American Economic Association

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Source: *The American Economic Review*, Vol. 88, No. 2, Papers and Proceedings of the Hundred and Tenth Annual Meeting of the American Economic Association (May, 1998), pp. 66-71
Published by: American Economic Association
Stable URL: http://www.jstor.org/stable/116894
Accessed: 04-05-2016 13:15 UTC

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Partnerships, Corporations, and the Theory of the Firm

By NAOMI R. LAMOREAUX *

The purpose of this essay is to use business history, in particular the history of the contractual choices made by 19th-century entrepreneurs to organize their businesses, as raw material for reflecting on the nature of that entity we call the firm. The essay uses a transaction-costs framework to argue that no clear economic boundary distinguished ordinary contracts from those considered by law to be firms. Although my approach emphasizes the role of power and thus in some ways is similar to that of Oliver Hart (1995), Hart's analysis does not allow for important differences in the nature of ownership that resulted from the use of alternative organizational devices. By contrast, I argue that businesspeople could choose from a range of contractual forms that offered varying degrees of "firmness," that is, that differed in the extent to which they protected contracting parties against holdup. I also argue that increasing the degree of "firmness" of a contract was not always desirable from the standpoint of entrepreneurs.

The organizational choices available to entrepreneurs varied over the course of the 19th century. During the early part of the century, most businesses were organized as single proprietorships or partnerships. The only way to form a corporation was to secure a special charter from a state legislature, but such charters were usually granted only to projects deemed to be in the public interest. As the century progressed, however, the states gradually liberalized their policies on charters, and by the 1870's most had passed general incorporation laws that made the corporate form widely available (Herbert Hovenkamp, 1991). Thus by the post-Civil War period, most businesses could organize either as partnerships or corporations.

The choice was an important one. On the most obvious level, partners had unlimited liability for their firm's debts, whereas the liability of members of corporations was limited. But there were other significant differences as well. For example, the partnership form of organization typically had a short time horizon. Partnership agreements either expired after fixed periods of time or included procedures for terminating the arrangement at the will of one of the members. The death of a partner also typically forced the dissolution of a firm. Although corporations could be organized for fixed periods of time, they were more commonly chartered in perpetuity. Moreover, the life of a corporation was independent of that of any of its stockholders. No one stockholder could force a dissolution of the firm, unless he or she owned a majority of the shares.

Another difference between partnerships and corporations, closely related to the issue of longevity, was the structure of governance. Members of a partnership all had the power to act as if they were the sole owners of the enterprise. As long as they were acting within the scope of the firm's normal business, they could enter into obligations that were binding on the firm without the consent of the other partners. Although partnership agreements might impose a hierarchical order on the firm's members and limit the actions that any one partner could take, such agreements did not exempt firms from liabilities assumed by partners contrary to their terms (Lamoreaux, 1995). Members of corporations, on the other hand, did not individually possess authority to bind the firm. The corporate form of organization concentrated management in the hands of officers elected by a vote of the stockholders, and the firm was not liable for debts incurred by members who were not empowered

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to act on the stockholders' behalf (Edward H. Warren, 1929 pp. 21–22).

It is important to realize that these differences between the partnership and the corporation were not rigidly fixed, but rather varied in magnitude over time. Over the course of the century, as the courts worked through a wide variety of cases involving such matters as bankruptcies and stockholders' rights, they drew upon contending bodies of legal theory regarding corporations. During the early part of the century, the view that corporations were artificial creatures of the state held sway; by the middle it was increasingly common to view corporations as private contracts made by "aggregations" of businessmen; by the end, the courts were moving toward the view that corporations were legal persons in the eye of the law. During the period when aggregation theory dominated, the courts applied many aspects of partnership law to cases involving corporations, and the differences between the two forms narrowed (Morton J. Horwitz, 1992). During the same period, there were various circumstances in which stockholders of corporations might find themselves liable for amounts in excess of their investment. As Horwitz (1992 p. 94) has written, "the distinction between the liability of the members of a corporation and a partnership, so clear to modern eyes, was still regarded as a matter of degree rather than of kind."

It makes sense, therefore, to conceptualize the differences between partnerships and corporations, not in terms of discrete categories, but rather in terms of continuous variables that could take on different values at different points in time. In particular, the differences between these forms might be arrayed along two dimensions. The first dimension would be liability (the extent to which members of a firm were responsible for the enterprise's debts), with partnerships generally high on liability compared to corporations. The second might be thought of as a measure of the firm's autonomy (the extent to which it had a legal existence beyond that of its members). The ability of a partner acting alone to bind a firm and to dissolve it at will meant that partnerships were low on autonomy compared to corporations. These two dimensions were not, of course, completely independent, but they can be distinguished analytically, and as I will show, it is useful to do so.

The literature on the advantages of the corporate form has focused almost exclusively on the first of these two dimensions, liability. Some scholars have argued that there were no clear benefits to limited liability because whatever savings it permitted in raising equity capital were offset by higher costs in securing loans. Others have countered that limited liability played an important role in lowering transaction costs, for example, those associated with transferring shares on the securities markets.[1] Arguments like the latter imply, however, that the benefits of limited liability were greater for large firms seeking public ownership than for small closely held companies. Although the historical record indicates that large enterprises almost universally adopted the corporate form, the vast majority of businesses choosing to incorporate during the late 19th century were small firms whose stock was closely held. It is important to understand why small as well as large firms made this decision, for the widespread adoption of the corporate form by small firms played a major role in its subsequent history.

In the case of small firms, there appears to be abundant evidence that liability rules in and of themselves did not determine the choice of organizational form. First, firms did not always take advantage of limited liability when it was readily available to them. Many British joint-stock companies, for example, could have obtained limited liability by reorganizing under a general incorporation law passed during the mid-1850's but chose instead to remain as they were (Forbes, 1986; Smart, 1996). Similarly, in the early 19th-century United States, small firms sometimes voluntarily wrote into their corporate charters clauses that specified unlimited liability. Throughout the century, moreover, it was common for the officers and leading stockholders of small corporations to endorse personally their company's debts in order to secure commercial credit and bank loans (Lamoreaux, 1997).

[1] For a survey of this literature, see Kevin F. Forbes (1986) and Michael Smart (1996).

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A second type of evidence, which is perhaps more revealing about the determinants of contractual choice, was small firms' reluctance to adopt an available alternative: the limited partnership. Legislation permitting this type of organization was first passed in New York and Connecticut in 1822 and then adopted by most other states over the next couple of decades—long before the advent of general incorporation laws made the corporate form a widely available alternative—and yet few firms seem to have chosen the new form. This lack of interest is somewhat surprising, because limited partnerships would seem to have had some advantages over ordinary partnerships. The statutes created firms with two types of partners: general partners, who had unlimited liability and whose rights and responsibilities were the same as those of members of ordinary partnerships; and special partners, whose liabilities were limited to their investments and who had no authority over the management of the company.[2] From the standpoint of a general partner, the limited partnership functioned much like a limited-liability corporation in which officers assumed personal responsibility for debts in excess of the firm's capital. From the standpoint of a special partner (i.e., an investor who did not intend to participate in the management of the firm) the form involved the possibility of greater gains than could be obtained from a simple loan contract without the risks that an ordinary partnership entailed. Compared to a corporation, moreover, the arrangement may have reduced principal–agent problems because the firm's general partners not only shared fully in whatever gains or losses their actions generated, but were personally liable for debts in excess of capital. Moreover, investors who were dissatisfied with the quality of the firm's general partners could vote with their feet and refuse to renew the partnership when its term expired. Stockholders of corporations could sell out only if there were willing buyers for their shares; limited partners could force the firm to reimburse them.

This, of course, was the crux of the problem from the standpoint of the general partners. If one adopts an Oliver Williamson type of transaction-cost view of the firm, the reason is apparent. According to Williamson, whenever resources have a significantly greater value in combination than they do in alternative uses, there is a risk of holdup which can only be countered by bringing the assets together within a single firm (Williamson, 1985). In general, however, firms organized as partnerships had much less ability to protect members against holdup than did firms organized as corporations for the simple reason that partnerships were lower in autonomy. The ability of partners to dissolve the firm at will or after the fixed term of the agreement meant that there were circumstances under which one party could use the threat of dissolution to force the others to grant more favorable terms. For example, during the first decade of the 19th century, E. I. Dupont's refusal to allow his partner, Peter Bauduy, to count as capital a note he had endorsed for the enterprise produced much ''animadversion on the part of P. Bauduy, who threatened to sue for a dissolution of partnership to stop the factory and could not be pacified, but by the new agreement'' in which Bauduy ''exacted from the concern some extra compensation and advantages.''[3]

Ordinary partnerships were nonetheless an improvement over nonfirm contractual agreements, because they raised the costs that had to be borne by a party that failed at an attempt at holdup. If, instead of better contract terms,

[2] There were problems with the way the legislation was written which, by exposing special partners to unlimited liability under certain circumstances beyond their control, reduced the attractiveness of the form (William Draper Lewis, 1917). What is intriguing, however, is how little interest there was in remedying these statutory deficiencies. Eventually a few Western states passed legislation protecting special partners who acted in good faith, but that was all until the drafting of the Uniform Limited Partnership Act in the second decade of the 20th century (Warren, 1929 pp. 309–10).

[3] ''Answer of Eleuthere Irénée Dupont made in his own name as well as in behalf of Mess. E. I. Dupont de Nemours & Co. to the bill filed in chancery by Peter Bauduy against him and the said concern,'' 1817, Special Papers, Bauduy Lawsuit (Part I) (1805–1828), Longwood Mss. Box 45, Accession Group 5, E. I. du Pont de Nemours & Co., Series C, Hagley Library Manuscript Collections, Wilmington, DE.

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the attempt resulted in the dissolution of the firm and the liquidation of its assets, all of the partners stood to lose from the forced sale of resources whose value outside the firm was less than it was within. In the case of limited partnerships, however, this principle of equal pain did not hold. Instead, the claims of the special partners took precedence over those of the general partners. At the end of the term of the limited partnership, the general partners either had to meet the special partners' conditions for renewal or face dissolution. In effect, they were in the position of borrowers who owed a big balloon payment at the end of a fixed period of time. If they could not get another loan, they would have to liquidate assets to pay off their debt. The risk of holdup, moreover, was not borne only by one side. If the firm was unusually successful, the general partners could extract higher payments from the special partners in return for their agreed-upon share of the profits. For example, Aaron Benedict reorganized his Connecticut button manufactory as a limited partnership in 1829. The firm did very well, and when the agreement expired in 1834, Benedict raised the price of the smallest share from $1,000 to $2,500. In 1838 he raised the price again to $5,000. In both 1834 and 1838, small investors who could not come up with the requisite sums were forced to drop out of the company (Matthew W. Roth, 1994).

In other words, the limited partnership, although lower on the liability dimension than the ordinary partnership, was also lower on the dimension of autonomy. The latter seems to have outweighed the former in the eyes of 19th-century entrepreneurs, and few seem to have organized their enterprises as limited partnerships.[4] The choice between the partnership and the corporate form was very different, however, for corporations were not only lower on the liability dimension, but higher on the autonomy dimension compared to partnerships; that is, corporations also offered greater protection against holdup. The following example helps to explain why.

The case involves the company formed by George Corliss to manufacture the famous steam engine that bore his name. The firm was first organized as a partnership in 1847 and then, ten years later, reorganized as a corporation, with the bulk of the stock evenly divided between Corliss himself and an investor named Edwin J. Nightingale, who served as the firm's treasurer. The two men agreed to admit several additional members to the firm by selling equal amounts of their stock to the new parties, but when Corliss sought to increase the number of shares owned by his brother William, Nightingale refused to reduce his own holdings for this purpose. Perhaps he realized that the two brothers would likely vote as a block and that by selling stock to William he would in effect be giving George control of the company. After repeated attempts to persuade Nightingale to change his mind, George sold William a block of his own stock. But he also determined to force Nightingale to sell out his interest. If the firm had still been organized as a partnership, this action would have been relatively easy to take. Corliss could have unilaterally forced a dissolution of the firm and, at the same time, prevented a mutually disastrous liquidation by offering Nightingale cash for his share. The corporate form of organization made things much more difficult, however, because the two parties had to agree to a dissolution. In this particular case, Corliss had an ace up his sleeve. He retained personal control of the patents on his steam engine and used them to threaten to destroy the company by licensing competitors to make his patented engines.[5] Nightingale was forced to capitulate, but later investors in similar situations would protect

[4] In France, the limited partnership (known as societé en commandite) was an important and commonly used business form. It had greater autonomy than the American variant, however, because it could be organized for long periods of time (typically 99 years) and included contract terms that gave the firm a lifespan independent of that of its general partners (Charles E. Freedeman, 1979). I am indebted to Lacey Plache for the information on contract periods.

[5] "Business from 1847 to 1861," Box 4, Folder 6, George H. Corliss Papers, Ms. 80.3; 13 February, 12 March, 19 March, 20 March, 1 June, 8 June, 24 June, 18 August, 19 August, and 24 September 1863, William Corliss Diaries, Ms. 80.4, Brown University Library, Brown University, Providence, RI.

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themselves against holdup by making the assignment of full patent rights a condition of their participation in the corporation.

If one adopts Williamson's logic and thinks about firms as organizational arrangements that reduced opportunities for holdup, then the Corliss example suggests that it is not very useful to think about firms and nonfirms as either/or categories. Rather it is more useful (again) to think in terms of a continuum of contractual arrangements arrayed according to their degree of "firmness." Some contracts offered parties relatively little protection against holdup; that is, they had relatively little of that attribute I am calling "firmness." Others with more "firmness" offered stronger protection. In general, organizational arrangements that ranked higher on the autonomy dimension had more "firmness" than those that ranked lower.

The Corliss example also suggests that increasing the degree of "firmness" of an organization entailed costs for at least some of the contracting parties that were directly related to the greater protection against holdup. The relatively lower "firmness" of the partnership form of organization would have allowed Corliss to benefit from Nightingale's investment when he needed it and then to take control of the company when he did not. The relatively higher "firmness" of the corporation made this sequence of events much more difficult to effect. The general point I wish to make here is that use of the term "holdup" may have misleadingly negative connotations. What is really at stake is the ability of one party to a contract to use some form of economic muscle against another. Although the exercise of such muscle could have undesirable consequences for one or more parties, so could blocking its use. In other words, from the standpoint of the economic actors involved, there was a trade-off between greater protection against holdup and the ability to use economic power. The corporate form of organization was not always an improvement over the partnership for all of the parties concerned.

A couple of concluding observations relate the above discussion to the literature on the theory of the firm. First, the argument I have presented is similar to that of Hart (1995) in the sense that it builds on the notion that incomplete contracts and power are keys to understanding the structure of economic institutions. For my purposes, however, Hart's notion of ownership, which he defines as the possession of residual rights of control, is not all that helpful because it is still basically an either/or proposition. It does not allow for subtle differences in the nature of ownership that result from employing different organizational forms. Second, my argument may also seem at first glance to be similar to that of theorists like Steven Cheung (1983), who argue that it is impossible to develop a workable definition of the firm that distinguishes it from other kinds of contractual arrangements. I would disagree, however. If one conceptualizes the central problem of economic development as the bringing together of producers and investors in a way that fosters the creation of sustained capabilities, then "firmness" becomes an attribute of great economic significance. Protection against holdup is crucial to actors' willingness to invest in the kinds of enterprise-specific capabilities that Richard Nelson and Sidney Winter (1982) have shown to be so important in economic progress. The question then becomes how much protection is optimal under different circumstances.

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