Business Organization in American Economic History
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Abstract: This chapter presents the history of the organization of American enterprise, up to the twentieth century and the emergence of large, vertically integrated conglomerates. It begins with a synopsis of the early origins of large-scale firms and the use of the corporate form. It then presents a discussion of the alternative organizational forms that were available to entrepreneurs in the American states, and the significance of those legal innovations. Finally, it presents a discussion of the rise of what became known as “big business” in the late nineteenth century, and the legal and institutional context within which those enterprises began to emerge. The discussion of each is focused on the changing nature of the problems faced by entrepreneurs, and the changing legal and institutional environment in which they operated. Among the topics discussed are: the evolution of corporation law; the choice of organizational form; recurring problems in corporate governance; the role of financiers in corporate governance; and the emergence of pyramidal holding company structures.
1. Introduction

In the decades that followed the Revolution, the American economy experienced a dramatic transformation. Whereas economic life in the colonies had been dominated by agriculture and commerce, in the Early National Period the economy began to industrialize. This process continued throughout the nineteenth century and by 1890, the value of American industrial output was threefold greater than the value of its agricultural output. By 1914, American industrial output was nearly as great as that of Great Britain, Germany and France combined, and real income per capita in the United States was slightly higher than that of Great Britain.

Facts such as these are well known. Less well known are the changes in the organization of firms that underpinned the development and industrialization of the American economy. As the work of Davis (1917) makes clear, at the time of the Revolution, few large-scale business enterprises of any kind existed in the United States: there was just one insurance corporation, no banks, and what little manufacturing was being done was mostly conducted in artisanal shops. During the subsequent decades, large-scale manufacturing enterprises began to emerge (see Clark, 1916, and Ware, 1931), as did firms engaged in the provision of financial services and the creation of transportation infrastructure (Hammond, 1957; Gillingham, 1933; and Klein and Majewski, 1992). The rapid proliferation and growth of businesses eventually began to produce some very large enterprises, such as railroads, but also much greater numbers of small and medium-sized firms. Many were organized as corporations, a form that the American states made increasingly accessible (Sylla and Wright, 2013). However, the partnership remained quite important in most sectors, and new organizational forms such as the limited partnership and the “partnership association” were made available as well.

In choosing an organizational form and capitalizing their firms, entrepreneurs confronted a range of problems. Overcoming adverse selection and attracting investments from outsiders was of course a significant issue. But also important were incentive problems that might be faced by the managers to whom day-to-day operations might be delegated; the potential for conflicts among the owners, or for a
controlling owner to utilize the resources of the firm for his own benefit; and, of course, the risk of
financial losses and how they would be borne. Early entrepreneurs configured the rights of their firms’
investors and creditors to address these problems, but in doing so, they were constrained by the menu of
available organizational forms, and the features of those organizational forms that the law made
accessible to them.

Over time new forms of economic activity emerged, as technological innovation created new
goods and new production techniques. In addition, declines in the cost of transportation and
communication contributed to greater economic integration, and expanded potential markets for firms.
However, exploiting those new opportunities required entrepreneurs to address a new series of
information and incentive problems, and create businesses capable of surmounting them (see Lamoreaux,
et al., 2003). The organizational and contractual means available to address those problems changed as
well, as legal doctrines relative to business enterprise evolved, and new managerial technologies, such as
sophisticated accounting and control systems, were developed.

To analyze the history of American business organizations is to trace two parallel processes of
evolution: the changing needs of entrepreneurs and investors, on the one hand, and the changing legal
and institutional environment, on the other. Over successive generations, as economic activity evolved,
entrepreneurs confronted new problems, and developed mechanisms to address those problems within the
existing institutional framework. Those mechanisms, however, were not necessarily optimal, or even
adequate. A learning process occurred, among entrepreneurs, as well as legislators and jurists. Prominent
failures and successes changed subsequent behavior on the part of all three. In extreme cases, waves of
scandals shattered investors’ faith in the management of large-scale enterprises, and the legal and
institutional framework that existed to protect their rights. The resolutions of such episodes sometimes
produced new laws, and sometimes produced other institutional changes beyond the law.

Another force behind these processes of evolution was politics. The governments of the
American states used the law to promote economic development, and granted corporate charters to large
numbers of enterprises. In the early nineteenth century, a corporation could only be created by a special
act of the state—essentially, the government had to pass a law granting a corporate charter to a business—and it was necessary for corporations to be chartered by the state within which they operated (see Henderson, 1918, and Hurst, 1970). However, control over access to the corporate form led to serious problems of corruption, and political factions within state governments sometimes rationed charters in profitable industries such as banking in order to perpetuate their influence (see Wallis, this volume). This led reform movements to push for the adoption of general incorporation statutes, which facilitated open access to the corporate form through a simple registration procedure. The reform impulse also contributed to efforts to authorize the use of new organizational forms that had some corporate characteristics, such as the limited partnership. The terms of a state’s general incorporation statutes (if it had one), and its statutes authorizing the use of other organizational forms, were important determinants of the degree of flexibility enjoyed by entrepreneurs in organizing their firms.

This chapter presents the history of the organization of American enterprise, up to the twentieth century and the emergence of large, vertically integrated conglomerates. It begins with a synopsis of the early origins of large-scale firms and the use of the corporate form. It then presents a discussion of the alternative organizational forms that were available to entrepreneurs in the American states, and the significance of those legal innovations. Finally, it presents a discussion of the rise of what became known as “big business” in the late nineteenth century, and the legal and institutional context within which those enterprises began to emerge. The discussion of each is focused on the changing nature of the problems faced by entrepreneurs, and the changing legal and institutional environment in which they operated.

Among the most influential scholarship on the history of business enterprises has been that of Alfred Chandler (1962; 1977; 1990). Chandler’s work chronicles the emergence of industrial conglomerates, and emphasizes the efficiency gains achieved by these firms. However, Chandler’s work has been criticized as exaggerating the role of vertically integrated firms in the early twentieth century economy (see, for example, Scranton, 1997). More importantly, economic changes that occurred around the time of the publication of Chandler’s work have partly undermined the dominant position of many large industrial conglomerates (see Lamoreaux, Raff and Temin, 2003).
More recent work on the history of American business enterprises has focused on the importance of firms’ legal forms of organization, and on the conflicts that may arise both between firms’ managers and their outside investors, and among a firm’s different owners. This research has renewed interest in the questions pursued in Berle and Means’ *The Modern Corporation and Private Property* (1932). Berle and Means’ work influenced the development of a literature focusing on incentive conflicts among corporate managers; prominent contributions include Baumol (1959), Williamson (1964), and Jensen and Meckling (1976). Some of the analysis of this literature stands somewhat at odds with the conclusions of Chandler (1977).

Less well known is the historical narrative of Berle and Means, which presents an account of the evolution of the business corporation. Berle and Means argue that the American business corporation was once a well-governed institution, partly due to the active participation of the state in its creation, and partly due to its small size and the active participation of its owners. They then argue that the changes in corporation law that occurred over the nineteenth century, and the emergence of firms of unprecedented scale with thousands of completely passive shareholders, together caused ownership to become separated from control in the early twentieth century. In their view, firms like AT&T, which had half a million shareholders at the time they were writing, were fundamentally different than corporations from earlier eras: the owners of the firm, none of whom held more than a tiny fraction of the company’s equity, were no longer the dominant or controlling force in its governance.

Most of the literature on the history of corporate governance has accepted Berle and Means’ characterization of the evolution of the business corporation; see, for example, Dodd (1938), Hovenkamp (1991) and Coffee (2001). But the early history of American corporations has not been well documented, and the arguments of Berle and Means may have been accepted simply because they seemed appealing and persuasive in light of what is known about corporate governance in the twentieth century. Recent work on the governance of early corporations has challenged Berle and Means’ characterization of early corporate governance (Hilt, 2008).
Another major strand of this literature has focused on the common-law origins of the American legal system, and its legacy. In a highly influential work, La Porta et al. (1998) argue that the advanced state of economic and financial development of the American economy is due in part to its adoption of the common law. An enormous literature on the consequences of “legal origins” followed; see La Porta, et al. (2008) for a survey. The advantages of the common law have been held to include its flexibility, and the efficiency with which its courts adjudicate disputes and revise doctrines in response to the real-world needs of businesses. However, recent work comparing the menu of organizational forms offered by countries with different legal systems, and the response of courts to innovations in organizational forms, have identified a relative inflexibility of the American common law toward new organizational forms (see, for example, Lamoreaux and Rosenthal, 2005; Guinnane et al., 2007; and Lamoreaux, 2014).

Some of the work presented in this chapter also indicates that the influence of the common law on the development of American enterprise may be somewhat overstated in the legal origins literature. For example, in contrast to other areas of the law, the United States did not inherit a well-developed set of judicial precedents relating to business corporations from England (Gower, 1956; Harris, 2000). The enterprise law that developed here was largely an American creation, which was shaped and modified in response to local circumstances and experience. Legislators in many states even drew on civil law institutions, such as the limited partnership, or created new organizational forms such as the “partnership association” out of whole cloth. The creativity and energy of American legislators was responsible for the character and quality of American business law as much as any courts, a fact that is difficult to reconcile with some of the claims made within the literature on legal origins.

2. Early Industrialization and the Corporation

In the years following the Revolution, the elite merchants and lawyers who controlled the federal and state governments began to create business corporations to facilitate economic development. Many of these enterprises created transportation infrastructure or provided access to water; others were
insurance companies or banks; and a few pursued large-scale manufacturing. Some of these corporations were unsuccessful, but many, particularly the banks, enjoyed immediate and lasting success. These included the largest businesses that had ever existed in North America, and they fundamentally reshaped the development of the American economy.

But they also provoked intense rancor, and divided American politics. The reasons for the opposition of those who would eventually come to call themselves Republicans or Democratic-Republicans are manifold, but the most important relate to the legal status of the corporation. Corporate charters conferred exclusive legal privileges on the businesses they created, which could range from limited liability for investors, to franchises from the state to engage in particular activities. Businesses without a corporate charter could not obtain these privileges; by controlling access to corporate charters, the government effectively controlled entry into many industries, or at least held the power to create firms with particular advantages. And the elite political figures who created these corporations, who came to be called Federalists, did not hesitate to use this control for personal financial gain for themselves and their allies. For example, Hilt and Valentine (2012) document that the wealthiest class of owners of New York’s early corporations were in fact political office holders, and included the governor, prominent jurists, and many state senators. Republican critics of corporations derided them as “monopolies,” not just in the sense of market power, but also meaning something dangerous and menacing toward democracy and access to opportunity.

Over time, American politics became more democratic, the Federalists’ control over governments in many states broke down, and the Republicans gained power. However, once in office, the party of anti-corporate rhetoric presided over the greatest wave of business incorporations the world had ever seen. “If they could not extirpate monopoly,” wrote Bray Hammond (1957:146), the Republicans “could at least reduce its inequities by seizing a share of its rewards.” In many economic sectors, particularly those in which incumbent firms or other interests were not acutely threatened by new entry, petitions for charters were granted quite liberally. Data from Davis (1917), Sylla and Wright (2013) and Kessler (1940) indicate that by 1830, around 4,500 business corporations had been created in the United States.
Many of the earliest corporations were quite large, and were initially conceived to be local monopolies. Their capitalizations required them to raise large sums from investors, which inevitably led them to seek subscriptions from individuals with little or no connection to their founders, many of whom would remain entirely passive as owners. The most important problem faced in the governance of such enterprises was the danger that a controlling shareholder could use the resources of the firm for his own benefit, or otherwise act in ways that were contrary to the interests of the other investors. Although ownership data from this era is quite scarce, a large sample of corporations from the 1820s reveals that many early corporations were indeed dominated by large shareholders (see Hilt, 2008).

Offering some assurance to outside investors that their interests would be protected was a critical objective in many early corporations. And many corporate charters from the early nineteenth century contain provisions intended to offer such protections. For example, some offered “graduated voting rights” to shareholders, which decreased the votes per share to which an investor was entitled as the number of shares they held increased, and thereby enhanced the relative influence of small investors when in the presence of large shareholders. A substantial literature has analyzed the purpose and effects of these voting rights: on their political significance, see Dunlavy (2004, 2006); on their effects among nineteenth century American banks, see Bodenhorn (2012); Hansmann and Pargendler (2010) analyze their effects on consumers; and Hilt (2013a) presents a synthesis of the different viewpoints. Early corporate charters also sometimes imposed requirements that the firms submit annual reports to the state or to shareholders, and regulated the size and sometimes also the composition of the board of directors.

Evidence from surviving lists of shareholders also indicates that early investors often resided in the same location as the corporation, and sometimes had business ties to the corporation. Although different motives could explain these patterns, it seems likely that they helped resolve information problems related to investment, in particular the conflicts between insiders and outsiders that were so acute among many firms. Detailed ownership data does survive from individual firms, from firms located in particular locations or operating in particular industries. See, for example, Davis (1958) on New England textile corporations; Majewski (1996) on transportation companies; Wright (1999) and

In the early nineteenth century, trading activity in corporate stock began to develop, and the shares of a few dozen corporations were listed on securities exchanges, along with some bonds of federal state and local governments (Werner and Smith, 1991; Martin, 1886). The public corporations traded in New York included some well-governed and successful urban banks, and, in an expansion of credit and speculative activity in the mid-1820s, the shares of a number of insurance corporations. Some of these latter corporations had defied banking regulations and issued banknote-like instruments to finance their lending (see Hilt 2009a). These firms are noteworthy not only for the aggressiveness with which they conducted their financial operations, but also for the degree to which their managers were able to profit personally from their utilization of their resources. When an economic downturn began, and investors began to regard the liabilities of those firms with suspicion, a panic broke out, and several firms faced runs. The failure of a number of prominent financial institutions in 1826 led to waves of criminal prosecutions, private litigation, and extensive legal reforms (see Hilt, 2009b.) A consensus emerged that the legal and institutional framework in place to protect the interests of investors in public companies, particularly financial institutions or “moneyed incorporations,” was inadequate, and a number of changes were made in response. New legal protections for investors were produced, through significant changes to New York’s corporation laws.

In addition to this evolution in the regulations imposed on corporations, the legal institutions governing the creation of corporations also changed significantly, particularly in the mid-nineteenth century. Beginning in the mid-1840s, a solution to the problems created by the special privileges granted to corporations was found in “general incorporation” statutes. Under general laws, incorporation became a routine administrative procedure, outside the realm of political influence. However, early general statutes often did not grant entrepreneurs much freedom in the configuration of their enterprises, but instead created an organizational template that corporations were required to adopt. Entrepreneurs
wishing to incorporate a firm that did not conform to the template, for example with a greater capitalization than permitted, would still need to petition for a charter.

General incorporation statutes typically only applied to one class of corporation. Many states first enacted them only for manufacturing firms, and then gradually added legislation for other categories of firms such as banks (the so-called “free banking laws”), insurance companies, or railroads. But gradually over the course of the nineteenth century, virtually every state introduced general statutes for most classes of corporations. These statutes are the precursors to the corporation laws that currently prevail in the American states. Chronologies of these laws and analyses of their contents are presented in Hamill (1999) and Hilt (2015).

3. The Partnership, and Alternative Organizational Forms

Some early businesses had no choice but to adopt the corporate form. This was true for firms that needed special franchises from the state, for example to engage in banking or to create transportation infrastructure. But the vast majority of entrepreneurs, at least those sufficiently well-connected to get access to a corporate charter, could choose whether to incorporate their business or to adopt some other organizational form. And many of them instead chose to organize their firms as partnerships, a form that required no authorization from the state.

The corporate form gave firms a number of characteristics that were difficult to obtain otherwise. These generally included: limited liability for the owners, transferability of shares, legal personality, and the “locking-in” of capital.¹ The first of these, limited liability, is often regarded as synonymous with the corporate form, and one might imagine that it was the principal reason to incorporate. Yet many early corporations were explicitly denied limited liability; the state of Massachusetts, a prolific creator of early business corporations, imposed unlimited personal liability on shareholders of manufacturing corporations until 1830 (see Handlin and Handlin, 1945). This suggests that attributes other than limited

¹ A thorough discussion of corporate attributes in the context of modern law is presented in Kraakman et al. (2004).
liability were sought among early incorporators. The other attributes of corporations, particularly the
transferability of shares, were likely desirable for firms seeking to obtain investments from large numbers
of passive shareholders.

For firms that did not need to raise large sums from outside shareholders, and particularly for
firms in which the human capital of a few individuals was critically important for its success, the
partnership was often preferred. This was frequently true for firms engaged in the provision of services,
such as wholesale and retail mercantile firms, private bankers, and law firms, but the partnership also
remained popular within the manufacturing sector as well. As there is no registration requirement for
partnerships within a common law legal system, it is not possible to obtain counts of partnerships from
public records. Early city directories, however, list large numbers of partnerships in those sectors (see,
for example, Hilt and O’Banion, 2009; and Lamoreaux, 1997).

In a partnership, the members of the firm all share in its profits, and bear unlimited personal
responsibility for its debts.\(^2\) The partners also hold discretion over the admission of any new members—a
membership stake is not transferable or divisible. These characteristics help provide strong incentives for
the members to perform their roles well, and help ensure that only highly productive new members are
admitted to the firm. Corporations attempting to compete with partnerships may therefore face a “lemons
problem”; see Kingston (2007).

But these same characteristics were unattractive to passive investors, and the partnership form
generally could not accommodate investments from anyone but full partners, bearing unlimited personal
liability, and holding non-transferable stakes. The resulting inability to raise capital from passive
investors represented a significant constraint for some firms that otherwise would have preferred the
partnership form. Experimentation with the corporate form in industries in which the partnership was
generally optimal did occur; the statute books of many states include some charters granted to mercantile

\(^2\) Another feature of partnerships is that their assets may not be fully protected from the demands of the partners’
creditors; on the concept of entity shielding see Hansmann et al. (2006).
firms, agricultural firms, and maritime enterprises, to name a few. These efforts generally did not meet with success; see Hilt (2006).

In other circumstances, the corporate form was preferred, but some of its characteristics created problems. This was particularly true for company founders who wished to retain control over their enterprise, or avoid disclosing sensitive information in annual reports, or prevent the owners of a competing firm from acquiring control or gaining access to strategic information by purchasing its shares. The shares of corporations were usually freely transferable, so any shareholder could sell her or his stake to a rival firm without the consent of the founders. And shareholders were entitled to access the company’s books, as well as vote in director elections. Entrepreneurs seeking to avoid these characteristics of the corporation for their enterprises were forced to use the partnership form. But they did so at the cost of facing substantial difficulties in attempting to raise capital from passive investors, and losing other corporate characteristics.

Over time, some American legislators developed innovative solutions to these problems in order to better meet the needs of entrepreneurs. The limitations of the partnership form were addressed in part through the introduction of a form previously unknown to the common law, the limited partnership. Limited partnerships were like ordinary partnerships except that they could have a new class of partner, known as a special partner, who was granted limited liability. The special partners were required to be passive investors, and were forbidden from participating in the management of the firm. But the form of the limited partnership created a mechanism for investments from outsiders in firms organized as partnerships.

The limited partnership form likely originated in twelfth-century Italy, and was among the organizational forms included in the 1807 commercial code of France. The earliest American limited partnership statutes were in fact adapted from the language of the French code. The first and most influential of these statues was New York’s, which was enacted in 1822 (Laws of New York, 1822, ch. 244.) By the late 1880s, limited partnerships were authorized in all but three of the then-existing states and territories (Bates, 1886). These statutes required that the founders file a registration certificate with
basic information about the firm with a government agency, and that the contents of the certificate be publicized in a local newspaper.

The limitations of the corporate form were addressed to varying degrees in different states’ corporation laws; some states offered entrepreneurs considerable flexibility in the configuration of their enterprises. But beginning in the mid-19th century, a few states began to offer entrepreneurs an organizational form that was a hybrid of a corporation and a partnership. This form, which was sometimes called a “partnership association” in the statutes, would later be called the Limited Liability Company (LLC). These were like corporations, in that the investors had limited liability, but they were also like partnerships, in that the members of the firms could exercise discretion over the admission of new members. Transferability of shares, which was fundamental to the corporate form, could be regulated or blocked by the members. A discussion of the advantages of the form is presented in Guinnane et al. (2007).

The earliest state to authorize the use of the partnership association was Michigan, whose 1846 statute referred to them as “private associations” (Laws of Michigan, 1846, no. 148). Eventually, a few other states authorized the use of the form, including Pennsylvania (1874), New Jersey (1880), and Ohio (1881), but the form was apparently not adopted by other states during the nineteenth century.

The innovative nature of these new organizational forms resulted in a source of uncertainty in their implementation: the stance the courts would take toward firms that adopted them. This was a particularly important concern with regard to the limited partnership. Partly because the form represented a radical departure from the common-law doctrine of personal liability in partnerships, limited partnership statutes declared that special partners would be made general partners with unlimited liability if the firm failed to adhere to any of the provisions of the law. Much of the prior literature on limited partnerships has argued that common-law judges tended to side with creditors who tried to use any minor deviation from the terms of the statutes to strip special partners of their limited liability (see, for example, Warren 1929). Some scholarship has concluded that as a result, the form was not widely adopted (Howard, 1934).
However, the stance taken by the courts toward these firms varied across states, and perhaps also over time. In the state of New York, for example, jurists appear to have been reasonably generous in their interpretation of the limited-partnership statute.\(^3\) And indeed, research on the use of the form in New York City, where the economic sectors in which the partnership form dominated were quite well developed, found that the limited partnership was used extensively, with more than a thousand created through the 1850s (Hilt and O’Banion, 2009). However, the experience with the form in New York City may not have been representative of other major cities; more research on the topic is needed.

In the case of the partnership association or LLC, even less is known about the frequency with which the form was adopted. Pennsylvania’s 1874 statute was utilized by some prominent firms, such as Carnegie Steel. However, at times the state’s courts took a particularly hostile approach toward the form, which reduced its utility. This problem was compounded by the fact that in 1897, a court in the state of Massachusetts, which did not have a partnership association law, held that a partnership association organized under Pennsylvania’s law was in fact an ordinary partnership with unlimited liability for its members (see Lamoreaux, 2014).

A final organizational form that may have found frequent use during this period is the unincorporated joint-stock company. These were firms that sought to obtain corporate-like characteristics through private contracting, rather than through the grant of a corporate charter from the state. Essentially, the founders would write a contract specifying the structure and characteristics of their new enterprise, declare themselves a “company,” and commence operations.\(^4\) Historians have documented the existence of numerous American unincorporated joint-stock companies, particularly in the eighteenth century when corporate charters were relatively difficult to obtain (Davis, 1917). Some have even claimed that the unincorporated joint stock company was more important in many respects than the

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\(^3\) For example, the state’s courts rejected the claims of a creditor that an error in the spelling of the name of the partners in the publication of the certificate was sufficient strip the special partners of their limited liability. See Bowen v. Argall, 24 Wend. 496 (N.Y. 1840).

\(^4\) British unincorporated companies, which were quite common given the difficulty of obtaining corporate status, often vested their assets in trustees through a deed of settlement. A trust enabled the firm to obtain some corporate-like characteristics, but also had some important shortcomings (see Harris, 2000; and Freeman et al, 2012). The frequency with which American unincorporated companies used the trust form has not been documented.
corporation itself (Livermore, 1939). However, unincorporated companies were most commonly used for businesses that would have been characterized as “joint adventures”—investments or speculative transactions undertaken jointly by several investors, such as investments in land, or maritime voyages. There is far less evidence of its use among more complex business enterprises, in which the corporate form would have offered greater advantages. Moreover, any claims among these firms to limited liability for their investors may have been vulnerable to challenges from creditors; as with limited partnerships and partnership associations, the stance that the courts would take toward these enterprises was likely a significant source of uncertainty. One legal treatise, citing a number of cases, stated that in an unincorporated company “each member is liable” for debts “no matter what the private arrangements among the members may be” (Rowley, 1916: II, 1419).

4. The Second Half of the Nineteenth Century: Railroads, “Big Business,” and Bankers

During the second half of the nineteenth century, most of the American states and territories adopted general incorporation statutes for many types of businesses. The corporate form became increasingly accessible, and was quite frequently used by businesses of all sizes. By 1900 there were more than thirty-seven thousand manufacturing corporations in the United States, many of which were relatively small. Systematic data on the organization form of manufacturing firms was first collected in 1900 the federal Census of Manufactures (Census of Manufactures 1905, Part 1, tables 8 and 9). A comparative study of the use of the form in 1910 found that corporations were unusually common in the United States, and their average size relative to those of other countries was unusually small (Hannah, 2014).

But this era also witnessed the emergence of a number of extraordinarily large business enterprises, particularly within the railroad industry. The regional railroad systems that were assembled from the merger of smaller railroads, along with the transcontinentals chartered by the federal government, created many corporations whose individual capitalization was equivalent to around 40% of
the total capitalization of all manufacturing companies traded on the Boston Stock Exchange, which was then the most important market for such securities (see Atack and Rousseau, 1999).

The growing influence of these firms in ordinary Americans’ lives, and the market power they enjoyed over routes where there was no competition from water transportation or other railroads, led to calls for regulation of railroad rate setting. After a halting series of efforts to regulate railroads at the state level, the Interstate Commerce Commission (ICC) was created by the federal government in 1887 to serve that purpose (see Ely, 2001). Although the railroads initially resisted the ICC with some success, its creation marked one of the earliest significant efforts on the part of the federal government to regulate businesses, and it was subsequently strengthened by the Hepburn Act of 1906 and the Mann-Elkins Act of 1910.

In addition to transforming domestic transportation and communication, the railroads had a significant impact on financial markets. The construction of a major railroad required enormous sums, which were raised by selling securities through investment banks, both domestically and overseas. Given the relative opacity of railroad operations to early investors, and the resulting information asymmetries between railroad insiders and investors, some historians have argued that “pecking order” theory of capital structure dictated that railroads rely most heavily on debt (Baskin, 1988), and they indeed did so. Railroads also had excellent collateral in the form of land and equipment, which also enabled them to issue debt in the form of mortgage bonds on more favorable terms than firms in other industries. Despite the heavy reliance on debt, railroad equities also gradually became widely held, and dominated trading on the stock market in New York, although these issues were regarded as highly speculative.

Railroads faced a range of unprecedented challenges in running their operations, and were great innovators in developing managerial and accounting systems to address those challenges (Chandler, 1977). But the governance problems they faced were equally significant, and perhaps even more difficult to resolve. Railroad insiders found ample opportunities to enrich themselves at the expense of the other investors, by paying themselves exorbitant salaries, engaging in insider trading, or issuing themselves shares of stock in exchange for worthless securities (see Lamoreaux and Rosenthal, 2006: 126-7). The
transcontinentals, which received subsidies from the federal government, offered their founders even more lucrative strategies for self-enrichment. The directors of the Union Pacific created their own construction company, Crédit Moblier of America, and hired it to build the line, while also distributing Crédit Moblier shares to important Congressmen (White, 2012).

When exposed, scandals in the management of railroads produced outrage among securities holders. Yet some of the worst manipulations undertaken by those men seemed to violate no law, or in extreme cases, railroad insiders used their political influence to manipulate the law so as to sanction what they had done. The legal system was at times no match for the “railroad barons,” and seemed incapable of protecting the interests of securities holders. Adams and Adams (1871) present a detailed narrative of several noteworthy and audacious railroad scandals, and the legal manipulations undertaken by railroad insiders.

Although efforts were made to strengthen the law in response to these episodes, some of the most important changes they produced were not legal. A relatively small number of investment banks had developed the capacity to distribute the large bond issues of railroads, and such scandals infuriated their clients, and threatened their ability to raise capital for the industry. The partners of some of these firms began to take an activist role in the management of railroads, often by holding board seats. This enabled them to monitor the managers, and offer to investors the assurance that they would represent the interests of the railroads’ securities holders in the conduct of the business. Particularly following the Panic of 1893, which resulted in a wave of bankruptcies in the industry, investment bankers became heavily involved in the reorganization and governance of railroads (Carosso, 1970). The power of bankers was certainly not absolute; efforts to withhold capital from wayward railroad managers who engaged in rate wars or threatened incumbent firms with construction along their lines were not successful. Nonetheless, their influence on management likely curbed the most egregious behavior among railroad executives.

The increasing integration of the economy created by the development of the railroad network (see Atack, this volume) made possible the emergence of large-scale manufacturing firms that could potentially distribute their products nationwide. Yet in spite of the Constitution’s prohibition against
internal tariffs or customs barriers, many states acted to protect local firms through licensing and inspection laws that discriminated against out-of-state competitors. As McCurdy (1978) makes clear, it took the emergence of large firms, which stood to realize significant gains if such barriers were removed, to actually pursue the costly legal challenges to states’ protectionist measures. In this sense, large industrial corporations were instrumental in creating a nationally integrated market.

Greater levels of economic integration presented a new set of problems for many producers, in the form of increased competition. In the face of price wars and unstable market conditions, firms in many industries attempted to form cartels by establishing what were called “pools,” often through trade associations. In the 1880s, pools were created among the producers of cotton bagging, metal pipes, and in the distilling industry, among others (Ripley, 1916). Yet such arrangements were often subject to cheating among the members, and were legally unenforceable – even before they were explicitly prohibited under Sherman Act of 1890 (see Freyer, 1992).

Given the problems associated with cartels, in some industries competitors sought to merge. However, many states’ corporation laws often presented significant barriers to the acquisition of one corporation’s capital stock by another, or to the ownership of property by an out-of-state corporation. Standard Oil developed an innovative solution to this problem, by using the legal form of the trust (hence the term “antitrust.”) The trust was used to facilitate combinations in the distilling industry, and in sugar refining. However, later court decisions held these trusts to be illegal (Ripley, 1916).

Ultimately a solution to this problem was offered by the State of New Jersey, which hoped to use its corporation statutes as a major source of revenue. In a series of revisions to its corporation laws enacted in the late 1880s and early 1890s, New Jersey granted businesses incorporated in the state the right to hold stock in other corporations—that is, to act as “holding companies.” New Jersey also granted its corporations the right to operate in other states; they only needed to establish an office in New Jersey in order to be officially domiciled there (see Grandy, 1989). In effect, any business could incorporate in New Jersey and utilize the liberal terms of its statutes. A handful of other states quickly moved to
emulate New Jersey’s statutes and compete for incorporations, with the state of Delaware copying New
Jersey’s statutes verbatim.

Corporate promoters were quick to take up the newly liberalized statutes. But the impetus to
merge was strengthened by the Supreme Court’s *E C Knight* decision of 1895, which held that a merger
of competitors in manufacturing did not violate antitrust laws, even if it absorbed virtually all of the
capacity of an industry, since manufacturing was not “commerce.” In response, an enormous wave of
mergers occurred, which has been denoted the Great Merger Movement. Between 1895 and 1904, more
than 1,800 firms were absorbed into mergers, many of which controlled more than 70 percent of their
industry’s markets (Lamoreaux, 1995). As a share of GDP, this was the largest merger wave in American
history. It died down partly in response to the Roosevelt Administration’s more aggressive pursuit of
antitrust cases, in particular the 1904 *Northern Securities* case that found that a merger of competing
railroads violated the Sherman Act.

Many of these mergers, particularly those operating in industries in which there were few barriers
to entry, ultimately performed poorly (Dewing 1914). Nonetheless, the Great Merger Movement
produced a number of successful firms, and resulted in unprecedented changes in the structure of
American business. As was the case in the railroad industries, financiers were frequently represented on
the boards of these new enterprises, to help reassure the holders of their securities that management would
represent their interests.

5. The Twentieth Century

The end of the nineteenth century and the beginning of the twentieth witnessed the emergence of
large industrial corporations that became vertically integrated (see Lee and Rhode, this volume). Firms
producing new goods, or operating at enormous scale, could no longer rely on traditional supply networks
for raw materials, or urban wholesalers for distributing their products; Porter (2006) presents numerous
illustrations of these problems driving firms to integrate vertically. In Chandler’s (1977) formulation,
firms replaced the “invisible hand” of market transactions for raw material supplies and for distributing their products with a “visible hand” of a vertically integrated organization that coordinated those functions internally through a managerial bureaucracy. Williamson (1981) developed a more formal analysis of the forces that led to this integration, based on the theory of transactions costs. Williamson notes that the asset specificity problem, which arises when an asset is specialized to a single user, and therefore increases the governance costs of market transactions, and the demand externality problem, which arises when the actions taken by a retailer can affect a product’s reputation and its sales by other retailers, can be addressed through backwards and forwards integration—the replacement of market transactions by expanding the boundaries of the firm to encompass all stages of production and distribution. The emergence of vertically integrated manufacturing firms can therefore be seen as a means to minimize transactions costs.

Beginning in the first two decades of the twentieth century, some of these firms began to diversify horizontally, often through acquisitions. Whereas the Great Merger Movement generally consisted of consolidations within a single industry, these acquisitions enabled large firms to diversify into new products and new industries, although they initially tended to be ones that were related to their existing operations. Thus, beginning with firms such as General Motors and Du Pont, industrial conglomerates were born. Chandler (1962) argues that this horizontal diversification ultimately required firms to change their internal organization to a “multi-divisional form,” as the centralized control structure, or “unitary form,” of most firms was ill-suited to coordinating production in multiple markets and industries. Williamson (1975) presents a transactions-cost analysis justifying the multi-divisional form’s efficiency in the context of a diversified firm.

Although these new industrial conglomerates may have created organizational structures that were well-suited to the challenges they faced, some contemporary economists held that their scale and diffuse ownership insulated them from accountability to their shareholders, and enabled their management to engage in various forms of self-enrichment at the shareholders’ expense (Ripley, 1915; 1927). The governance of major corporations was examined in detail by Berle and Means (1932), who
documented the ownership structures of the 200 largest companies of their time. Berle and Means present a typology of ‘control structures’: private ownership, majority control, minority control, control by legal device, and management control. Their data indicates that many firms were in fact controlled by large shareholders—just as public companies often were in the 1820s (Hilt, 2008). They also argue, however, that 32.5% of their firms had no significant shareholders, and were therefore subject to management control. Berle and Means do not, however, document any serious consequences associated with this separation of ownership from control, and indeed Adolph Berle (1959) later developed a favorable view of “power without property,” in which corporations were run by a kind of “non-statist civil service” of salaried administrators.

Berle and Means also documented the existence of some pyramidal business structures in the early 1930s, which resembled somewhat the “business groups” familiar in other countries today (La Porta et al., 1999). However, they were almost never created among industrial corporations (Bonbright and Means 1932). Instead, they were used among railroads, and to a much greater extent, among public utilities. For utilities, the complex holding company structures that emerged in the 1920s were created principally in response to local utilities regulation and public service commissions. Thus, to the extent pyramidal structures did emerge in the U.S., they were mostly used for industry-specific purposes. Broad, diversified business groups that encompass manufacturing firms and financial institutions, such as those of Asia today, do not seem to have been present (see also Cheffins and Bank, 2010).

One element of the governance of major corporations that was not considered by Berle and Means, and yet was the subject of intense public controversy, was the role of financiers. In 1912 the House of Representatives authorized an investigation of the “money trust”—the concentration of control over access to finance among a small number of New York institutions—by a committee headed by Representative Arsène P. Pujo. The committee collected extensive data, and documented the nearly ubiquitous presence of prominent financiers on the boards of major non-financial corporations. In a series of essays published as the book Other Peoples’ Money and How the Bankers Use It, Louis Brandeis used the committee’s finding to argue that the control of a small group of elite financiers over access to credit,
and over the operations of many important corporations, enabled them to cartelize much of the economy, and enrich themselves at the expense of the shareholders in those companies. These views became quite influential among the public, and in government: several provisions of the Clayton Antitrust Act of 1914 reflected the spirit of the committee’s findings.

However, research by financial historians has challenged the Brandeis-Pujo view of the role of investment bankers in the economy (Carosso, 1970; Morrison and Wilhelm, 2007; O’Sullivan, 2015). Econometric analyses by De Long (1991), Ramirez (1995), and Cantillo Simon (1998) all found positive effects of the presence of J.P. Morgan partners on a firm’s board. In more recent work, Frydman and Hilt (2014) used a provision of the Clayton Act that prohibited securities underwriters from holding board seats with their client railroads to estimate the effects of banker directorships, and found that the effects were positive. Although their positons as banker-directors created potential conflicts of interest, they also enabled financiers to monitor management and help resolve problems associated with asymmetric information. And as influential “independent” directors, they could also potentially help address problems related to the separation of ownership from control.

The Great Depression and the New Deal fundamentally changed many of the institutions relating to the governance of American corporations, and the organization of the economy. During the 1920s, the rate at which ordinary Americans held financial assets grew rapidly, and the numbers of shareholders of the largest public firms rose into the hundreds of thousands. And a rapid run-up of stock prices beginning in 1927 seemed to herald the beginning of a new era of prosperity (White 2006). The stock market crash of 1929 shattered investors’ confidence in financial markets in general, and in the institutions that distributed corporate securities in particular. This led to another Congressional investigation of financiers, the Pecora hearings, which produced a number of embarrassing revelations about prominent financiers. Ultimately, the New Deal included a series of new regulations on financiers and financial markets. The Glass-Steagall Act of 1933 prohibited investment banks from engaging in deposit banking or holding directorships with commercial banks. The Securities Exchange Act of 1934 created the first federal securities regulations, and a new agency, the Securities and Exchange Commission to enforce
those regulations. Together, these changes had significant effects on the returns earned by investors on new issues (Simon, 1989), the governance mechanisms chosen by firms (Avedian et al., 2015), and likely diminished the role of financiers in corporate governance.

Other new regulations included the Public Utility Holding Company Act of 1935, which was intended to break apart the pyramidal holding company structures that had been created among public utilities, and the Investment Company Act of 1940, which, among other things, restricted the role that mutual funds or other such intermediaries could play in corporate governance (Roe, 1994). A new era of regulated and routinized corporate finance was to prevail (Seligman 1982).

Other New Deal policies promoted labor unions, cartelized industries, and established new regulatory commissions. Some of these changes, coupled with the effects of the financial collapse which differentially impacted smaller and lesser-known firms (Bernanke, 1983), may have strengthened the position of large industrial conglomerates in the economy. Over subsequent decades, many such firms continued to expand, and there was something of a “merger mania” that peaked in the 1960s. Careful empirical research has shown that the shareholders of acquirers benefitted from these diversification acquisitions (Matsusaka, 1993). The market clearly believed that these acquisitions were beneficial.

And yet, beginning in the late 1970s or 1980s, the dominant position of conglomerates began to end. The stock market applied significant discounts to diversified firms (Lang and Stulz, 1994). New merger waves aimed at undoing the earlier shifts toward conglomeration and returning to specialization occurred, and firms began to divest unrelated businesses (Kaplan and Weisbach, 1992). And new generations of highly specialized and entrepreneurial technology companies became the source of dynamism in the economy.

What accounts for the decline in industrial conglomerates? Increased competition from international firms offering innovative, high-quality products certainly challenged many large American firms, whose bureaucratic managerial structures were seemingly incapable of adapting. But more importantly, those organizations were created to minimize problems related to transactions costs, and technological changes and innovations in business practice made it possible to address those problems
without expanding the boundaries of the firm (Lamoreaux et al., 2003). Vertical integration and conglomeration was no longer necessary, and their limitations began to exceed their advantages.

6. Conclusion, and Topics for Future Research

The discussion in this chapter has characterized the development of business organizations in American history, and has traced out two parallel processes of evolution. Over time, changes in the economic environment presented entrepreneurs with new problems. And simultaneously, the legal and institutional environment evolved, which changed the range of potential solutions available to entrepreneurs.

The problems and solutions found in some eras were unique. For example, the emergence of greater levels of competition among firms in different industries, a product of greater economic integration beginning in the second half of the nineteenth century, combined with a legal environment that seemed to tolerate horizontal mergers, led to an unprecedented wave of consolidation within industries. Once the legal environment changed, as the Roosevelt Administration began to pursue stricter antitrust enforcement, the Great Merger Movement died down.

Other problems seem to have always have been present, although the solutions found differed over time. For example, agency problems between controlling insiders and outside investors were an issue for large-scale enterprises in the eighteenth, nineteenth, and early twentieth centuries. They were so ubiquitous one might consider them an inherent problem. Over time, the solutions utilized to address the problem varied. In the eighteenth and early nineteenth centuries, corporations attempted to address it using graduated voting rights for shareholders. In the late nineteenth century, railroads began to address the problem using the participation of financiers in their governance. During the New Deal, federal securities laws were imposed, which were intended to create new legal mechanisms to address the problem.
A number of interesting questions are raised by the analysis of this chapter, which might serve as productive topics for future research. One question that is quite general in nature is: to what extent and in what way do legal constraints matter for businesses? That is, if existing statutes do not offer entrepreneurs an appropriate mechanism for addressing a particular problem was the legal system sufficiently flexible for them to develop their own solutions? For example, if a state was extremely restrictive in granting access to the corporate form, or if its laws imposed extremely restrictive constraints on the ways business organizations could be configured, were fewer firms created? In theory, entrepreneurs could “contract around” such limitations of existing law and, for example, create an unincorporated joint stock company with whatever characteristics they desired. But how well such organizations’ claims to limited liability or other attributes normally reserved to corporations would have withstood challenges in the courts is unclear. One promising strategy for investigating this question might be to evaluate the impacts of significant changes in states’ laws, particularly if they were implemented in response to political pressures unrelated to prevailing business conditions. If the law truly matters, then sharp changes in the law should be reflected in the rate at which businesses were created or in the survival rates or profitability of businesses.

A second question is more comparative in nature, and relates to unique patterns in the organization of American businesses. Whereas firms in many countries become affiliated together in “business groups” that are often family controlled, this does not seem to have been present in the United States. This is a topic that has aroused some recent controversy; using a particularly broad definition of “business groups,” Kandel et al. (2013) argue that they were in fact present up through the mid-twentieth century. The claims of Kandel et al. contradict some of the arguments of Bonbright and Means (1932), as well as Cheffins and Bank (2010). Careful evaluation of these authors’ evidence, and perhaps the presentation of new, comprehensive data on the subject, would be quite valuable. But putting aside this debate, if it is indeed the case that business groups were not important phenomena in the United States, an interesting question is: why? For example, why didn’t the Rockefellers, whose Standard Oil controlled close to 90 percent of petroleum refining capacity in the United States, use their enormous incomes to knit
together a network of affiliated companies, which might have included banks, railroads, manufacturing
and mining firms, and so on?

Finally, the decline of many of America’s conglomerates merits further research. An enormous
empirical literature developed particularly in the 1990s, which analyzed their valuations and measured the
“diversification discount.” Yet there has been relatively little work on the deeper causes of their demise.
The work of Chandler (1977) and Williamson (1981) held that these organizations were created to
minimize transactions costs, and Lamoreaux et al. (2003) have argued that the changing economic
environment made available new techniques to address those transactions costs. But much more detailed
analysis is necessary in order to fully understand these developments. A careful study of the demise of
the conglomerates might shed new light on the forces that led to their creation, and whether the
Williamson (1981) analysis was indeed correct.

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