Constructing Firms: Partnerships and Alternative Contractual Arrangements in Early Nineteenth-Century American Business

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Like all human institutions, firms are constructed entities--that is, they are the products of social and cultural (as well as economic) processes, and indeed, vary quite strikingly from one nation to the next.[1] In some ways, of course, this is an obvious point, but it is a point that business historians too often ignore. For example, scholars who write about industry during the nineteenth century tend to take the set of organizational choices as a given and to view the shift over time from single proprietorships to partnerships to corporations as a natural and inevitable response to the growth of the market and to technological change. The work of Alfred D. Chandler, Jr., which has dominated the field of business history for the last quarter century, is an excellent illustration. Although Chandler has devoted considerable energy to explaining the emergence and structure of large firms in the late nineteenth and early twentieth centuries, his model of organizational change is largely technologically determined. Social and cultural factors either account for only minor variations in the structure of firms in different countries or, conversely, operate to prevent large firms from emerging (and the economy from prospering) [Chandler, 1990].

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It is not my aim to question the broad outlines of Chandler's story. There is no doubt that as the domestic market grew large and it became profitable to invest in large-scale, capital-intensive technology, firms shifted from the partnership to the corporate form in order to increase their ability to raise funds. There is also no doubt that the imperative to maintain a high level of throughput in their plants encouraged firms with such investments to expand their boundaries and integrate vertically, both forward into distribution and backward into raw-materials acquisition. Nonetheless, this story leaves much unexamined--not only the details of the evolution, but the conceptual processes involved and the social and cultural contexts that both structured the set of organizational choices and conditioned the decisions that business people made. Why did enterprises take the particular organizational forms they did? What were the implications of these forms for the functioning of the economy? Were certain types of business organizations more conducive to innovation and technological change than others? Were certain types more conducive to the exploitation of opportunities for increasing efficiency?

The purpose of this article is to take seriously the notion that firms are human constructions by examining the contractual choices that entrepreneurs made during the early nineteenth century. Many businesses at the time were organized as partnerships despite the high degree of risk that this form of organization entailed. My aim is to understand why. What contractual alternatives were available to business people at the time? How were they perceived to differ from partnerships? Under what circumstances might one expect business people to choose the partnership form over other possibilities? How might one explain deviations from the expected pattern of choices?

Unfortunately, there is really no historical literature that is relevant to these questions. There is, however, an important literature in economics that can serve as a starting point for this study. Although neoclassical economics traditionally has treated the firm as a black box--as an entity for equating marginal revenue and marginal cost--in recent years economists have shown increasing interest in understanding how firms actually function and also in distinguishing analytically between activity that occurs within firms and that which occurs "in the market." One important stream of this research has built on Ronald Coase's pioneering insight that firms arise in order to economize on transaction costs [Coase, 1937]. Because incomplete information can make it extraordinarily costly to write contracts that specify all relevant contingencies, it may be cheaper under certain circumstances to negotiate long-term contracts that give one party to an agreement discretionary authority over another. Thus, Coase argued, firms are essentially long-term contracts whereby the owners of an input (whether it be capital, labor, or some other resource) surrender its control to an entrepreneur in exchange for income. Viewed in this way, firms are nothing more than particular kinds of contracts which, because of the discretionary authority they entail, supersede a more costly form of contracting that occurs in the market [Cheung, 1983; Jensen and Meckling, 1976].[2]

As Steven Cheung [1983] has argued, however, contracts can take such a range of forms that in practice it can be extremely difficult to decide what is and what is not a firm. He posed the following thought experiment as an example: "if an apple orchard owner contracts with a beekeeper to pollinate his fruits, is the result one firm or two firms?" The question, he concluded, had no clear answer. The relationship between the orchard owner and the beekeeper could be defined contractually in so many ways that examples could "easily be found to counter almost any definition of a firm." In the end, Cheung concluded, "it is futile to press the issue of what is or is not a firm."

The problem, however, is not so easily dismissed. As Peter Behrens has pointed out, the legal system distinguishes between those parties to a contract that are risk bearers and those that are not and

[2]For a survey of this literature, see Eggertsson [1990], especially chapter 6. Economists have, of course, proposed other ways of understanding the firm. For example, building on Edith Penrose's pioneering study, *The Theory of the Growth of the Firm* [1959], Richard R. Nelson and Sidney G. Winter [1982] have argued that the essence of a firm is the organizational capabilities that it develops over time.

effectively defines a firm in terms of the former group [Behrens, 1985]. But how is the boundary between risk bearing and non-risk bearing parties to be drawn? This question, it turns out, was both especially pressing and extraordinarily difficult for the courts to resolve during the early nineteenth century. As both the pace and uncertainty of economic activity increased, a growing number of cases reached the appeals courts in which creditors attempted to claim that parties to what had once been regarded as ordinary contracts were in fact partners and thus liable for the other parties' debts. In Massachusetts, for example, the first case of this type was decided in 1821. There were an additional nine cases during the 1820s, and fifteen more during the years 1830 to 1845. Over this same period of time the length of the court's written opinions grew from about five pages during the 1820s to over ten pages in the early 1840s, suggesting that the justices were having an increasingly difficult time resolving the issues raised by these suits. By the mid-1840s, however, a fairly coherent set of legal rules had emerged, thanks, as will be shown, largely to the efforts of Justice Joseph Story, who wrote an influential treatise on partnerships in 1841. As a result, both the number of cases and the length of the decisions declined.[3]

In the remainder of this article I first compare the partnership form of organization to some of the other contractual arrangements that business people employed at the time, and then analyze the case law of early-nineteenth-century Massachusetts in order to trace the process by which the boundary between partnerships and other types of contractual arrangements was constructed. I argue that the solution at which Story and the courts finally arrived made the defining characteristic of the partnership form an equal distribution of power among its members--a condition of equality that the partners could

[3]The Massachusetts Supreme Court handed down no decisions on this issue in the late 1840s and only six during the 1850s. The average length of these last six decisions dropped to five pages. During the 1860s, however, the number of cases again rose, suggesting that there were new legal issues to be resolved. The count of cases is from the *Massachusetts Digest Annotated.* See also Story [1859]. The editor of this edition bracketed additions to Story's treatise.

not escape in any legally binding way by specifying alternative arrangements in their articles of copartnership. I conclude by speculating about the implications of this legal solution for business people's choice of contractual form during the early nineteenth century and suggest that early Americans' sensitivity to issues of power, and in particular their desire to avoid relations of dependence, may help to explain the popularity of partnerships during this period.

Partnerships versus Other Contractual Forms

The limitations of the partnership form of organization are (and were) well known. The most obvious--unlimited liability--was important because it constrained firms' ability to raise capital. The only way to invest in a firm was to become a partner, and because all partners were fully liable for the firm's debts, in general only investors who planned to play an active role in management could afford to take the risk.[4] A second obvious and important limitation of the partnership form of organization was its short time horizon. Many partnership agreements expired after fixed periods of time, and most included procedures for terminating the arrangement should one of the partners wish to withdraw.[5] The death of a partner also

[4]Massachusetts enacted a law permitting limited liability partnerships in 1835, but this form of organization never became common. The problem was that lenders at this time strongly preferred granting credit on the basis of personal rather than collateral security and typically demanded that a firm's debt be endorsed individually by its partners, thus negating much of the advantage of limited liability. On the passage of the law, see Handlin and Handlin [1947, p. 234]. On the lending practices of banks, see Lamoreaux [1994a, pp. 1-2].

[5]For example, the partnership between Horace Abbott and John S. Gilman of Baltimore was scheduled to last five years. Either partner, however, could terminate the agreement earlier by giving six months notice. See copartnership agreement, March 30, 1857, Horace Abbott Papers, Massachusetts Historical Society Manuscript Collections. Similarly, Nathan Appleton's partnership contracts typically contained a clause allowing any partner to give six months notice if he wished to withdraw from the agreement. Copartnership agreement, May 24, 1810, Appleton Family Papers, Box 2, Folder 19, Massachusetts Historical Society Manuscript Collections. See also copartnership agreement, June 1, 1815, Box 3, Folder 1, copartnership agreement, January 1, 1829, Box 4, Folder 10, and copartnership agreement, May 7, 1838, Box 5, Folder 14.

typically forced the dissolution of a firm, an eventuality that could have potentially disastrous consequences if assets had to be liquidated to pay off the deceased partner's heirs. Firms that were temporarily overextended could end up insolvent, and even a strong firm could suffer serious losses if the timing of the dissolution meant that assets had to be sold at fire-sale prices. Although some contracts contained provisions specifically aimed at avoiding this eventuality, most did not.[6] Apparently, most businessmen did not wish their heirs' assets to be tied up in the partnership after their death.

In addition to these obvious limitations, the partnership form of organization was fraught with the kinds of risks economists call "moral hazard." Problems of joint production meant that partners could not always verify that associates were working as hard for the firm as they claimed [Alchian and Demsetz, 1972; Holmstrom, 1982]. Perhaps more important, unlimited liability meant that investors had to worry whether unscrupulous partners would involve the firm in their own debts or exploit the assets of the firm for their personal advantage. The disastrous consequences that might result from such complications can be seen from the experience of Philadelphia merchant Thomas P. Cope. Victimized by the "imprudent conduct" of his New York partners, Cope not only lost the capital he had invested in the business but was forced to advance "large sums to pay [his partners'] debts" [Harrison, 1978, pp. 62, 94, 128-9].

The ease with which partners could withdraw from agreements also exposed their associates to serious risk. Membership in a partnership gave a potential rival access to such firm-specific assets as business connections and carefully constructed relations with customers, access that a partner could exploit on his own after the firm dissolved. Francis Coffin reported one such incident from France in 1807. An ambitious merchant, who had been taken into a

[6]One famous example of such a contract was Carnegie Steel's so-called "iron-clad agreement." The minor partners in the firm were so afraid of what would happen if Carnegie died that, in exchange for a clause permitting Carnegie's estate to be paid off gradually, they submitted to a provision that greatly reduced the value of their holdings should they choose to withdraw from the firm. See Landry [1994, p. 67].

partnership by a more established colleague, used his position to play "so artfull a role toward the Captains & Supercargoes as to instill into their minds the idea that he was the sole active partner of the house in order to secure to himself their further consignments whenever a separation took place." He then moved to dissolve the firm.[7] That fears of such exploitation were widespread is suggested by a letter Boston merchant Jonathan Jackson wrote to reassure a relative about his partnership with John Bromfield. "As to my Partner's going off with the Business hereafter there wou'd be no fear of that while I chose to give him the advantages I now do Mr B--D confesses an entire Ignorance of Mchts Accts. I have undertaken the care of the Books intirely myself" [Porter, 1937, p. 161].

Because of all these problems with partnerships, but especially their short life expectancies and the constraints that unlimited liability placed on their ability to raise capital, the conventional historical wisdom has been that this form of organization was unsuitable for industrial ventures and that it was replaced by the corporation as soon as charters became more widely available. Although a number of enterprises did incorporate during the early nineteenth century, there were still enough drawbacks to the corporate form that many businesses retained their partnership structure throughout the century. The more interesting question, in my opinion, is not why partnerships persisted into the corporate era, but why businesses so frequently chose the partnership form of organization over other (non-corporate) contractual forms that were available at the time.

In order to explore this issue, it is helpful first to think about the economic reasons why businessmen might join together in partnerships. One possibility is that businessmen might seek out partners in order to secure some badly needed input for the firm. Their business, for example, might require more labor than they themselves were willing or able to provide. Thus Boston merchant

[7]Letter from Francis Coffin to John Derby, April 20, 1807, Appleton Family Papers, Box 2, Folder 16.

Jonathan Jackson formed Jackson and Bromfield because the poor state of his health prevented him from keeping up with the business alone [Porter, 1937, p. 161]. Similarly, Nathan Appleton formed partnerships with Benjamin C. Ward and James W. Paige in order to free his own time for other pursuits [Gregory, 1975, pp. 106, 214-15, 229-30]. Partners might also be valued for the capital they brought to a firm. Thus the Jones and Laughlin Steel Company of Pittsburgh got its start when two immigrant German iron workers sought an infusion of capital for their rolling mill. They first formed a partnership with members of the mercantile firm of Jones and Kier; when they needed still additional funds, another Pittsburgh merchant (James Laughlin) joined the concern [Porter and Livesay, 1971, pp. 65-8]. Finally, it is possible that businessmen sought partners who could bring some complementary capability to the concern. Judith McGaw has argued that firms in the Berkshire paper industry were more likely to survive if their partners were tied into different information networks--for example, if one partner had experience and connections in commerce and another in papermaking [McGaw, 1987, 127-47].

All of these economic goals, however, could be achieved by means of other contractual forms. Obviously, firms could secure investment capital by borrowing on a variety of short-term and long-term debt contracts, and they could secure labor inputs by hiring employees on wage contracts. But there were also additional alternatives. For example, Hugh Lindsay contracted in 1817 to provide the United States Navy with a supply of live oak timber. Not having the financial resources to fulfill the obligation on his own, he contracted with John P. Rice to advance him the necessary funds in exchange for one half of the profits [*Rice v. Austin*, p. 198]. To give another example, in 1851 the East Boston Manufacturing Company (a partnership of William T. Hawes and the firm of Robinson, Wiggin & Company) financed its inventory of manufactured goods (candles) by contracting with the firm of Mixer & Pitman to own the output jointly [*Hawes v. Tillinghast*, pp. 289-90]. Labor contracts could also take a variety of forms. B. W. Dodge of Malden, Massachusetts, negotiated an agreement with Nathaniel L. White in 1842, according to which White assumed responsibility for managing Dodge's store in return for a share of the profits of the business. The two men were not partners; rather Dodge conceived of White's share as a payment for labor services [*Bradley v. White*]. In another instance, a man was hired to manage a foundry in exchange for a fixed salary and a share of the profits [*Denny v. Cabot*, p. 91].

Businessmen also used a variety of non-partnership contracts to combine their complementary talents and skills in joint ventures. For example, the merchant firm of Cabot, Appleton & Co. of Boston signed a contract in 1841 with Hiram Cooper, a manufacturer who had leased a mill in Medford, Massachusetts. The merchants agreed to furnish Cooper with materials, and Cooper in turn agreed "to cause to be manufactured the stock furnished, into satinets, in the best manner, to be thoroughly made in a workmanlike manner in every respect." The merchants were to handle the sales, and Cooper was to receive a fixed rate for each yard of cloth produced as well as a share of the profits [*Denny v. Cabot*, pp. 83-4]. Similarly, the firm of Judson & Company together with one Williams agreed "to furnish such materials as are required for the purpose of manufacturing and making glass bottles" to a man named Foster, who was skilled in the manufacture of glass. Foster agreed "to manufacture said materials, furnished by said Judson & Co. & Williams, into such glass ware as they shall direct, and to do the same in a faithful and workmanlike manner, and to give his whole time and attention to said business." Judson & Company and Williams would handle the sales and Foster would receive a share of the profits as his remuneration [*Judson v. Adams*, p. 558].

The choice of the partnership form of organization over one of these alternative contractual arrangements was a decision that had momentous legal implications. The most obvious, of course, was unlimited liability for the debts of the firm, but there were other ramifications as well. For example, partnerships differed from other forms of joint ownership in that any single partner had "full power and authority to sell, pledge, or otherwise to dispose of the entirety" of the firm's assets [Story, 1859, pp. 134, 142-52].[8] Each partner "may, in like manner enter into contracts or engagements on behalf of the firm in the ordinary trade and business thereof" that are binding on all the partners, whether they were consulted or not [Story, 1859, 170]. There were, in addition, a variety of implications for such issues as what happened when a party to a contract died, the order of claims in cases of insolvency, who had standing to sue whom in cases of insolvency or nonperformance of contract, and even whether a suit could be brought without the participation of all parties to an agreement.

These issues were so important that early-nineteenth-century courts were faced with a variety of cases that hinged on the determination of whether a particular type of legal arrangement was a partnership (that is, whether it was a *firm* in the eyes of the law) or whether it was an ordinary contract. The determination, as I have already suggested, was not an easy one, but by observing the intellectual struggles of justices in the first half of the century to define what a partnership was and what it was not, we can gain an understanding of the process by which the idea of a firm was constructed in the early nineteenth century, as well as some vital clues as to what may have motivated businessmen to choose the partnership form over other kinds of contractual arrangements.

The Evolving Legal Concept of Partnership

If one flips through the digests of any of the state court systems for the Northeast during this period, it quickly becomes apparent that the bulk of the legal business, at least on the civil side, involved the adjudication of debt cases. It was in this context that the legal concept of the firm evolved, as the two premises on which the courts based their early decisions make clear. The first premise was the idea that a contract might be deemed a partnership even if the parties to the agreement did not so intend. The second was the

[8]This rule did not extend to real estate.

principle that an agreement among two or more people to share the profits of a venture was by its very nature a partnership contract.

That the first principle aimed to protect the interests of creditors is clear. If two or more businessmen stood in relation to each other as partners, then they could not escape the resulting liabilities to creditors merely by claiming that they were not partners.[9] But what precisely did it mean to "stand in relation to each other as partners"? The courts' first attempt at a criterion--sharing in the profits of a venture--was also obviously articulated with the interests of creditors in mind.[10] As Justice Putnam of the Supreme Judicial Court of Massachusetts quoted precedent 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" [*Rice v. Austin*, p. 204].[11]

But this principle raised as many questions as it resolved. How precisely were payments to those who had a claim on profits different from other kinds of payments (to labor or capital, for example) that also reduced the fund available to satisfy creditors' demands? Moreover, did not payments in exchange for labor or other services often take the form of a share of profits? Did it really make sense to regard all of these agreements as partnerships? Should, for example, seamen who contracted to work on whaling ships in exchange for a share of the proceeds from the catch be considered partners? Should they have the same right as the owner of the ship to dispose of the catch? Should their debts be binding on the owner as well?

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[9]This principle appeared in case after case. See, for examples, *Bailey v. Clark*; *Turner v. Bissel*; *Goddard v. Pratt*; and *Blanchard v. Coolidge*. Story wrote a long chapter on the subject [1859, pp. 46-113].

[10]In the following discussion I follow the example of the courts and use the term profits as a synonym for income or earnings.

[11]See also *Blanchard v. Coolidge* [pp. 154-5]; and Story [1859, pp. 93-4].

The courts had no difficulty answering these last two questions with a resounding no [*Rice v. Austin*, pp. 204-5; *Turner v. Bissel*, pp. 194-5; Story, 1859, pp. 68-9]. To have granted seamen partnership status because they participated in the profits of a venture would have meant overturning the entire power structure of the mercantile world, a power structure built around the hierarchical authority of ship owners and masters over the personnel of their vessels. Similarly, the courts were reluctant to apply the principle that sharing in profits defined a businessman as a partner whenever such a decision threatened to upset long-standing customs of the trade. For example, the courts concluded that "shipments to India upon half profits" were not partnership agreements. As Justice Putnam declared in *Rice v. Austin* [pp. 204-5], "it would hardly be contended that the numerous freighters, often unknown to each other, have by such shipments become answerable for each other, or in any way interested as partners with the ship-owner . . . . If such were the result, there would soon be an end of that very extensive class of commercial enterprises."[12]

Nonetheless, judges had a great deal of trouble articulating a consistent set of legal principles that allowed them to distinguish situations of this sort from agreements that they felt should be considered partnerships. Payments out of profits to remunerate labor, they reasoned, were both inevitable and legitimate; labor costs were part and parcel of the process of doing business, and creditors would take these sorts of expenses into account when they estimated the likely returns from a venture. Indeed, if such payments took the form of a share of the profits, creditors might even be better off, for in contrast to the case where labor received a fixed remuneration regardless of earnings, payments to labor would decline along with profits [Story, 1859, pp. 60-1].

The problem, then, was to determine when an agreement to share profits was nothing other than a means of remunerating labor. Over time judges posed two related standards. One was that a

[12] See also *Turner v. Bissel* [pp. 194-5]; and Story [1859, pp. 68-9].

partnership agreement meant sharing in losses as well as profits; the other was that it involved sharing in profits *as profits*, a confusing definition that was refined over time to mean much the same thing as the first standard--that is, sharing in *net* profits, or sharing in losses as well as in profits [*Denny v. Cabot*, p. 86; Story, 1859, pp. 52-3, 90-2]. But this resolution was not very helpful for two reasons. First, as Justice Joseph Story pointed out at the beginning of his treatise on partnerships, it was perfectly conceivable that two or more partners might draw up an agreement that exempted a member of the firm from bearing the risk of losses: "It is . . . competent for the partners by their stipulations to agree, that the profits shall be divided, and if there be no profits, but a loss, that the loss shall be borne by one or more of the partners exclusively, and that the other shall, *inter sese*, be exempted therefrom" [Story, 1859, pp. 28-9]. Second, it quickly became clear that there existed contracts in which parties shared losses in some form or another, as well as profits, but which judges nonetheless thought should not be considered partnerships.

For example, in 1843 the Massachusetts Supreme Court decided in the case of *Denny v. Cabot* [p. 82] that the agreement (described above) whereby Cabot, Appleton & Company arranged for Hiram Cooper to manufacture satinets on their account was not a partnership, even though the contract stipulated that Cooper was to receive a share of the net profits of the venture. Justice Wilde, who wrote the decision in the case, attempted to apply the standard test, explaining that "although, in terms, the agreement was to pay Cooper one third of the net earnings, yet . . . by the words immediately following . . . it appears that Cooper was entitled to one third of the gross profits, after deducting certain specified charges; and that in no event was he to be liable for any losses." Wilde well knew, however, that an agreement to share losses was not a necessary component of a partnership contract. As he admitted, "If [Cooper] had stipulated for a share in the profits, (whether gross or net profits,) so as to entitle him to an account, and to give him a specific lien, or a preference in payment over other creditors, and giving him the full benefit of the profits of the business, without any corresponding risk in case of loss;

justice to the other creditors would seem to require that he should be holden to be liable to third persons, as a partner." But he argued that such liability would not hold "where a party is to receive a compensation for his labor, in proportion to the profits of the business, without having any specific lien upon such profits, to the exclusion of other creditors" [*Denny v. Cabot*, pp. 90, 92]. This argument seems strange, however, because claims for payments for labor services would have priority over claims for repayment of the firm's debts, so it was precisely by declaring the agreement not a partnership that creditors would be disadvantaged.

Ultimately, however, Wilde's decision was based on a new test for partnership proposed by Justice Story in his 1841 treatise: the intention of the partners themselves [Denny v. Cabot, p. 92; Story, 1859, pp. 68-9]. At first glance, this new standard would seem to make little sense, because the whole point of the judicial exercise was to determine when agreements that were not considered partnerships by the parties involved nonetheless should be considered partnerships with respect to creditors. However, by closely analyzing Story's thought processes and exploring precisely what he meant by the "intentions" of the parties to a contract, we can gain insight into the concept of the partnership that finally satisfied early-nineteenth-century legal thinkers and determined the boundary between activities that were defined as internal to firms and those that occurred in the market.

Story's frustration with the problem of defining the essence of a partnership agreement is evident in his treatise. On the one hand, he was committed to the idea that common-law precedents should govern the dispensation of cases. The distinction that earlier writers and judges had attempted to draw between a share of profits as a compensation for labor services and a share of profits *as profits*, struck him as unhelpful. As he put it, it "does certainly wear the appearance of no small subtlety and refinement, and scarcely meets the mind in a clear and unambiguous form." For that reason, he wondered "whether it would not have been more convenient, and more conformable to true principles, as well as to public policy, to have held, that no partnership should be deemed to exist at all, even as to third persons, unless such were the intention of the parties, or unless they had so held themselves out to the public." But, he concluded with a tone of resignation, "the common law has already settled it otherwise; and therefore it is useless to speculate on the subject" [Story, 1859, pp. 52-3, 55-6].

In fact, however, the footnotes of Story's treatise are filled with argumentation and speculation on the subject. Moreover, despite Story's claim that as a result of his reformulation of the problem "all the supposed repugnancy or difficulty of the various decided cases vanishes, and they are in harmony with each other, as well as with common sense" [Story, 1859, pp. 60-2], when Story attempted to apply his own principle of intentionality to the case law he was often forced to fall back on the old, in his view unsatisfactory, distinction between gross and net profits. Thus, two men were judged to be "partners *inter sese*, as well as to third persons" in a case "were one person advanced funds for carrying on a particular trade, and another furnished his personal services only in carrying on the trade, for which he was to receive a part of the net profits." In explaining the decision, Story made no reference to the intentions of the parties but instead repeated the old justification that "by taking a part of the profits, [the second person] takes from the creditors a part of that fund, which is the security for the payment of their debts" [Story, 1859, p. 93]. Similarly, as he reported the dispensation of another case:

> So, where A., B., and C. entered into partnership in the business of tanning hides, and it was stipulated that A. should furnish one half of the stock, to keep that tannery in operation, and should market and receive one half the leather, and that B. and C. should furnish the other half of the stock, and receive and market for the other half of the leather, and that in making purchase each should use his own credit separately; *it was held, that they were partners as to*

> *third persons, as well as between themselves, as to stock sold to one of the partners; for the stipulation, as to the division of the manufactured article specifically among the partners, was equivalent to a participation of profit and loss* [my emphasis] [Story, 1859, pp. 93-4].

Story was unable to apply his new criterion to past judicial decisions because these cases simply had not hinged on the issue of intentionality. It was with respect to the future, not the past, that Story's distinction would prove important, for despite his disclaimer, his focus on intentionality did in fact mark the introduction of a new standard. It is important, therefore, to understand precisely what he meant by the term.

A key passage in the midst of Story's discussion of "Partnerships as to Third Persons" suggests that the concept of intention should be interpreted in a very specific way. It was not the intention of the parties as to whether their agreement was in formal terms a partnership that really mattered. Rather it was their intention as to the distribution of *power* among themselves: "In other words, the question is, whether . . . the portion of the profits is taken, not in the character of a partner, but in the character of an 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. In this way the law carried into effect the actual intention of the parties, and violates none of its own established rules. It simply refused to make a person a partner, who is but an agent for a compensation payable out of profits; and there is no hardship upon third persons, since the party does not hold himself out as more than an agent [Story, 1859, p. 59].

The courts originally had had no difficulty determining that seamen who were paid a share of the profits of a whaling voyage were not partners, because the inequality of the power relationship was so clear. Instead of generalizing this point, however, concern for the rights of creditors had caused judges to preoccupy themselves with the attempt to distinguish profits as compensation for labor services from profits as profits. What Story did in effect was to return to the underlying principle in the seamen's cases and generalize it to all situations. What mattered was not whether a party obtained a share of the profits, net or gross, but rather what the intent of the parties was as to the division of power among themselves. Partnerships were those agreements that conferred an equality of power on the contractees. Everything else was a matter of agency. Thus in *Denny v. Cabot*, the court decided (explicitly following the logic laid out in Story's treatise) that the relationship between Cooper and Cabot, Appleton & Company was one of agency not partnership, because the terms of the agreement were so one-sided: "The stock was to be supplied by [Cabot, Appleton & Company], and the satinets were to be of such colors as they should direct, and, when manufactured, were to be delivered to them." On the basis of these terms, the court concluded, "It seems to us very clear, that the defendants never contemplated a partnership, by the contract between them" [*Denny v. Cabot*, pp. 93-4].[13]

The crucial point, then, for understanding the contractual choices that businessmen made at this time is that a decision by two or more associates to employ the partnership form of organization was a decision to accept a distribution of power among themselves that, at least in the eyes of the law, was equal. 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 the property at issue as if he were the sole owner, but in the latter case only one party actually had ownership

[13]See also *Bradley v. White*; *Emmons v. Westfield Bank*; *Ryder v. Wilcox*.

rights. If an agent decided to dispose of the goods himself rather than pass them on to the principal who had contracted for their manufacture, the principal could sue for their recovery. But if a partner in charge of a factory did the same thing, his associate would have no recourse against him. It was perfectly within his powers to sell the goods himself.

In one sense, there was nothing new about Story's concept of partnership. It had long been accepted that each and every partner had the right and authority to dispose of the firm's property as if he were the sole owner and to bind the other partners with debts contracted in the prosecution of the firm's business. What was different in the 1840s was a context that gave this definition new significance. The growth of the market during the early nineteenth century had brought about both an increase in the level of economic uncertainty and a breakdown in customary ways of resolving contract disputes. Desperate creditors were taking advantage of the confusion to try to extract payments from people who had contractual relations with debtors but who, in earlier times, would never have been viewed as having an obligation to repay their associates' debts. Existing legal definitions of the partnership contract that hinged on the sharing of profits, net or gross, could not resolve the confusion. What Story accomplished by his new focus on intentionality, in effect, was to bring legal rules back into conformity with what he called "common sense"--that is, with distinctions that had long been customary between partnerships and other kinds of contractual arrangements.

But the implication of Story's new emphasis on equality of power among the members of a partnership was nonetheless profound, because the same context that made earlier legal rules ineffective also undermined partners' ability to regulate each other's behavior--in particular their ability to use their articles of copartnership to impose restrictions on one another's freedom to bind the firm with debts and act individually as full owners. Indeed, the courts had already arrived at this position by a different path. The key case 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 against moral hazard by insisting that Winship sign an agreement not to endorse the notes of anyone outside the firm. As they later learned, however, this agreement did not, in the eyes of the law, prevent them from being held liable for notes that Winship nonetheless endorsed, for the courts ruled that creditors could not be expected to know of its provisions. 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.

Indeed, Marshall went so far as to insist that the Binneys were liable for Winship's debts, even though the money Winship borrowed was later applied to his own concerns and not to those of the partnership: "the holders [of the debts] not being parties or privies thereto, or of such intention, would not deprive them of their right of action against the co-partnership" [*Winship v. The Bank of the United States*, pp. 552-4, 561-2; Story, 1859, pp. 163, 351-81].[14] Such a

[14]In theory, partners were bound by the terms of the partnership agreement, but restrictions embodied in articles of copartnership were difficult to enforce. In extreme cases an equity court might issue an injunction against a partner whose disregard for the provisions of the partnership agreement was injuring the firm, but such a remedy also typically brought about

ruling was badly needed in a context where economic development and the growth of the market were making lending relations more impersonal. Lenders could not be expected to have intimate knowledge of the internal structure of the firms to which they granted credit, so outward appearances became critical. One purpose of the law was to make sure that appearances were not deceiving.

The Legal Definition of Partnership and Contractual Choice

In order to explore the implications of this concept of partnership for early nineteenth century businesses' contractual choices, it is helpful to recall the various economic motives that brought people together in joint business ventures in the first place. One might hypothesize, for example, that such a concept of partnership might be appealing in situations where the parties to an agreement had roughly comparable resources, whether of labor or capital, or where they each possessed some unique talent or ability that could be combined for their common advantage.[15] On the other hand, one might hypothesize that investors in search of outlets for their capital and businesses seeking additional labor for their firms would be reluctant to choose a form of organization that conveyed so much unrestricted power on their associates, especially as there were

the dissolution of the partnership. As Story put it, "as in some relations in life, we enter into the [partnership] connection for better or for worse" [1859, p. 352]. See also *Sweetser v. French*; and *Hayward v. French.*

[15]Oliver Williamson [1985] would argue instead that firms were likely to be formed wherever the venture required at least one of the parties to invest in assets that were so specific to the enterprise that other contractual arrangements would subject him to exploitation. However, the life expectancy of partnerships was so short that this form of organization really did not protect a party from the repeat contracting that made investments specific to the enterprise so vulnerable to extortion. For an excellent example, see the 1817 lawsuit brought by Pierre Bauduy against E. I. du Pont. As the details of this case suggest, the costs and risks of dissolution may have made partnerships more vulnerable to holdup than ordinary contracts. See E. I. du Pont de Nemours & Co., Series C--Special Papers, Bauduy Lawsuit (Part I) (1805-1825), Longwood Manuscripts, Box 45. The view of the firm to which this legal definition gives rise is more like Alchian and Demsetz's conception of firms as teams [1972] than Coase and Williamson's argument that they are long-term contracts.

other contractual forms available that served similar ends without entailing the same loss of authority.

We know, however, that there were many agreements in the early nineteenth century that did not conform to these expectations. Some of the deviations are relatively easy to explain. For example, at least some of the agency contracts formed under circumstances where one might expect partnerships to occur instead were obviously the product of desperate situations. The reason why Cooper signed an agency contract with Cabot, Appleton & Co., for instance, was because he had previously failed in business and had been discharged from his debts under the Massachusetts insolvency act. The only way he could get supplies on credit was to display his contract with this prestigious firm [*Denny v. Cabot*, pp. 84-5]. Similarly, as background information in the case of *Blanchard v. Coolidge* reveals, Nathaniel Blanchard made himself his son's agent in a shoe manufacturing business because a previous failure prevented him from obtaining credit on his own.[16] It is also likely that investors who chose the partnership form over other types of less risky contracts had motives beyond simply finding a profitable way to dispose of their savings. For example, merchants with capital to invest may have sought partnerships with manufacturers as a way of integrating backward so as to realize economies from specializing in the distribution of a particular kind of commodity.[17] It is also possible that savers who made such investments were motivated by ties of kinship or similar kinds of personal connections. The trust, knowledge, and extralegal

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[16]It is, of course, possible that these examples from the case law are not representative of the universe of such agreements.

[17]This motive is consistent with story told in Livesay and Porter [1971]. Although it is possible that, in the early years, partnerships may have been attractive to merchants as a way of subverting the usury laws and earning interest in excess of the legislated ceiling of 6 percent, it is doubtful that this motive was very important as time went on. In the first place, the expected profits from the partnership would have to have been extraordinarily high. In the second, the effect of the usury laws on privately contracted debt declined over time. As Morton Horwitz [1977, pp. 243-5] has shown, by the end of the Jacksonian era usurious interest was no longer grounds in most states for voiding contracts or forfeiting debt.

disciplinary mechanisms that family ties entailed undoubtedly helped to overcome the limitations and risks of the partnership form.[18]

The use of the partnership form of organization to obtain labor services is much more difficult to understand, yet it was also probably much more common. Stuart Blumin has shown that shopkeepers in the mid-nineteenth century often rewarded their clerks with partnerships after a term of service; indeed he suggests that such rewards were a major avenue of upward mobility in that period [Blumin, 1989, pp. 66-137]. My own study of a random sample of firms drawn from the 1845 Boston city directory indicated that nearly 40 percent of partnerships were formed when an experienced businessman took on a (presumably younger) partner with few financial resources and little in the way of business experience--in other words, a partner who had little besides labor to offer the firm [Lamoreaux, 1994b].

Once again, it is possible that many of the partners taken on in this way were family members or others with close personal ties to the firms' proprietors. However, very few (only about 20 percent) of the cases involved people with the same last name. Of course, having different last names did not necessarily mean that the partners were unrelated; they may have been cousins or connected by marriage. Moreover, even if the partners were not related to each other, there may have been other kinds of personal ties that brought them together in the first place. The low survival rate of firms that united an experienced with an inexperienced partner (only a third were still in existence five years later) suggests, however, that whatever personal connections may have linked the members of these firms, they did not have much holding power over the long run [Lamoreaux, 1994b].[19]

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[18]For example, in the case of *Lord v. Baldwin*, Aaron Brown was found to be a dormant partner of his brother John Brown. On the role of kinship connections in early-nineteenth-century finance, see Lamoreaux [1994a], especially chapters 1 and 3. For a theoretical discussion of the economic advantages of kinship ties, see Pollak [1985].

[19]For the sample as a whole, survival rates for firms in which at least two of the partners had the same last name were substantially greater than those where all the partners had different names, an indication that there was a measurable difference in the strength of the personal

It is also possible that employers wanted to make key employees partners--after a suitable probationary period--because they thought that profit sharing would prevent shirking and induce employees to keep the interests of the firm in the forefront of their minds. Once again, however, the courts' distinction between agency and partnership meant that there were other types of profit-sharing contracts that could have achieved the same result. For example, the Massachusetts Supreme Courts decided in *Bradley v. White* that the agreement whereby Nathaniel L. White managed Dodge's store in return for a share of the profits was not a partnership agreement and that neither man was liable for the other's debts.[20]

Another possibility is that employers could only effectively delegate certain types of tasks to an employee who held the status of partner, perhaps because customers had a strong preference for dealing with owners rather than with hired hands. Although this hypothesis requires further investigation, it seems an unlikely explanation for the phenomenon. It was precisely their greater status in dealing with customers that made partners such a potential threat to the firm-specific capital of the enterprise--it was a much more serious matter to face competition from a former partner than it was from a former employee. Moreover, it is difficult to understand why customers would have been reluctant to do business with employees, as there was a well established body of law that gave deals negotiated

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ties binding these two types of partnerships. Of the firms in which all the partners had the same last name, 43 percent survived at least five years, as opposed to 29 percent of the firms in which all the partners had different last names. It is not possible to tell what proportion of the disappearances owed to failures and what proportion to voluntary dissolution.

Another possibility is that the partnership form of organization was a way for retiring businessmen to pass on their enterprises to new owners but still retain a claim on their firms' earnings. The low survival rate for partnerships that united experienced and inexperienced members suggests, however, that this strategy can not explain the frequency of partnerships of this type, with the likely exception of cases where both parties to the agreement shared the same last name.

[20]According to Alchian and Demsetz [1972], moreover, the partnership form of organization did not solve the shirking problem.

with agents the same protection as those negotiated with partners.[21]

Given the risks associated with granting employees equal standing in the firm, it makes more sense to conceive of the choice as a matter of employee preference in an environment where labor of this type was relatively scarce. But why might employees prefer partnership contracts to other agreements that enabled them to share in profits without bearing as much risk? One can imagine both economic and non-economic reasons for the choice. With respect to the former, it is possible that employees wanted a say in the direction of the firm so that they could influence the level of profits in which they would share. It is also possible that, for some types of businesses, partnership status was the only way to lay claim to accumulated firm-specific assets such as carefully established relations with customers.[22]

As for non-economic motives, there is a large literature about the positive value that Americans in this period placed on the independence associated with small proprietorship--and conversely on the negative ways in which they viewed positions of dependence. There is also a growing literature that connects this preference for independence with emerging concepts of masculinity. Hence it may be that the popularity of the partnership form of organization during the early nineteenth century resulted more than anything else from young men's (for that was who the partners overwhelming were) abhorrence of relations of dependence.[23] In any event, we know that many other firms (fully another 35 percent of the partnerships in my

[21]Indeed, the law of partnerships was articulated in terms of the law of agents. Thus Story [1859, pp. 1-2, 163-4] quoted another learned judge: "One partner by virtue of that relation (of partnership) is constituted a general agent for another as to all matters within the scope of the partnership dealings . . . ."

[22]I am suggesting, in other words, that it was more difficult for an employee to leave a firm and take customers with him than it was for a partner.

[23]For a general view of the importance of independence, see Wood [1992]. For a more specific discussion of economic motivation, seeVickers [1990]. On the connection between masculinity and independence, see Aron [1987], Blewett [1988], and Lewchuk [1993].

Boston sample, for example) were formed by men who lacked both business experience and capital, but who clubbed together whatever meager resources they had to get a start in business. Despite the low survival rates for such firms, the men involved seemed to have preferred the independence that came with owning one's own business to the dependent status of employee.[24] We also know that men who applied for civil service jobs later in the century were acutely sensitive to the status implications of becoming permanent employees. E. Lac Haskins, for example, justified his application for a job in the Census Office in 1890 by claiming, "I have not been lucky in late years in my transactions . . . . I want to go forward again--to go honestly--and it is asked *not* from preference but because at 49 years old I have nearly lost my capital and *must* work as employee instead of doing business for self" [Aron, 1987, p. 26]. According to Cindy Aron, who has studied civil-service employees, such defensiveness was pervasive: "Would-be federal office workers repeatedly apologized for seeking government clerkships, implying that to do so was somehow less than admirable" [Aron, 1987, p. 34]. As one writer put it at the time, a clerk for the federal government had "no independence while in office, no true manhood" [Aron, 1987, p. 36].[25]

To summarize then the argument of this essay, the boundary between partnerships and other kinds of contracts was drawn in the

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[24]Only 17 percent of the firms with no experienced partners survived five years, as opposed to 33 percent with one experienced partner, and 53 percent of the firms with all experienced partners [Lamoreaux, 1994b].

[25]A handful of high-status occupations serve as exceptions that prove the rule. For example, retiring masters of whaling ships had effectively to be bribed by owners (who feared harm to their vessels) before they were willing to accept the risks associated with partnership. See Craig and Knoeber [1992]. To give another instance, my own research in bank records indicates that young men eagerly sought positions as cashiers. Apparently, the status in the community that derived from control of access to credit offset the disadvantages of employee status.

Upward mobility out of clerkships seems to have been less common in England, but whether this difference was a result of a lack of concern for independence or of the relative abundance of labor is not clear. See, for example, Lockwood [1989, pp. 19-35].

early nineteenth century by judges who were mainly concerned with protecting creditors' rights but who, at the same time, did not wish to award the rights of partners to parties (like seamen on whaling ships) who, they felt, clearly did not warrant them. After struggling for several decades to develop a consistent set of legal rules, Justice Story finessed the entire problem by refocussing attention on the parties' own intentions--that is, on the distribution of power to which they had implicitly agreed. Partnerships, in other words, came to be defined not just as contracts that involved a sharing of profits (though this remained an important element of the definition) but also as contracts that effectively distributed power equally among all the parties to the agreement. This redefinition of the concept of the firm occurred in an environment in which Americans were acutely sensitive to relations of power, and I would like to suggest that the interaction of this environment with the evolving legal definition of the partnership form helps to explain contractual choice during this period, particularly the growing attraction of the partnership form for upwardly mobile white collar employees.

If this view holds, and clearly more research on these issues is needed, then the way firms were constructed during the early nineteenth century may have had implications for the pace and pattern of the nation's subsequent economic development. On the one hand, it is possible to argue that young men's reluctance to accept positions of dependence promoted the formation of firms and thus the competitiveness and dynamism of the economy. Businessmen working for the success of their own firms may have been more innovative than those working for others. In a period when the skills necessary for invention were widely available, the preference for independent proprietorship may thus have operated as a stimulus to technological change.[26] On the other hand, it is possible to argue that young men's reluctance to serve as clerks beyond a probationary period kept the size of individual businesses smaller than they

[26]On the widespread availability of technological knowledge and the patterns of invention that resulted, see Sokoloff [1988], and Sokoloff and Khan [1990].

otherwise would have been and thus prevented the exploitation of economies of scale or specialization. In effect, the only way that firms could grow was by taking on new partners, but the difficulties and risks associated with the partnership form of organization worked to limit this avenue of expansion. Before the size of firms could increase significantly, therefore, ways had to be found to acculturate men to positions of dependence [Kwolek-Folland, 1994; Landry, 1994, pp. 39-41; and Aron, 1987, pp. 139-61]. Firms would have to face this challenge in the second half of the century.

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