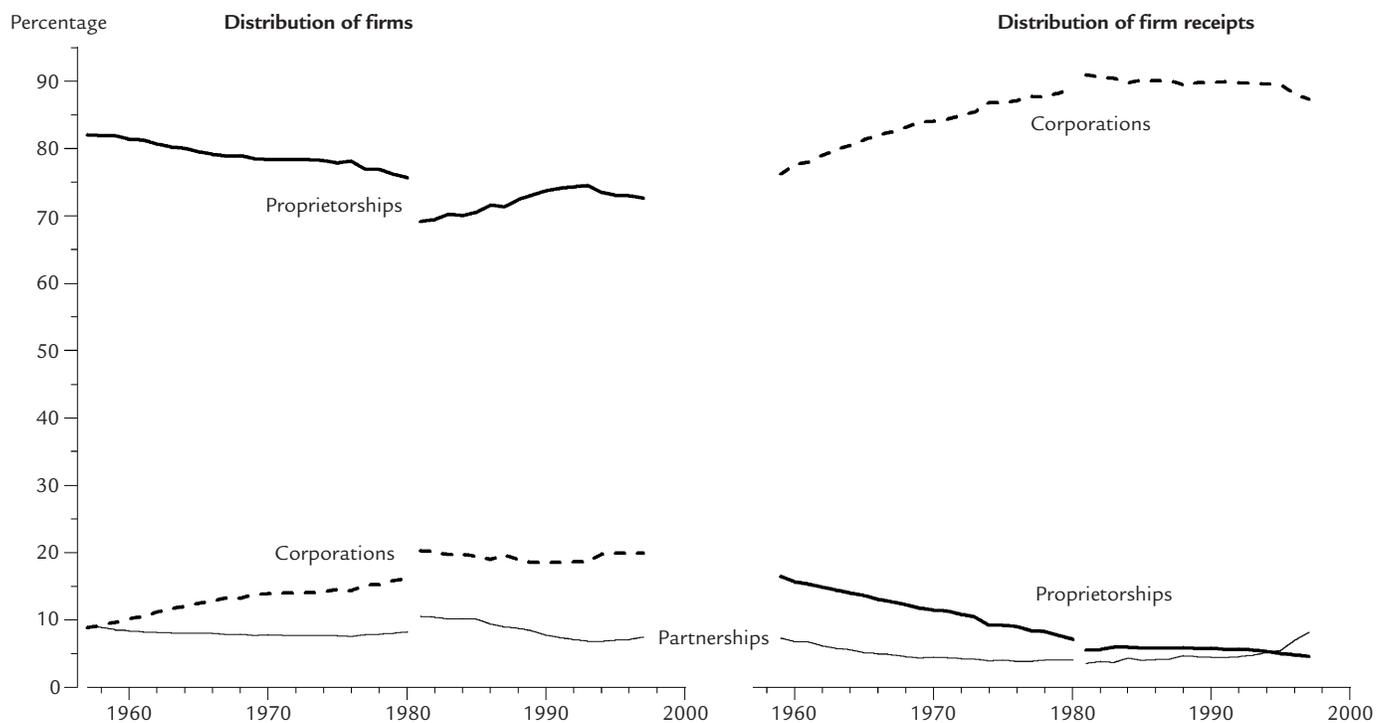


FIGURE Ch-A Proprietorships, partnerships, and corporations – distribution of firms and firm receipts: 1959–1997

Sources

Proprietorships: through 1980, series Ch4; thereafter, series Ch7. Partnerships: series Ch10. Corporations: series Ch13. In each case, the values are expressed as a percentage of series Ch1.

Proprietorship receipts: through 1980, series Ch5; thereafter, series Ch8. Partnership receipts: series Ch11. Corporation receipts: series Ch14. In each case, the values are expressed as a percentage of series Ch2.

Documentation

Note that beginning in 1981 only nonfarm proprietorships are covered.

Although there were a few well-established exceptions to the rule that sharing in profits made an individual a partner in a firm (for example, seamen who contracted to work on whaling ships in exchange for a share of the catch were not considered partners), these two principles caused a great deal of difficulty during the early nineteenth century. As both the pace and uncertainty of economic life increased, a growing number of cases reached the courts in which creditors attempted to claim that parties who had entered into what were conventionally thought to be ordinary contracts had in fact formed partnerships and were thus liable for each other's debts. In Massachusetts, for example, ten cases of this type reached the appeals courts during the 1820s and fifteen during the years 1830 to 1845. The contracts asserted to be partnerships involved such widely varying matters as an individual's agreement to manage a foundry owned by others, a manufacturer's commitment to supply a mercantile firm with cloth to sell, and a loan to provide a dealer with working capital to fulfill a supply contract with the navy. All of these agreements involved the sharing of profits, sometimes in addition to a fixed form of compensation (Lamoreaux 1995, pp. 46, 50–2).

Although the appeals court justices knew that holding businesspeople liable for the debts of parties with whom they had entered into ordinary contracts would destabilize conventional business relationships, they had a great deal of difficulty avoiding this outcome, given the existing legal rules. Not surprisingly, the average length of the court's written opinions in these kinds of cases grew (from about five pages during the 1820s to over ten pages in the early 1840s), and the justices' reasoning became increasingly convoluted, as they tried to rationalize new distinctions between sharing in profits and sharing in profits *as profits* or tried to argue that partnerships differed from ordinary contracts in that they entailed sharing in losses as well as sharing in profits. None of these stratagems really worked, and the issue was not resolved until 1841, when U.S. Supreme Court Justice Joseph Story proposed (in a treatise on partnership law) the addition of a third legal principle that would enable the courts to recognize the existence of a category of ordinary contracts involving sharing in profits. In essence, Story argued that for an agreement to be considered a partnership, a claim on profits had to be accompanied by real power to direct the business of the enterprise. What mattered was whether the individual sharing in profits was acting in the capacity of a principal or agent: "If the participation in the profits can be clearly shown to be in the character of agent, then the presumption of partnership is repelled" (Story 1859, p. 59). Thus, the difference between a partnership contract specifying that one partner was to run a factory and the other to handle sales and an agency contract with the same division of labor was that in the former case each partner had full authority to dispose of any of the property involved in the transaction as if he were the sole owner, whereas in the latter case each party had ownership rights over only their own parts of the business (Lamoreaux 1995, pp. 46, 54–9).

Even as Story was clarifying the boundary between partnerships and proprietorships, however, the definition of what it meant to be a partnership was becoming more rigid. Indeed, the ownership rights that the partnership form conferred on all members of the firm had already become so critical an aspect of this organizational form that attempts to contract them away had lost legal standing. A good example was a Massachusetts dispute that ended up in the U.S. Supreme Court in 1831. In 1817, Amos and John Binney had

formed a partnership with John Winship to manufacture soap and candles. Winship was responsible for the actual manufacturing enterprise. The Binneys provided capital for the business and tried to protect themselves by insisting that Winship sign an agreement not to endorse the notes of anyone outside the firm. Winship violated the agreement, but the Binneys were nonetheless held liable for the notes he endorsed on the grounds that creditors could not be expected to know of the provisions of the agreement. As John Marshall, Chief Justice of the U.S. Supreme Court, explained in *Winship v. The Bank of the United States*, specific clauses restricting the rights of any of the partners to act in the interest of the firm could not be employed to limit the firm's liabilities:

The articles of copartnership are perhaps never published. They are rarely if ever seen, except by the partners themselves. The stipulations they may contain are to regulate the conduct and rights of the parties, as between themselves. The trading world, with whom the company is in perpetual intercourse, cannot individually examine these articles, but must trust to the general powers contained in all partnerships.⁵

Decisions such as Marshall's effectively prevented partners from negotiating binding governance structures for their firms that differed from the standard partnership template. Partners could, and did, continue to write copartnership agreements, but these arrangements were really only as good as the people making them and, indeed, depended for their enforcement on extralegal mechanisms, such as those provided by family and community. Although, in theory, an aggrieved partner might seek an injunction in equity against another member of the firm, such a remedy typically could do little more than force the dissolution of the partnership and a settlement of accounts. It was of no use whatsoever in a situation such as the Binneys found themselves, where their partner was essentially bankrupt. As Story reminded readers of his treatise, problems in a partnership were akin to those in marriage: "As in some relations in life, we enter into the connection for better or for worse" (Story 1859, p. 352).

Although there is no way to compare directly the use of the partnership device relative to ordinary contracts, scattered evidence suggests that partnerships were becoming an increasingly popular business form during the early to middle nineteenth century. Samples drawn from Boston city directories indicate that the number of partnerships relative to the city's total population nearly doubled between 1800 and 1860 (Lamoreaux 1997, p. 279). Moreover, Jeremy Atack and Fred Bateman have shown that, between 1850 and 1870, the number of partnerships increased relative to single proprietorships in the manufacturing sector (Atack and Bateman 1995).

It is somewhat surprising that increasing numbers of proprietors turned to the partnership form during this period to combine their skills and resources with those of other owners, especially after the courts made it possible to use profit-sharing arrangements to align the parties' incentives in ordinary contracts. One possible explanation is that, compared to ordinary contracts, partnership agreements offered superior protections against the various kinds of contracting problems that can occur whenever parties must make

⁵ *John Winship and Others v. The Bank of the United States*, 5 Peter's Supreme Court Reports, 529 at 552–4, 561–2. See also Story (1859), pp. 163, 351–81.

investments, whether human capital or otherwise, that are specific to the enterprise. For example, as Harold Demsetz and Armen Alchian have pointed out, the kinds of *ex ante* compensation rules that must be written into ordinary contracts create an incentive for shirking whenever the parties' respective contributions to output cannot easily be distinguished. Members of partnerships have greater ability than parties to ordinary contracts to monitor each other's activities and thus reduce the possibility that shirking will undermine the profitability of the "team" enterprise (Alchian and Demsetz 1972). It is also possible that the threat of dissolution provides a mechanism not available in ordinary contracts that can effectively limit the extent of the rent-seeking behavior when the terms of the agreement are renegotiated. If a partner attempts to extract more than his or her fair share of income from the other partners, they (unlike parties to ordinary contracts) can respond by dissolving the firm, in which case all the parties will have to bear proportionately the cost of liquidating enterprise-specific investments unless they work out an amicable settlement. Finally, it is also possible that the mutual liabilities that the legal system imposes on partners, but not on parties to ordinary contracts, serve the useful purpose of enabling partners to bond themselves to the enterprise – to signal both to insiders and to outsiders their commitment to its ongoing vitality – by assuming responsibility for its debts. Hence, for certain kinds of ventures, particularly those that involved enterprise-specific investments, partnerships may have offered advantages over ordinary contracts that can explain their growing popularity during the early nineteenth century. As the century progressed, however, businesspeople could more easily exploit other organizational alternatives that enabled them to avoid some of the disadvantages of the partnership form. The first to become readily available was the limited partnership. Legislation permitting this type of organization was first passed by the New York and Connecticut legislatures in 1822 and then by most other states over the next couple of decades. Limited partnerships consisted of two types of partners: general partners, who ran the company and had unlimited liability for its debts, and special partners, who had no managerial authority but whose liabilities were limited to their investments. From the standpoint of a general partner, the limited partnership functioned much like an ordinary partnership but afforded greater possibilities for tapping external sources of capital. From the standpoint of a special partner, the form created the possibility of greater gains than could be obtained from a simple loan contract (especially given usury restrictions) without the risks that an ordinary partnership entailed.⁶

What is most interesting about the limited partnership form, however, is how rarely it was used, despite the advantages it would seem to offer over ordinary partnerships in raising capital. Stanley Howard searched the records of five New Jersey counties (representing about a third of the population of the state) over a period of nearly one hundred years and found that only 142 limited partnerships had been formed (Howard 1934, pp. 309–12). Because of the way the legislation in New Jersey and other states was written, special partners in limited partnerships were exposed to unlimited liability under certain circumstances beyond their control; nevertheless, these statutory deficiencies should have been easy to remedy. Except in a small number of Western states, however,

legislatures generally did not bother to do more than tinker in a minor way with the statutes until the movement to pass uniform laws that occurred during the second decade of the twentieth century. The most likely reason for the lack of interest was the growing availability of another organizational form, the corporation.⁷

Corporations

Like the partnership, the corporation has a long history that can be traced back to classical times. Unlike the partnership, however, the corporate form could not be freely used for private business purposes until the nineteenth century. In early modern England, the Tudor kings had used corporate charters as a device to help them consolidate their power. When these monarchs granted (or confirmed) charters to urban governments and other associations like churches and guilds, they offered these organizations privileges, mainly the right to create a set of rules that would be binding on their members – that is, the right to be a governing authority – in exchange for recognition that the ultimate source of this authority was the king. Over time, however, kings began to use their power to charter corporations for other purposes – for example, to promote trading companies. Although these ventures typically took the form of profit-oriented joint-stock enterprises whose shares were owned by private individuals, the crown justified the grants on the grounds that the charters furthered the geopolitical interests of the nation, and the companies generally received broad governmental powers as well as trading rights within their jurisdictions (Hurst 1970, pp. 2–4).

The corporate form retained its essentially public character in the United States after the American Revolution, though, in the absence of a king, the power to grant charters of incorporation became a legislative prerogative exercised primarily by individual state governments. The vast majority of charters issued during the late eighteenth and early nineteenth centuries were for towns and other governmental entities. Most of the rest went to churches and charitable associations of various kinds. A small number were granted to business associations, but these were restricted initially to projects deemed to be in the public interest (Maier 1993; Hurst 1970, pp. 15–18; Handlin and Handlin 1969, pp. 87–133). States chartered turnpike or bridge corporations as a way of encouraging badly needed transportation projects. Similarly, legislatures viewed banks as vehicles for providing vital community services, and merchants seeking to organize them had to couch their appeals for charters on public interest grounds. For example, petitioners for the Massachusetts Bank, incorporated in Boston in 1784, promised that their bank would make it possible for citizens of the Commonwealth to obtain credit at reasonable rates of interest, thus ensuring that "the enormous advantages made by the griping Usurer from the Necessities of those who want to borrow Money will be immediately checked & in great Measure Destroyed" (quoted in Gras 1937, pp. 212–14). Even charters for manufacturing ventures had to have a civic justification. Indeed, many were granted during the period of the Embargo and War of 1812, when manufacturing had come to be considered, as William Kessler has suggested,

⁶ The 1822 statutes aimed to introduce to American practice the "commandite" form of enterprise that had been in use in Europe since the Middle Ages (Lopez 1976, pp. 76–7; Howard 1934, pp. 296–301; Lewis 1917, p. 716).

⁷ Ironically, one of the original motivations for passing limited partnership statutes was fear of the economic dominance of corporations. On the lack of popularity and deficiencies of limited partnerships, see Howard (1934), Lewis (1917), pp. 718–21, and Warren (1929), pp. 306–10.

a “patriotic duty” (Kessler 1948, p. 51). When the Boston Associates sought a corporate charter for their first textile enterprise in Waltham in 1813, they believed that it was necessary to emphasize the social value of securing “the establishment of manufactures upon a more permanent foundation than has hitherto been found practicable in this commonwealth” (quoted in Dalzell 1987, p. 28).

The principle that charters should be restricted to public infrastructure projects was not incompatible with the expectation that these investments would earn profits for the corporations’ shareholders. Quite the contrary, the idea was that the special privileges that went along with the grant of a corporate charter would make it possible for participants to earn a profitable rate of return and therefore encourage them to channel their savings into such socially useful investments. These privileges always included the right to hold property and sue or be sued as if the corporation were a natural person. Depending on the purpose of the corporation and the extent of the community’s need, they might include other valuable boons – a grant of monopoly power or, in the case of banks, the right to issue currency in the form of banknotes. They also sometimes included a limitation on shareholders’ liability for the corporation’s debts.⁸

Although many early corporations were not profitable, the privileges that corporate charters conferred on those who were able to secure them became a source of heated political controversy.⁹ Banks in particular were objects of criticism because they often lent substantial proportions of their funds to their own officers and directors, and because the currency that they alone were allowed to issue appeared to give them power over the community’s money supply (see Lamoreaux 1994, especially pp. 31–51). At one extreme, critics proposed abolishing corporations entirely; at the other, they advocated the passage of general incorporation laws that would eliminate the element of privilege that inhered in corporate charters by enabling virtually any group that so desired to obtain a charter for their venture. Although both options were tried at different times and places and for different types of corporations, in the end the second group won out – in part because there was broad support for economic development and interest in participating in corporate ventures, and in part because incorporation fees were so lucrative that states that chartered large numbers of corporations could thereby reduce the property-tax burden on their citizens (Wallis, Sylla, and Legler 1994).

State legislatures generally responded to these pushes and pulls first by making it easier for petitioners to obtain special charters and then by passing general incorporation laws that enabled any group that paid a fee and met specified requirements (such as minimum capitalization) to take out a charter (Hurst 1970, pp. 13–57; Maier 1993).¹⁰ As a result of this liberalization, the number

⁸ Early charters were often silent on the issue of stockholders’ liability, creating considerable uncertainty that, beginning in the second decade of the nineteenth century, was gradually resolved by the courts in favor of the presumption of limited liability. Where charters were not silent, they sometimes provided for limited liability but sometimes (especially in the case of manufacturing concerns) explicitly denied stockholders this privilege (Dodd 1954, pp. 365–437; Handlin and Handlin 1945, pp. 8–17; Perkins 1994, pp. 373–6).

⁹ On the meager returns earned by many early transportation companies, see Majewski (2000). Paskoff (1983) has shown that corporations differed little in profitability or performance from other firms in the early-nineteenth-century iron industry.

¹⁰ There are a number of studies of this process in different states; see especially Handlin and Handlin (1969), Cadman (1949), and Seavoy (1982).

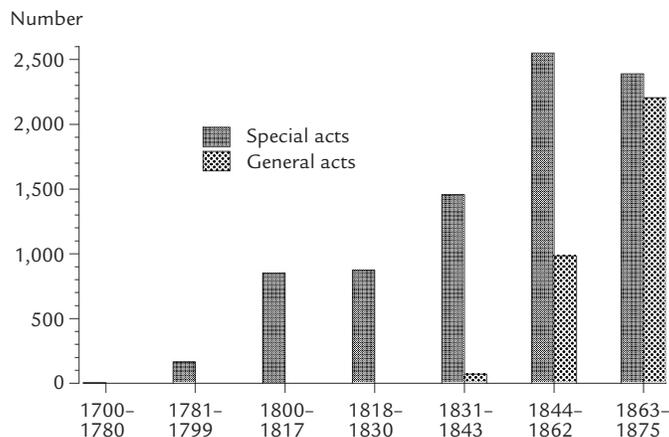


FIGURE Ch-B Business incorporations in New England, by type of incorporation law: 1700–1875

Source
Table Ch380–391.

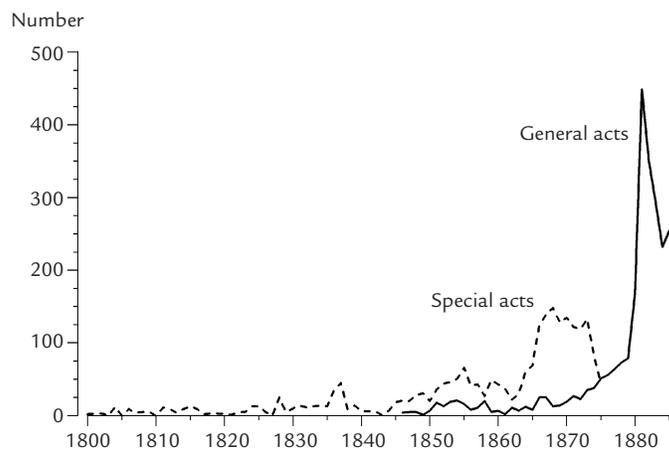


FIGURE Ch-C Business incorporations in New Jersey, by type of incorporation law: 1800–1885

Sources
Series Ch306–308.

of corporations increased dramatically. Between 1800 and 1817, the New England states chartered about 850 corporations under special laws; between 1844 and 1862, they chartered more than 3,500, over 70 percent by means of special legislation (see Table Ch380–391 and Figure Ch-B). Similarly, between 1826 and 1835, New Jersey authorized on average 11 corporations per year using a special charter system; between 1846 and 1855, it granted on average 45 per year through a combination of special and general incorporation; between 1866 and 1875, 145 per year under a similar combination; and between 1876 and 1885, 202 per year using general incorporation alone (see Table Ch293–318 and Figure Ch-C).

As these numbers suggest, even after incorporation became routinely available, it was still possible for entrepreneurs who wished to secure more favorable provisions than those available under the general laws to petition their legislatures for special charters. Hence the controversy over corporations as vehicles of privilege continued, and the upshot, during the third quarter of the nineteenth century, was that many states added provisions to their

constitutions forbidding the chartering of corporations by special legislative act.¹¹ Even before the passage of these amendments, it was increasingly common for legislatures to apply standard templates in writing charters for corporations in the various sectors of the economy. After the amendments, the extent of variation was dramatically reduced. Although some differences still existed among states and across sectors of the economy, certain features of the corporate form became standard – most typically, perpetual life, limited liability, and majority rule by stockholders entitled to one vote for each share they owned (Wallis 2003; Dunlavy 2004).

As their numbers increased, corporations inevitably lost much of their public character, and references to the larger civic good gradually disappeared from their petitions for charters. For example, although some applicants for bank charters in the 1820s and 1830s continued to invoke the public interest, many made more strictly personal appeals. Incorporators of the Smithfield (Rhode Island) Exchange Bank, for instance, declared that they desired an institution in which “they can become stockholders, and particularly if they can have one located and established in their own vicinity or neighborhood; in order to share or participate with their fellow Statesmen in equal privileges.” As time went on, more and more petitioners made no attempt whatsoever to justify their requests. Their applications for charters consisted solely of a list of participants and a brief statement explaining that the undersigned wished to organize a bank.¹²

The growing use of the corporate device to organize ordinary private businesses also inevitably changed the way legal thinkers viewed the form. When incorporation required a special act of the legislature, the resulting charters defined both the powers of the company and the scope of its business. Corporations formed in this manner were thus clearly creations of the state – “artificial beings” to use Marshall’s phrase in his famous *Dartmouth College* decision – and “being the mere creatures of law,” it posed no problem to conceive of them as having in some respects the legal standing of natural persons (*Dartmouth College v. Woodward*, 17 U.S. 518 at 636). For example, according to the classic definition offered in Stewart Kyd’s 1793 *Treatise on the Law of Corporations*, a corporation was a group of individuals united “in one body” that was “vested by the policy of the law, with a capacity of acting, in several respects, as an individual, particularly of taking and granting property, contracting obligations, and of suing and being sued.” Kyd went on to state that corporations, like individuals, were similarly vested with the capacity “of enjoying privileges and immunities *in common*, and of exercising a variety of political rights, more or less extensive, according to the design of its institution” (quoted in Angell and Ames 1832, p. 1).

On the other hand, because corporations were creations of the state, it also posed no problem to conceive of them as having a legal status that was different from natural persons. For example, an individual was free to enter into any contract that was not contrary to law. A corporation, on the other hand, not only could “make no contracts forbidden by its charter, . . . but in general [could] make no contracts which [were] not necessary either directly or

incidentally” to fulfill the purpose of its charter. Moreover, it was generally recognized that, unlike a natural person, a corporation could not “be deemed a moral agent, subject to moral obligation.” Nor could it “be subject to personal suffering.” Nor could it generally participate, like an ordinary citizen, “in the civil government of the country.” Nor did it automatically receive the protections afforded natural citizens by the U.S. Constitution (Angell and Ames 1832, pp. 2–3).¹³

As more and more private businesses took out corporate charters, however, it became increasingly difficult for the individuals involved to accept the idea that they had lost some of their constitutional protections just because they used a particular organizational form. It also became increasingly difficult for the courts to maintain a clear distinction between the corporate and partnership forms, for as the number of ordinary private businesses using the corporate form increased, the number and kinds of disagreements involving these corporations inevitably increased as well, as did the number and kinds of lawsuits reaching the courts. Because widespread use of the corporate form was so new, in many cases judges did not have precedents in corporate law on which to base their decisions, so they turned for assistance to the one well-articulated body of business law they had available – cases involving partnerships.¹⁴ In order to apply these precedents, however, they had to assert that corporations were, at least in certain respects, essentially similar to partnerships. For example, in his opinion finding that a stockholder in the Portland Bank was wrongly prevented by the directors from buying additional shares authorized by the bank’s charter and voted to be issued by its stockholders, Justice Sedgwick of Massachusetts declared that “all the stockholders of the bank were *partners*.” The decision followed from this premise, for “whenever a partnership adopts a project, within the principles of their agreement, for the purpose of profit, it must be for the benefit of all the partners, in proportion to their respective interests in the concern” (*Gray v. Portland Bank*, 3 Mass. 364, Tyng 364).¹⁵

As a result of these kinds of decisions, over the course of the nineteenth century corporate law grew more similar to partnership law, and the differences between the two forms of organization eroded. For example, although corporations made decisions by majority votes about important matters such as who was able to act on behalf of the firm, by the mid-nineteenth century the courts established the principle that any nontrivial change to a corporation’s charter required stockholders’ unanimous consent. The analogy to partnerships in these cases was explicit. As Chancellor Bennett of Vermont pointed out in *Stevens v. Rutland and Burlington Railroad Company*, partnerships and joint stock associations “cannot by a vote of the majority change or alter their fundamental articles of copartnership or association, against the will of the minority,

¹³ The last quotation is from Marshall, who qualified it with the phrase “unless that be the purpose for which it was created,” again pointing to the importance of the specific provisions of the charter. For further discussion of the ascendancy of this “artificial person” theory of corporations during the first half of the nineteenth century, see Mark (1987), pp. 1447–55.

¹⁴ It is important to realize that the use of the corporate form to organize ordinary businesses was not only new in the United States; it was new in the world. In Britain and on the continent of Europe, the corporate device was not as widely used until much later (Maier 1993).

¹⁵ For similar comparisons of corporations to partnerships in very different kinds of cases, see *State of Connecticut, ex rel. Kilbourn v. Tudo*, 5 Day 329; *Slee v. Bloom*, 19 Johns. 456; and *Bissell v. Michigan Southern and Northern Indiana Railroad Companies*, 22 NY 258.

¹¹ For a summary of such constitutional provisions, see Evans (1948), p. 11. All the major industrial states outside New England passed such amendments during this period.

¹² See Rhode Island, General Assembly, “Charters,” manuscript records, Rhode Island state archives. For the Smithfield application, see Volume 7 (1820–1823), p. 52.

however small, unless there is an express or implied provision in the articles themselves that they may do it.” The same principle must hold for corporations. To find otherwise would undermine the sanctity of contract because when an individual purchased a share in a corporation, he or she invested “for the purpose specified in the charter, . . . and there was at the same time a trust created, and an implied assumption on the part of the corporation, to apply it to that object, and none other.” Altering the charter without the individual’s consent violated his or her rights, for as Bennett put it, “no one can suppose, that upon the payment of his subscription, the personal identity of the plaintiff was merged in the corporation, or that he ceased to have distinct and independent rights.”¹⁶

This growing similarity between corporate and partnership law provided the basis for the emergence during the late nineteenth century of the so-called aggregate theory of the corporation – that is, the idea that corporations were contracts into which businesspeople entered freely just as they did any other business form, and that, consequently, the legal status of corporations could not be distinguished from those of the natural persons of whom they were comprised. The most notable proponent of this view, Victor Morawetz, began his *Treatise on the Law of Private Corporations* with a critique of Marshall’s definition of a corporation as an artificial being. “It is evident,” he countered, that the corporation cannot be “in reality a person or a thing distinct from the corporators who compose it.” As a result, “when it is said that a corporation is itself a person, or being, or creature, this must be understood in a figurative sense only.”

Although a corporation is frequently spoken of as a person or unit, it is essential to a clear understanding of many important branches of the law of corporations to bear in mind distinctly, that the existence of a corporation independently of its shareholders is a fiction; and that the rights and duties of an incorporated association are in reality the rights and duties of the persons who compose it, and not of an imaginary being. (Morawetz 1882, pp. 1–2)¹⁷

For Morawetz, “the ultimate object” of “every ordinary business corporation” was “the pecuniary profit of the individual members” (Morawetz 1882, p. 346). There is no talk in his treatise about corporations serving the public interest. Rather, they served the interests of their stockholders, who came together voluntarily to pursue some particular business purpose. From this basic assumption, Morawetz derived most of the important principles of corporate law. From his perspective, for example, corporations were forbidden to enter into contracts that were contrary to their charters (*ultra vires*), not because they were artificial creatures of the state, but because the charter delimited the boundaries of the business that the incorporators had themselves decided on when they formed the enterprise: “Those who become members of a corporation for purposes of pecuniary profit evidently intend that the object of their

company shall be to prosecute the enterprise expressly set forth in their charter or articles of association; and they evidently do not intend to join in any speculation which is not in pursuance of the purposes thus indicated” (Morawetz 1882, p. 148).

This view of the corporation was increasingly influential in the late nineteenth century and, as Gregory Mark and Morton Horwitz have convincingly argued, provided the logic that underpinned the Supreme Court’s famous *Santa Clara* decision in 1886 – the first decision that extended Fourteenth Amendment protection against discriminatory legislation to corporations (Mark 1987, pp. 1460–4; Hovenkamp 1991, pp. 43–7; Horwitz 1992, pp. 66–70). The case originated in a suit brought by the Southern Pacific and other railroads to overturn property taxes based on a provision of the California constitution that the plaintiffs claimed discriminated against their businesses. Because the provision was written into the state constitution, the only way in which the railroads could obtain redress was to show that the tax violated the equal protection clause of the recently ratified Fourteenth Amendment to the federal Constitution. The issue of whether the amendment could be used to protect corporations in this way was settled even before lawyers for the two sides were able to make their oral arguments. Chief Justice Morrison R. Waite simply announced “the court does not wish to hear argument on the question whether the provision in the Fourteenth Amendment to the Constitution, which forbids a State to deny to any person within its jurisdiction the equal protection of the laws, applies to these corporations. We are all of opinion that it does” (*Santa Clara County v. Southern Pacific Railroad Company*, 118 U.S. 396). Waite provided no explanation for the Court’s action, instead proceeding immediately to consideration of the technical aspects of the tax case, but as Mark and Horwitz have shown, the Court had accepted the logic, laid out by Justice Stephen Field in a series of lower-court decisions, that corporations were made up of people who did not lose the protections of the federal Constitution just because they had become members of firms that took a particular contractual form. As Field wrote in *County of San Mateo v. Southern Pacific Railroad Company*, “It would be a most singular result if a constitutional provision intended for the protection of every person against partial and discriminating legislation by the states, should cease to exert such protection the moment the person becomes a member of a corporation” (13 F. 744).

Although this effort to reinterpret corporate law in terms of the law of contract – to see corporations as essentially similar to partnerships – triumphed in the *Santa Clara* case, it was only partially successful elsewhere because many features of corporate law could not be reconciled with this view of the nature of the form. For example, shares in corporations could be held by women subject to coverture, by children, and by individuals who were mentally incompetent. That is, many members of corporations were people who could not legally enter into contracts on their own.¹⁸ Similarly, the case law on investors who were induced to buy stock in corporations on the basis of fraudulent claims suggests that, in the eyes of the law, investors were viewed more like passive consumers than like parties who were actively contracting to participate in a business (Morawetz 1882, pp. 300–2).

There were many other significant differences as well. But the one that posed the most serious problems for Morawetz and other proponents of the aggregate theory was the fact that parties could

¹⁶ 29 Vt. 545. For a summary of the case law, see Dodd (1954), pp. 134–48, and Morawetz (1882), pp. 47–9. Carney (1980) has shown that this unanimity rule was seriously weakened in the second half of the century as courts permitted firms effectively to liquidate and reorganize in order to bypass recalcitrant shareholders. But I would argue that this change too was consistent with partnership law. In a partnership, if one member disapproved of a new direction for the firm, the likely outcome was dissolution of the old firm and formation of a new one.

¹⁷ On the rise of the aggregate theory of corporations, see Horwitz (1992), pp. 90–3, and Mark (1987), pp. 1455–64.

¹⁸ Morawetz recognized this fact but ignored its implications (1882, p. 18).

not form corporations at will the way they could partnerships. Forming a corporation required permission from the state in the form of a corporate charter. Moreover, this permission was required because corporate charters were conceived of as conveying privileges that could not be acquired by means of ordinary contracts. Indeed, as late as the second decade of the twentieth century, many state laws defined corporations as associations “having any of the powers or privileges not possessed by individuals or partnerships” (Crane 1915, p. 778).¹⁹

The most important of these privileges was, of course, limited liability. Without a corporate charter from a state, parties who wrote contracts that imposed limits on their liabilities to creditors assumed significant risk that they might nonetheless find themselves judged fully liable for their enterprise’s debts.²⁰ Morawetz argued that such contracts should be allowed – that individuals should be free to contract for corporate privileges such as limited liability. In his view “an assumption of the privilege of acting in a corporate capacity [did] not involve an infringement of the rights of other persons.” Creditors could easily be protected, he argued, “by requiring due notice of the corporate organization to be given to the world.” Indeed, he pointed out that states had already gone a long way in this direction by passing general incorporation laws that effectively “repeal the prohibition of the common law, and leave the right of forming a corporation and of acting in a corporate capacity free to all, subject merely to such limitations and safeguards as are required for the protection of the public” (Morawetz 1882, pp. 24–5).

This argument, however, did not carry the day, and though aggregate theory continued to be influential, it never vanquished other views of the corporation. In particular, the theory that corporations were artificial entities regained considerable power by the end of the nineteenth century. The reason was the sudden rise of large-scale business enterprises to positions of market dominance. In the context of a weak federal state, jurists latched onto the view that corporations were artificial creatures in order to provide a basis for greater government regulation. One ironic consequence was to increase the rigidity with which the courts imposed the standard corporate form on small businesses as well as on large.

The Rise of Big Business

Most corporations chartered during the nineteenth century were scarcely distinguishable in the scale and type of their operations from partnerships, but the form did permit some firms to expand beyond the size feasible for partnerships by selling equity. For most of the century, however, problems of asymmetric information on the securities markets made it difficult for corporations to exploit this possibility to its fullest potential. It was really not until the Great Merger Movement of the turn of the century (see Table Ch416–421) that industrials were able to tap the equity markets to any significant degree, but, even then, only the largest firms had access to this source of capital. The more general availability of equity finance awaited the passage during the 1930s of regulatory legislation to protect investors and provide them with better information, and the growth after World War II of retail brokerage houses aimed at middle-class savers. Even then, however, the

vast majority of corporations would continue to be private affairs whose stock was held by a relatively few individuals, generally either the firms’ managers or their relatives and friends (Navin and Sears 1955; McCraw 1984, pp. 153–209; Baskin and Miranti 1997; Perkins 1999, pp. 145–236).

The first businesses that attempted to any significant degree to raise capital on broad, extralocal markets were the railroads. The earliest transportation ventures had been local enterprises whose investors had contributed capital, less for the return they thought they could earn on their shares (which was often meager) and more because they lived along the route and expected to benefit from cheaper freight rates. As longer railroads were constructed to link major cities, and as local roads expanded their routes or merged with others into systems of trunk and feeder lines, the profitability of railroad securities rose, and investors were increasingly attracted by the promise of high rates of return rather than indirect benefits (Taylor 1951, pp. 74–103; Majewski 1996; 2000, pp. 111–40). Although railroads were corporations and thus in theory could have raised capital by selling equity, investors’ lack of information about the finances of individual roads (and the very real fear that insiders might deliberately manipulate the value of railroad equities to their own advantage) made bonds rather than stock the preferred instrument for attracting funds (Baskin and Miranti 1997, pp. 127–66; Chandler 1977, pp. 89–93). When railroads representing approximately a quarter of the nation’s mileage went bankrupt during the depression of the nineties, however, J. P. Morgan and the other financiers who handled the reorganizations sought to reduce fixed charges by convincing bondholders to exchange debt for equity (in the form of some mixture of preferred and common stock). Morgan had painstakingly built a reputation for financial probity and fair dealing, and he exploited his stature in the eyes of investors to build a market for the railroads’ stock. In the early stages of a reorganization, for example, he typically established a voting trust that would be under his control. The officers of the trust took responsibility for monitoring the corporation’s business and, because they controlled a majority of the corporation’s shares, had real power to shape its business practices. When these trusts expired at the end of some agreed-upon period, Morgan continued to protect investors’ interests by putting one of his partners on the railroad’s board and often on its finance committee as well (Carosso 1987, pp. 363–9; De Long 1991).

Banks and utilities did raise funds throughout the nineteenth century by selling shares of their stock, but trading in these securities was largely restricted to local markets where investors had reasonably good knowledge of the firms and their managers. It was much less common for industrials to raise capital by selling equity, even on local markets. For example, Joseph G. Martin, who published stock quotations for the Boston exchange, wrote as late as 1898 that “it was exceedingly difficult to obtain reliable quotations of” manufacturing stocks, even for the region’s largest enterprises, because the securities rarely appeared on the market “except in stray shares or in the case of executors’ sales.” Virtually all the firms for which he provided quotations came from the top ranks of the region’s textile enterprises. The securities of the vast majority of the manufacturing corporations in this heavily industrial region were never publicly traded (Martin 1898, p. 126).

Some manufacturing enterprises nonetheless were able to grow quite large by plowing back earnings and borrowing both short- and long-term to meet their needs for additional funds. Carnegie Steel, for example, never went to the equity markets for capital. Indeed,

¹⁹ Crane listed eighteen states whose statutes defined corporations in this way.

²⁰ For a lengthy discussion (and defense) of the idea that corporate privileges could not be achieved by contract under common law but could only be granted by statute, see Warren (1929), especially pp. 327–404.

the firm was a limited partnership association until a lawsuit in 1900 by Henry Clay Frick forced the firm to revalue its assets and reorganize as a corporation – with a capitalization of \$320 million (Bridge 1903, p. 301; Wall 1970, pp. 714–64). Other firms that grew large by drawing on traditional funding sources included Armour & Company, the Singer Sewing Machine Company, and the McCormick Harvesting Machinery Company (Doyle 1991; 2000, p. 213).²¹

In other cases, however, the lack of equity finance seems to have been more of a constraint. In many industries, firms initially drew on family resources and borrowed funds to build plants capable of exploiting new capital-intensive technologies. Often, however, a number of firms made similar investments at about the same time, and the result was severe competition, downward-spiraling prices, and poor (or even negative) earnings. Firms in this situation did not generate profits that they could plow back into growth. Nor, as price competition became more and more severe, were they good risks for lenders. The only possible way for a firm to escape this cycle of competition and decline was to raise enough capital to break away from the pack by investing in more efficient technology and/or vertically integrating to reduce costs and improve access to markets. With this option unavailable, firms concentrated instead on stopping the downward-spiraling price competition. After trying and failing repeatedly to achieve this result through collusive arrangements of escalating degrees of formality, firms in these industries ultimately turned to mergers for relief (Davis 1966; Lamoreaux 1985, pp. 46–86).

The first giant merger, Standard Oil, had been organized in 1882 to enable the leaders of the Standard Oil Alliance, a cartel of oil refiners, to make common managerial decisions. Members of the alliance had already taken the first step toward merger by exchanging stock in each other's concerns, but they lacked a governance structure that would enable them to shut down inefficient refineries and concentrate production in those with the lowest costs. With the help of a clever lawyer named S. C. T. Dodd, they devised an alternative form of organization – a trust company that would hold the stock of firms in the Alliance and whose officers would thereby have the managerial authority to reallocate production among the constituent firms (Chandler 1977, pp. 321–6).

In several other industries – most notably sugar, lead, whiskey, linseed oil, cottonseed oil, and cordage – firms joined together during the 1880s and adopted Standard Oil's trust form of organization. After the passage of the Sherman Antitrust Act in 1890, this type of organization became vulnerable to prosecution. But, eager for the revenues to be derived from chartering corporations operating primarily in other states, the New Jersey legislature had enacted a liberal general incorporation law for holding companies during its 1888–1889 session, making an alternative form of organization readily available. Most of the trusts subsequently reorganized as New Jersey corporations, and Morgan and other financiers of comparable stature showed that they could successfully market the equities of these giant consolidations on the exchanges.²²

²¹ Doyle uses evidence from the sugar and meatpacking industries to argue that firms financed most capital investment in the traditional way and turned to the equity markets only to facilitate the reorganization of existing investment by means such as mergers.

²² During the early twentieth century Delaware would surpass New Jersey in “charter mongering” (Grandy 1989; 1987; Roy 1997, pp. 221–58; Chandler 1977, pp. 326–31; Carosso 1987, pp. 390–4; Navin and Sears 1955).

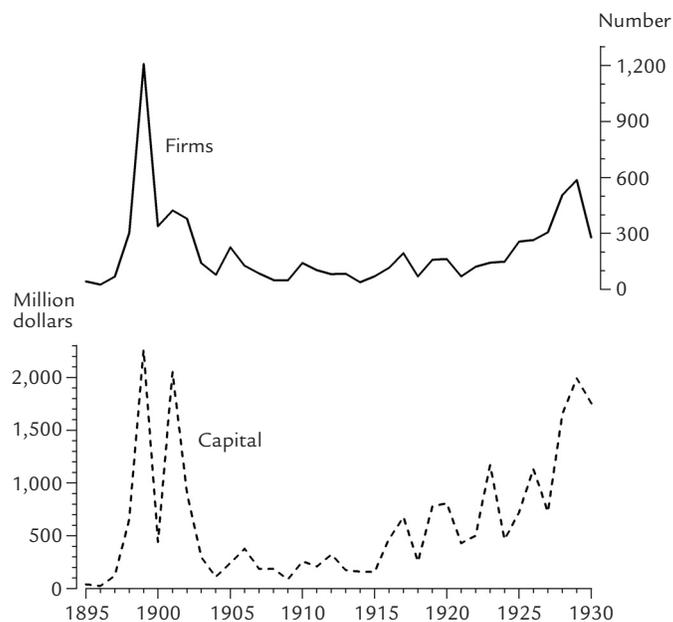


FIGURE Ch-D Mergers in manufacturing and mining – number and capitalization of firms that disappeared into consolidations or were acquired by larger firms: 1895–1930

Sources

Series Ch416–417.

A larger wave of mergers occurred during the period 1895–1904 and involved industries that had experienced unrelenting competition during the depression of the mid-1890s (see Figure Ch-D). In these industries prices did not rebound with the return of prosperity. The upturn did, however, stimulate a rise in activity on the securities markets. Morgan had demonstrated the usefulness of equities in the railroad reorganizations of the 1890s, and the trusts and mergers of the previous decade had shown that the stock of large industrial combinations could be sold on the exchanges. Now promoters began to apply these lessons on a larger scale by merging all the firms in industries experiencing severe competition into giant consolidations. The idea was to buy out existing owners by offering them the value of their firm in preferred stock with an equivalent amount of common stock as a sweetener. The expectation was that the preferred stock would find a ready market on the exchanges from investors eager to participate in the monopoly gains that consolidation would yield (under the oversight of well-known promoters). Then, when the firm did well, the desirability of the common stock would increase as well (Nelson 1959, pp. 89–100; Kolko 1963, pp. 17–25; De Long 1991).

The result was a flurry of consolidations. Only thirteen multi-firm consolidations were formed during the depression years 1895–1897, but in 1898 the number rose to sixteen and in 1899 suddenly to sixty-three. Thereafter the numbers began to trail off again – to twenty-one in 1900, nineteen in 1901, seventeen in 1902, five in 1903, and three in 1904. During the years 1895–1904, more than 1,800 manufacturing firms disappeared into consolidations, many of which acquired substantial shares (at least initially) of the markets in which they operated. Of the ninety-three consolidations whose market shares it is possible to estimate, around the time of their formation seventy-two controlled at least 40 percent of their industries, and forty-two controlled at least 70 percent. Even

assuming that none of the remaining mergers achieved significant market power, these figures meant that nearly half the consolidations absorbed more than 40 percent of their industries, and more than one quarter absorbed in excess of 70 percent (Lamoreaux 1985, pp. 1–5).²³

Although many of these consolidations would subsequently lose market share and some would even fail, contemporaries reacted to the Great Merger Movement with alarm. The passage of liberal incorporation laws by states like New Jersey had enabled these mergers not only to occur but also to amass capital on a hitherto unheard of scale. At the same time, these laws seriously undermined the regulatory authority that other states could exercise. Although the power to charter corporations theoretically gave states the authority to determine the very conditions under which their “creations” could do business, giant consolidations could respond to efforts to regulate their behavior by obtaining a charter from a more friendly jurisdiction, or even by closing down their operations in a state (see Roy 1997, pp. 144–258).²⁴

However weak the states’ charter powers now were in practice, they nonetheless hamstringed the federal government (itself small and inexperienced in regulatory affairs) in its efforts to fill the power vacuum. The main legal tools that were available to national authorities to regulate giant corporations were the common-law prohibitions against restraint of trade and attempts to monopolize that had been embodied in the Sherman Antitrust Act of 1890. Although prosecutors found it relatively easy to wield these tools against pools and similar collusive devices that involved agreements between more than one firm, they had much greater difficulty using them against combinations that took the form of state-chartered corporations and whose existence therefore seemingly had received state sanction (McCurdy 1979; Freyer 1992, pp. 61–8, 90–102). Hence, the central questions in antitrust law during the first decade of the twentieth century became, first, how the federal government could assert regulatory authority over corporations operating in interstate commerce without undermining states’ powers over corporations and, second, how the special status of corporations as creatures of the states could be used to bolster the federal government’s otherwise weak position (Lamoreaux 1985, pp. 159–86).²⁵

The ultimate solution to the first of these problems was the “rule of reason,” articulated by the Supreme Court’s Chief Justice Edward Douglass White in 1911 in the *Standard Oil* and *American Tobacco* decisions. White classified combinations into two distinct categories, for which two different tests of restraint of trade were required. First, there were those contracts or combinations whose “inherent nature or effect” was to restrain trade. This category included combinations involving more than one individual or corporation, such as gentlemen’s agreements, pools, and other types of cartels. These combinations were illegal per se; that is, the Sherman Act applied literally to them. Combinations formed by merger, however, did not fall into the category of agreements

whose “inherent nature or effect” was to restrain trade. In order to find combinations in violation of the Sherman Act, the Court must have proof that the “evident purpose” of the combination was to restrain trade. If this proof was available, it did not matter that the combination took the form of a state-chartered corporation because states did not have the right to charter corporations whose purpose was to violate federal law (*Standard Oil Company v. United States*, 221 U.S. 1; *United States v. American Tobacco Company*, 221 U.S. 106; Lamoreaux 1985, pp. 159–86).

Demonstrating such purpose, however, was highly dependent on the continuing power of the artificial theory of the corporation, as an earlier Supreme Court decision involving one of the companies implicated in the *American Tobacco* case had demonstrated. The government had subpoenaed records of a number of firms for evidence of anticompetitive activity. The secretary-treasurer of one of these companies, MacAndrews & Forbes, had refused to produce the requested documents on a number of grounds, among them that by doing so he would violate the corporation’s rights under the Fifth Amendment to the Constitution. In his opinion for the Court, Justice Henry B. Brown rejected the corporation’s claim to Fifth Amendment protection, using the states’ charter powers to bolster federal authority. The corporation, he pointed out, “is a creature of the State.”

It is presumed to be incorporated for the benefit of the public. It receives certain special privileges and franchises, and holds them subject to the laws of the State and the limitations of its charter. . . . Its rights to act as a corporation are only preserved to it so long as it obeys the laws of its creation. There is a reserved right in the legislature to investigate its contracts and find out whether it has exceeded its powers. (*Hale v. Henkel*, 210 U.S. 43 at 74–6)

Brown acknowledged that an individual “may lawfully refuse to answer incriminating questions unless protected by an immunity statute.” But, he asserted, “it does not follow that a corporation, vested with special privileges and franchises, may refuse to show its hand when charged with an abuse of such privileges.” Indeed, it would be “a strange anomaly” if a state could not, after chartering a corporation and granting it certain privileges, “demand the production of the corporate books and papers” to ensure that these privileges were legally employed. Because such privileges “must also be exercised in subordination to the power of Congress to regulate commerce,” the federal government “may also assert a sovereign authority” over the corporation to make sure that its laws are being upheld. Thus, Brown put the state’s charter powers in service of the federal government: “The powers of the General Government . . . are the same as if the corporation had been created by an act of Congress.”²⁶

The heightened importance that the rise of big business gave to the states’ charter powers also had broader implications, fueling among other things an increased tendency at the state level for

²³ For a more complete listing of mergers that includes smaller consolidations as well as acquisitions, see Table Ch416–421.

²⁴ An exception was Texas, which was able to use its petroleum resources to assert regulatory authority in that industry (Pratt 1980). For the contemporary reaction, see Galambos (1975).

²⁵ One manifestation of this concern was the attempt to secure a federal incorporation law during the first decade of the twentieth century (Sklar 1988, pp. 203–85).

²⁶ In a dissenting opinion, Justice David J. Brewer opposed this attempt to harness the states’ powers in service of the federal governing, countering that such a supervisory power belonged only “to the creator of the corporation” – which in the case at hand was a state, not the federal, government (*Hale v. Henkel*, 210 U.S. 83–9). The corporation had also claimed Fourth Amendment protection against unreasonable searches and seizures, but Brown found this argument much more difficult to dismiss (mainly on aggregate-theory grounds) (Lamoreaux 2004).

judges to draw a rigid line between partnerships and corporations. A good example is the case of *Jackson v. Hooper*, decided by the New Jersey Appeals Court in 1910. Several years earlier, Walter M. Jackson and Horace E. Hooper had organized two corporations, one in Britain and one in the United States, to publish and distribute the *Encyclopaedia Britannica*. Jackson and Hooper divided the stock of the corporations equally between them and also contracted to run the two businesses as a partnership. They agreed that all decisions were to be made by mutual assent, and they bound the other directors, whose positions were merely nominal, to ratify whatever actions they took. By 1908, however, the two men had a falling out. Hooper, with the support of the dummy directors, effectively stripped Jackson of his power in the enterprise, and Jackson sued in equity to enforce the partnership agreement. Although Jackson initially secured an injunction to enforce his partnership rights, the order was reversed on appeal. The court adamantly declared that partnerships and corporations were different legal forms and that businesspeople could not “Proteus-like” become “at will a copartnership or a corporation, as the exigencies or purposes of their joint enterprise may from time to time require.”

If the parties have the rights of partners, they have the duties and liabilities imposed by law, and are responsible in solido to all their creditors. If they adopt the corporate form, with the corporate shield extended over them to protect them against personal liability, they cease to be partners, and have only the rights, duties, and obligations of stockholders. (*Jackson v. Hooper et al.*, 76 N.J. Eq. 592, 75 Atl. 568)

The subtext for this decision was the tremendous importance that the states’ charter powers had acquired as a result of the rise of big business. To allow the partnership agreement between Jackson and Hooper to stand, the court declared, would render “nugatory and void the authority of the Legislature . . . in respect to the creation, supervision, and winding up of corporations.” This result, the court underscored, could not “be tolerated” (75 Atl. 571).

A Dual Economy

The rigid distinction between partnerships and corporations that the New Jersey Appeals Court articulated in 1910 would persist until the middle of the century.²⁷ Throughout this period, however, there was ongoing debate about the nature of both partnerships and corporations. For example, a new breed of legal theorists emerged to challenge the resurgence of artificial entity theory by arguing that corporations should be regarded as “natural” entities that were comparable to human beings even to the extent of developing their own identities and personalities. According to Horwitz and Mark, this view of the corporation originated in Germany during the second half of the nineteenth century as part of a philosophical project stimulated by, and in reaction to, the growth of the modern nation-state. The writings of prominent German thinkers, the most influential of whom was Otto Gierke, were first introduced

²⁷ For additional examples of cases where the courts overturned agreements that members of small businesses had used to circumvent some of the standard features of the corporate form, see Weiner (1929), pp. 275–7, and Schwartz (1965), pp. 66–7. Rutledge (1937) claimed that the more liberal incorporation laws that states like New Jersey and Delaware passed during the late nineteenth century had actually made the problem of small corporations worse by reducing the power of individual shareholders.

to America at the turn of the century, where they immediately appealed to intellectuals seeking to legitimate the giant corporations that had emerged to dominate the American economy. Natural-entity theory, according to Horwitz and Mark, allowed these intellectuals to present corporations as existing in a Lockean sense prior to the state, as organisms which the law could “no more create . . . than it [could] a house out of a collection of loose bricks” (Arthur W. Machen, quoted in Horwitz 1992, p. 103).²⁸

As Mark Hager has pointed out, however, natural-entity theory could serve very different political purposes as well. Some of the leading proponents were reformers searching for a more effective means of asserting the government’s regulatory authority over large corporations. If corporations were equivalent to natural persons, then they could be subjected to the state’s police powers just as ordinary citizens and not exempted from oversight on the grounds that they were creatures of state governments whose privileges were protected by their charters (Hager 1989). Moreover, it is clearly the case that some of the most vocal advocates of the natural-entity theory were not primarily concerned about corporations at all. Rather, they were intent on articulating a more general theory of the personality of groups that would apply to (and help to legitimate) other forms of organization – for example, labor unions – that were under attack as conspiracies or illegitimate restraints of trade. For example, when Harold Laski (the future head of the Labor Party in Britain) made the case in the *Harvard Law Review* that “less than the admission of a real personality [for corporations] results in illogic and injustice,” this demonstration was only the first step in an argument that had as its ultimate purpose proving that the “unincorporate body was [not] any less the result of self-will than its corporate analogue” and that “the distinction between incorporate and voluntary association must be abolished” (Laski 1916, pp. 416–17, 424).

Theorists also applied this more general version of natural-entity theory to the case of partnerships. When the Conference on Uniform State Laws (a Progressive-era effort to standardize legal practice across states) in 1902 directed its Committee on Commercial Law to draft a new uniform law of partnerships, the committee initially delegated this task to James Barr Ames, dean of the Harvard Law School and a proponent of the new ideas about the personality of associations. Ames died before the bill could be completed, and the committee turned to William Draper Lewis of the University of Pennsylvania School of Law to complete the task. Apparently, some members of the committee were having doubts about Ames’s approach, because Lewis was asked to prepare two drafts – one on the basis of real-entity theory, as Ames had done, and another on the standard (aggregate) theory of partnerships. After Lewis finished his work, the committee held a conference in 1911 attended by a number of experts in partnership law. Although, according to Lewis, virtually all the participants had originally supported the real-entity view, the consensus that emerged from the conference was that this draft should be abandoned. It seems that the changes that the revision entailed were now perceived to be too radical. Participants worried that the bill would effectively overturn much of the existing case law and that it might also have the undesirable consequence of weakening partners’ sense of responsibility for their business dealings. In any event, the committee asked Lewis to write yet another draft based on the aggregate theory of

²⁸ Also see Horwitz (1992), pp. 71–4, 100–5; and Mark (1987), pp. 1464–78.

partnerships. This Lewis did, and after further discussion, the bill was accepted in 1914 and subsequently adopted by virtually all of the states (Lewis 1911, pp. 93–4; Williston 1915, pp. 206–12; Crane 1915, pp. 769–70; Lewis 1915, pp. 162–73; Warren 1929, pp. 293–301).

Hence, despite the growing strength of the view that all groups (including partnerships as well as corporations) were natural entities, the rigid legal differentiation between partnerships and corporations continued. Nor was there much innovation during this period in the sense of creating intermediate forms that would allow small businesses to obtain limited liability without having to accept all of the other aspects of the corporate form. After it completed its work on the partnership law, the Committee on Commercial Law did turn its attention to drafting a uniform limited partnership law. The act that emerged from the committee in 1916 remedied the defects of earlier laws under which ostensibly limited partners might find themselves through no fault of their own fully liable for their firms' debts. Nonetheless, the form continued to be little used. As late as 1980 there were only 170,336 limited partnerships in the entire United States, as opposed to 1,209,318 ordinary partnerships and 2,710,538 corporations (Lewis 1917; Howard 1934; see Table Ch157–168).²⁹

It seems that members of small businesses preferred a form, like the corporation, that granted them all limited liability over a form, like the limited partnership, that afforded this privilege only to partners who did not participate in management.³⁰ As we have seen, however, this benefit of incorporation was potentially offset by costs associated with other aspects of the corporate form, most significantly the possibility that minority shareholders could be “held up” by those owning a majority of the stock. That growing numbers of businesspeople nonetheless chose the corporate form over the partnership during the early twentieth century (see Table Ch1–18) suggests that, in their minds, the advantages of limited liability more than offset the costs associated with the standard corporate governance structure. But it is also possible that members of firms, who typically were well acquainted with each other and likely to err on the side of trust, overly discounted the possibility

that something would go wrong with their relationship.³¹ In any event, there were lots of problems with these kinds of firms and, as time went on, a growing volume of legal writings advocating remedial legislation on the grounds that the corporate form, with its one-size-fits-all character, was not well suited to the needs of small business.³²

The first major statutory response occurred in North Carolina in 1955. That year several provisions were embedded in the state's new Business Corporation Act that aimed specifically at small businesses, including one declaring that agreements among all the shareholders of such corporations shall not, regardless of their form or purpose, “be invalidated on the ground that [their] effect is to make the parties partners among themselves.”³³ A few other states passed similar statutes over the next decade or so, but the late 1960s and especially the 1970s brought forth a flood of new legislation that in most jurisdictions created a separate legal status for close corporations. In some cases, the new statutes not only gave members of small corporations flexibility to govern their enterprises like partnerships, but also provided greater ease of exit. For example, Delaware's law permitted close corporations to include in their charters provisions granting to one or more shareholders the right to “have the corporation dissolved at will or upon the occurrence of a specified event or contingency” (O'Neal 1958, pp. 876–8). Still other states followed South Carolina's lead and gave judges broad powers to intervene in the affairs of, and even dissolve, small corporations suffering from internal dissension. Protection of minority shareholders became a major legislative preoccupation, and during the 1970s and 1980s there was another wave of legislation that defined and established legal remedies for “corporate oppression” and other similar torts (O'Neal 1958, pp. 873–80; Mitchell 1990, pp. 1679–81).

Ironically, the rise of big business had facilitated the development of this separate legislative status for small corporations at the same time as it spurred the courts to enforce more rigidly the standard corporate template. The growth of a market for industrial securities that the Great Merger Movement had initially stimulated made it easier to distinguish public corporations (those whose equities were traded on the exchanges) from close corporations (those whose equities were not).³⁴ Moreover, there was growing

²⁹ In 1874, Pennsylvania passed a law providing for the creation of a new form of enterprise called the limited partnership association. Michigan followed suit in 1877, New Jersey in 1880, and Ohio in 1881, but the device did not spread beyond these four heavily industrial states. Moreover, even in these states the form was rarely adopted, most likely because the governance structure dictated by the legislation was highly restrictive. The statutes vested the power to incur debts in a board that had to consist of at least three managers elected by the members of the firm. Debts in excess of \$500 required the signature of at least two managers, and there were situations in which the prior approval of a majority of the members was required before the managers could take action. Approval of a majority was also necessary for the transfer of shares to new members (even from decedents to heirs) and for the acquisition of additional shares by an existing member (Schwartz 1965).

³⁰ Even the corporate form, however, did not ensure that businesspeople would be able to limit their obligations to the amount they had invested in the firm. Indeed, stockholders of small firms often found that they had to assume personal liability for the enterprise's debts in order for it to secure loans at affordable rates (see Woodward 1985 and Forbes 1986). Limited liability did, however, resolve to an important degree the principal-agent problems that partners faced vis-à-vis each other because it eliminated the possibility that one member of a firm could unilaterally encumber the enterprise with debts that the others might have to repay out of their own assets. In a firm with limited liability, members were responsible personally only for obligations that they deliberately chose to assume.

³¹ As Hetherington and Dooley have argued, small firms usually “are founded by individuals who have a virtually complete identity of interest and strong feelings of trust and confidence for one another.” Even in such firms, however, “time and human nature may cause a divergence of interests and a breakdown in consensus,” a situation that can be resolved relatively easily by dissolution in the case of partnerships but that poses more severe difficulties for corporations (1977, p. 3).

³² F. Hodge O'Neal (1958) was a leader of this movement. For a survey of this literature, see O'Neal (1965), pp. 642–3.

³³ The North Carolina law also contained a provision that made it possible for any shareholder to precipitate a judicial dissolution if the corporation's charter or any other written agreement among all the shareholders entitled “the complaining shareholder to liquidation or dissolution of the corporation at will or upon the occurrence of some event which has subsequently occurred” (O'Neal 1965, pp. 646–8).

³⁴ This development did not completely solve the definitional problem, however. Indeed, as late as 1965, there was considerable confusion about how to draw the line between close and other corporations, and states adopted widely different strategies. Florida, for example, defined a close corporation as one whose securities were not generally traded on the markets, but Delaware placed limits on the number of shareholders a close corporation could have and insisted that its charter include restrictions on the transferability of its stock. Maryland

recognition that the economy had acquired a dual structure. The “center” portions of the economy were now dominated by a relatively small number of very large firms operating in oligopolistic markets – multiunit enterprises whose far-flung plants (often spanning a variety of different industries) and vertically integrated facilities were coordinated by managerial hierarchies (see Table Ch440–449). The economy’s “periphery,” on the other hand, consisted of small, mostly single-unit, owner-managed firms operating in competitive markets (Averitt 1968, pp. 1–21). It no longer seemed to make sense to force these small firms of the periphery to conform to the same organizational rules as center firms.

The increasingly burdensome character of the personal income tax may also have played a role in these changes by providing an incentive for firms that might not otherwise have chosen to do so to organize as corporations and thus confront the aspects of the form that were inappropriate for small businesses. Corporations paid a flat tax rate on their income that ranged from a post–World War II peak of 52 percent to a low of 46 percent on the eve of the Tax Reform Act of 1986. The top personal income tax rates were above this level (often substantially) during these years, increasing the attractiveness of the corporate form relative to partnerships. In addition, whereas the flat corporate tax rate was unaffected by inflation, the progressive personal income tax subjected individual taxpayers to bracket creep, forcing marginal rates relatively higher. In 1950, the amount of revenue raised by the corporate and personal income taxes had been about the same; by 1980, the personal income tax yielded four times the revenue of the corporate tax (Brownlee 1996, pp. 89–129).

Legislation during Ronald Reagan’s presidency reversed this situation, first in 1981, by reducing the top personal tax rate to 50 percent, and then, with the Tax Reform Act of 1986, by reducing it to 28 percent (the 1986 Act also dropped the corporate rate from 46 to 34 percent). The impact of these changes on businesspeople’s organizational choices was to a large extent counteracted, however, by legislation liberalizing the rules under which small corporations could claim Subchapter S status, which essentially allowed them to be taxed as partnerships. Especially after the 1986 Act, growing numbers of firms filed as S-corporations, but there was comparatively little shifting from the corporate to the partnership form (Petska and Wilson 1994; Petska 1996).

The 1986 law did, however, spur the American Bar Association to appoint a drafting committee to begin the process of revising the Uniform Partnership Act to make the form more attractive. The end result, the Revised Uniform Partnership Act (RUPA) of 1992, reversed the tack taken at the turn of the century and declared partnerships to be legal entities with the right to hold property and sue and be sued like an individual. Members of partnerships could still withdraw from their firms at will, but the Act also aimed to stabilize the form by reducing the number of circumstances under which partnerships would be dissolved. For example, the withdrawal of a member from a firm no longer automatically triggered dissolution but instead typically resulted in a buyout (Weidner 1991, pp. 427–8).

Tax incentives also fostered the growth of interest groups that pressured legislatures to expand the range of organizational choices

required only that the charter include a statement saying that the firm was a close corporation (O’Neal 1958, pp. 875–7; 1965, p. 644).

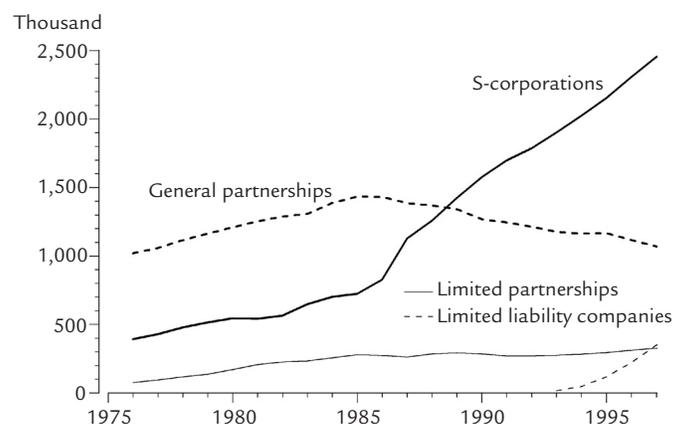


FIGURE Ch-E General partnerships, limited partnerships, limited liability companies, and S-corporations: 1976–1997

Sources

Series Ch16, Ch160, Ch163, and Ch166.

available to small businesses. Wyoming, for example, passed enabling legislation for limited liability companies (LLCs) as early as 1977, consciously designing the form so as to allow firms to acquire the privilege of limited liability without losing the tax status of partnerships. Few states followed Wyoming’s lead, however, until the IRS confirmed in 1988 the tax advantages of the new form (Gazur and Goff 1991, pp. 389–93). Then there was a wave of statutes establishing the LLC as a legal form of organization, followed by a second wave of enabling statutes for limited liability partnerships (LLPs). The latter laws permitted all members of an ordinary partnership to limit their liability for their firm’s future debts simply by filing appropriate notice.³⁵

The result of all this legislative action has been to create a dual economy organizationally as well as economically. (See Figure Ch-E for trends in corporate and partnership forms.) Businesspeople involved in small enterprises now have virtually complete freedom to organize their enterprises as best suits their needs and can contract on the extent of their liability, the governance rules to which they must adhere, and the ease with which they can exit from the firm. Large firms, on the other hand, still employ the traditional corporate form, though there is ongoing debate about the legal character of these entities. One of the two main conceptions of the corporation currently vying for dominance harks back to Morawetz’s “aggregate theory” that the corporation is the private property of its owners, the stockholders. This view seeks implicitly to reverse the split that has arisen between small and large businesses by conceiving of all firms regardless of size or form as private contracts whose purpose is to advance the wealth of their owners. The opposing side conceives of the corporation as a social institution in which many groups besides stockholders (labor, for example) have a stake equivalent to ownership. According to this view, the directors of a corporation are not just representatives of shareholders but rather are officers vested with responsibility for mediating among the various stakeholders in the interests of the

³⁵ Although the initial Texas legislation creating the LLP form was apparently “a response to astronomical losses threatening lawyers and accountants as a result of their partners’ involvement in the savings and loan crises of the late 1980s,” the rapid spread of the form to other states owed more to tax considerations (Stover and Hamill 1999, pp. 815–16).

TABLE Ch-F Important events, legislation, and judicial decisions relating to business organization: 1811–1992

1811	New York passes legislation to encourage manufacturing by providing for the routine incorporation of businesses in certain specified industries.
1819	U.S. Supreme Court decision in <i>Dartmouth College v. Woodward</i> defines corporations as “artificial beings” having the legal standing of natural persons in some respects.
1822	New York and Connecticut pass legislation allowing limited partnerships.
1831	U.S. Supreme Court decision in <i>Winship v. Bank of the United States</i> rules that specific clauses restricting the rights of any of the partners to act in the interest of the firm could not be employed to limit the firm’s liabilities.
1837	Connecticut passes a general incorporation act.
1845	Louisiana adopts a constitutional amendment prohibiting corporations from being chartered by special act of the legislature.
1882	Organization of the Standard Oil Trust.
1886	U.S. Supreme Court decision in <i>Santa Clara County v. Southern Pacific Railroad</i> extends the Fourteenth Amendment protection against discriminatory legislation to corporations.
1888	New Jersey passes a general incorporation law allowing the formation of holding companies.
1890	Congress passes the Sherman Antitrust Act authorizing the federal government to institute legal proceedings against trusts for the purpose of dissolving them.
1895–1904	The Great Merger Movement sees 157 consolidations and more than 1,800 firms disappearing into consolidations.
1906	U.S. Supreme Court decision in <i>Hale v. Henkel</i> defines the corporation as a “creature of the state . . . presumed to be incorporated for the benefit of the public.”
1911	U.S. Supreme Court decisions in <i>Standard Oil v. United States</i> and <i>United States v. American Tobacco</i> invoke the “rule of reason” to classify industrial combinations into two distinct categories, to which two different tests of restraint of trade applied.
1913	Ratification of the Sixteenth Amendment to the Constitution (income tax).
1914	Uniform Partnership Law standardizes criteria for determining which contracts are partnerships and which are not.
1916	Uniform Limited Partnership Law remedies defects of earlier laws under which ostensibly limited partners might find themselves, through no fault of their own, fully liable for their firms’ debts.
1955	North Carolina passes a new Business Corporation Act with special provisions aimed at small businesses.
1977	Wyoming passes enabling legislation for limited liability companies (LLCs).
1986	Congress passes the Tax Reform Act reducing the top personal income tax rate below the corporate tax rate.
1991	Texas passes enabling legislation for limited liability partnerships (LLPs).
1992	Revised Uniform Partnership Act declares partnerships to be legal entities with the rights to hold property and sue and be sued like individuals.

enterprise as a whole. Both of these views have found support in the case law. As William T. Allen, Chancellor of the Delaware Court of Chancery (effectively the nation’s primary court of corporate law) has argued, this “schizophrenic” state of the law is unlikely to end because at its root are ongoing, and largely unresolvable, political disagreements over the role of government in regulating large-scale capital. For a summary of the two positions, see Allen (1992), Blair (1995), and Blair and Stout (1999).

What We Are Missing

This narrative has, of necessity, focused on changes in the organizational forms that the legal system has designated as firms (see Table Ch-F for some of the key events). These are the forms whose numbers it is possible to count, and much can be learned by analyzing their relative incidence across industries and over time. Much can also be learned by analyzing the additional information that it is sometimes possible to collect for firms that took these standard forms. For example, using balance-sheet data of the sort reported in Table Ch510–524, we can track the effects of the development of a broad national securities market on corporations’ sources of finance. Similarly, by comparing the data in this table with that provided for S-corporations in Table Ch645–658, we can get some sense of how the financial structures of small and large corporations differed. For example, we can compare their debt-to-equity

ratios or the ratio of their share capital to their accumulated surplus.³⁶

It is important to bear in mind, however, that the figures in these tables represent only part of the economic activity that Cheung and other theorists think should be included in the study of business enterprises. It is impossible to estimate even roughly the relative magnitude of the missing portion, because many of the long-term contracts that structure these enterprises are private documents that are not recorded in any regular way. It is likely, however, that the relative size of this missing portion has changed dramatically over the course of U.S. history and that, as a result, we are severely handicapped in our efforts to understand both the magnitude and the determinants of organizational change. For example, as Chandler has argued, for approximately a century beginning during the 1870s, firms in a number of important industries grew and expanded their boundaries, first by integrating horizontally to acquire competitors, second by integrating vertically into supply and distribution functions, and third by diversifying into new product areas (Chandler 1990, pp. 47–233). During the last quarter of the twentieth century, however, this trend was significantly reversed. Large firms began actively selling off acquisitions and spinning off

³⁶ The IRS also published (although not in every year) aggregated balance-sheet data for partnerships. See its various *Statistics of Income* (SOI) volumes and the *SOI Bulletin*.

entire divisions into independent firms. They also began, in a process that Michael Dell has dubbed “virtual integration,” to substitute long-term contracts for vertical integration. His Dell Computer Company is an excellent example (Lamoreaux, Raff, and Temin 2003).

These new virtually integrated networks of firms can be as much repositories of capabilities as the vertically integrated behemoths of Chandler’s account. For example, Toyota, the model for many “new economy” firms such as Dell, involves its suppliers in its strategic planning and codevelops new technologies with them. Undoubtedly, these alternative organizational arrangements have both advantages and disadvantages over the type of vertical integration Chandler described, but unfortunately their relative invisibility in the quantitative record makes them difficult to study in any systematic way. As a result, we may never be able fully to answer the questions that Cheung argues are central to an understanding of business enterprises: “why contracts take the forms observed and what are the economic implications of different contractual and pricing arrangements” (Cheung 1983, p. 18).

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