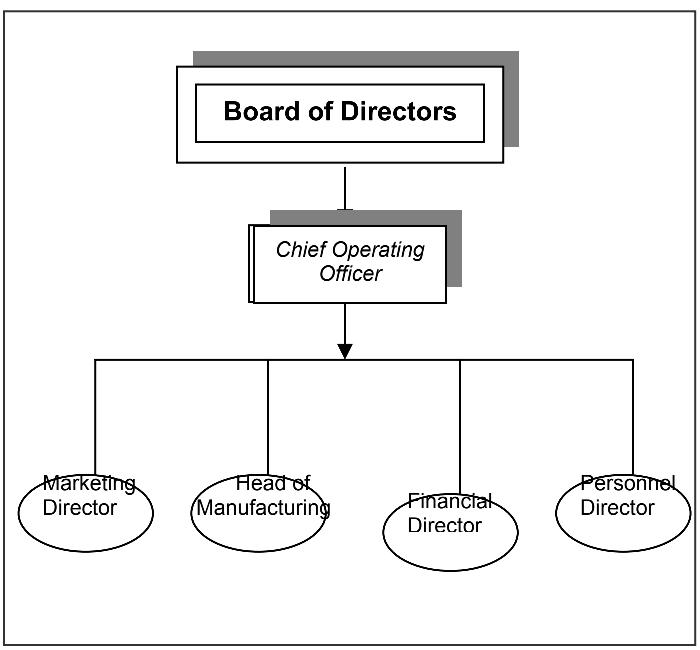
Chapter 6
Business 0rganizations

In the days when most goods were made by hand, the craftsman needed only to hang his shingle over the door of his shop to organize his business. He did not need to worry about forming a partnership, a corporation, a trust, a holding company, or a conglomerate. But as businesses increasingly were organized to sell on national rather than local markets, a need for more complicated forms of organization arose. Today, these organizational structures permit corporations to buy and sell oil in all parts of the world, operate a huge fleet of super tankers, and employ more people, own more property, spend more money and generate more wealth than most governments in the world. These activities would be impossible under the forms of business organization that were used by the local blacksmith or candle maker. This chapter will acquaint readers with the new forms of business organization that developed during our Industrial Revolution and the uses that were made of them.

From Individual Proprietorship and Partnership to Corporation

Not too long ago a young woman entered a grocery store, asked for the rest room, and was mistakenly directed toward the door leading to an elevator shaft. She broke both legs after falling ten feet to the basement. The store's owner was sued for over $100,000 and since his insurance did not cover him, he had to sell his store, house and automobile in order to pay the claim. This story helps explain why fewer and fewer business people are satisfied to remain as individual owners or partners in a businesses that can hold them personally liable for debts the business incurs. Two other disadvantages of simple ownership or partnership are its limited life should the principal or a partner die and its difficulty in raising money. Forming a corporation avoids these problems and has become a preferred form of business organization.



A corporation is a business owned by its stockholders. The stockholders manage the corporation by electing a board of directors to supervise the president and other officers. In addition to the vote, a share of stock in the corporation entitles the stockholder, to a share, (called dividends) of the corporation's profits. When one stockholder dies, his/her heirs inherit the stock so that the corporation continues without disruption. The Hudson Bay Company, for the debts incurred by the corporation, a very important consideration for investors wishing to buy stock.

example, was incorporated in 1670 and is still in existence. The other distinct advantage of the corporation is the protection it offers its owners. No stockholder can be held liable for

One reason owners of a corporation are not liable for their debts is that corporations according to the U.S. Supreme Court are "artificial being(s), invisible, intangible, and existing only in contemplation of law." Therefore, corporations can sue and be sued, borrow and lend money, and have the right to due process under the law. Most business in this country is performed by corporations. Corporations have become both a convenient and an accepted way of raising large sums of money and executing complicated business dealings. In short, a corporation can be defined as a firm usually established for the purpose of doing business; owned by its stockholders, and a legal entity before the law.

Abuses of Corporate 0rganization: Watered Stock

One of the least respectable businessmen of the period after the Civil War was a shrewd manipulator of stocks and securities named Daniel Drew. Drew got his start in business as a boy driving cattle to New York City from his home in up state New York. Just before weighing his livestock for market, young Drew allowed them to lick salt tablets and gave them large quantities of water to satisfy their thirst and add to their weight. Thus the term 'watered stock' has been used to describe the huge amounts of water sold as beef. After Daniel Drew entered the corporate business world he found even more devious ways of watering stock. In 1867 Cornelius Vanderbilt tried buying stock in the Erie Railroad which was then controlled by Drew, Jay Gould, and Jim Fiske. The trio printed up some 23 million dollars worth of watered stock in a single year and Vanderbilt bought it. This stock, like the watered beef, represented no real value and only diluted the value of shares owned by others. Nevertheless, watering stock was a common way for corporations to raise money for a few insiders and thus cheat stockholders. In 1901, for example, the great banker J.P. Morgan bought out Andrew Carnegie and several other huge steel companies for $700 million. He promptly issued and sold $1.4 billion worth of stock — half of it, because it represented no real value, was said to be water.

The Pool

While the purpose of forming corporations was to reduce liabilities and to perpetuate the life of a firm, other business organizations were formed for somewhat less legitimate reasons. The continual pressure of many firms bidding for an increasingly small market often forced competitors to reduce prices below their costs. Such was the condition of the salt industry described by J. E. Shaw in 1876s:

> *Salt has depreciated in value, dropped steadily down, until today it has no market price on the Saginaw River, and is quoted at only $1.27 in Chicago, and $1.00 in Toledo. That the experience of '75 will be that of each succeeding year, unless something is done to check the general demoralization, cannot be gainsaid. The oldest manufacturers of the Syracuse, Kanawha, and Ohio districts, tell us that their experience, dating back forty years in some cases, has always been this: "0rganized we have prospered. Unorganized we have not."* .[10]

Shaw's resolution to his problem was to form a pool, which was a kind of gentleman's agreement, with other salt manufacturers to limit competition. Members of a pool might agree either to keep its prices high no matter what the competition and limit the amount produced, or to divide the market along some geographic lines. In all these cases the purpose was to maintain an artificially high price. The South Improvement Company scheme developed by Rockefeller and his partners is another example of the

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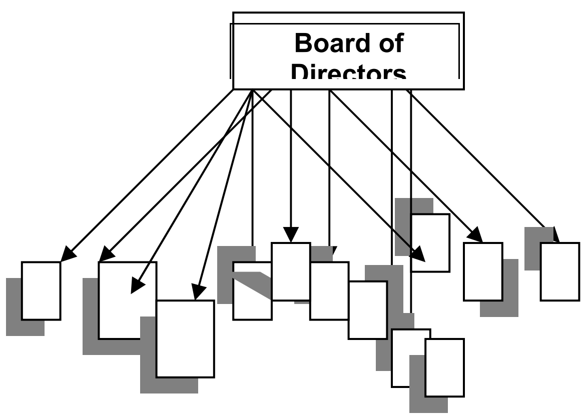
10Quoted in William Z. Ripley, ed., Trusts, Pools and Corporations, Ginn and Company, Boston, 1916). p. 6.

pool, and the agreement among Oil Producing and Exporting Countries (OPEC) is a modern example on an international scale.

The problem with forming a pool was that its members often did not live by their agreements. In one frequently cited example, railroads that were agreeing on fixed rates found that one member of the pool asked his home office to cut the rates the pool was setting while the meetings were still in progress. Because pools were not legal agreements that could be enforced under law they often failed to accomplish their objectives. Therefore, other means of organization were devised.

The Trust

Samuel Dodd, the ingenious lawyer working for Standard Oil, devised a way to escape from state laws that prohibited one firm from owning the stock of another. Here he suggests the advantage of forming a trust:



One Board of directors controls 12 Corporations that once competed

…[Y]ou could have a common name, a common office, and a common executive committee. If the directors of one of the companies and their successors shall be made trustees of all such stock, you thus procure a practical unification of all the companies. [11]

Under Dodd's leader-ship thirty-nine different companies refining and transporting oil secretly formed a single super corporation called a trust.

The stockholders in each of the corporations were told to surrender the voting rights of their stocks to the Board of Trustees. This Board was then permitted to make decisions for all the corporations in the trust and thus was able to eliminate waste, overlapping operations, and price competition. With the formation of this trust in 1882, a total of 700,000 shares of certificates worth $70,000,000 were issued to a total of forty-one people. This single organization refined 80% of the nation's oil and controlled 90% of its pipelines. This ingenious device was widely imitated by the formation of trusts in whiskey, beef, sugar, farm machinery, and steel.

After Congress passed the Sherman Anti-Trust Act in 1890, Standard Oil was forced to reorganize its subsidiary corporations. Seizing upon the laws in New Jersey that permitted single corporations to own and operate firms doing business in other states, Standard Oil formed a holding company. The parent corporation, Standard Oil of New Jersey, was given the controlling stock in its empire of thirty-nine other oil refineries and pipeline operators. In this way the trustees, who had once commanded the Oil Trust, were able to maintain their control through the holding company.

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11. Quoted in Bernard Bailyn et. al. The Great Republic: A History of the American People, D.C. Heath and Company, Lexington, Ma., 1973, p. 838.

In forming a holding company in 1899, Standard Oil once again pioneered in adopting a new form of business organization to insure maximum profits and efficiency at the expense of price competition. Other businesses followed this example, and in some instances controlled scores of corporations in the same line of trade. When the Standard Oil Company was ordered dissolved in 1911 and broken into thirty-three competing companies, not much changed in the way of price competition. Many of the men who sat on the board of directors of one of the Standard companies, also directed several of the others. This practice, known as interlocking directorships, again became common practice in many other industries. Furthermore, Standard Oil was able to maintain the old pooling arrangement made possible by the Trust. Each separate corporation, Sohio, Esso, Mobile, and Chevron, for example, maintained their geographic divisions, confining their operations to Ohio, New Jersey, New York and California respectively.

The Supreme Court ordered the executives of the Standard holding company not to plan business operations together. But the Court could not prohibit the many social gatherings attended by men who had worked together for many years, nor could it prevent the continuation of business arrangements that these old friends had found mutually beneficial. Thus their community of interests prevented a quick return to direct competition between rival oil firms. Similar communities of interest reduced real competition between the corporations that dominated such diverse industries as farm machinery, whiskey, shoe machinery, and sugar refining.

Why Monopolize?

Why did businessmen form ever-larger organizations? Why did corporations form pools; pools turn into trusts, and trusts into holding companies? Why did giant companies devour one another in a kind of corporate cannibalism with each meal creating a larger and larger industrial organization? For the cynic the answer might be quite simple -- to destroy competition, and to obtain monopoly.

Monopolists (from the Greek word 'mono' meaning single) can set their own prices because no competitor can force them to charge less. But there are other reasons for increasing the size of a business. Corporations today sell and buy in a national if not an international market. At the height of his career, Andrew Carnegie could boast that his steel mills took:

> *…two pounds of ironstone mined upon Lake Superior and transported [them] nine hundred miles to Pittsburgh; one pound and one-half of coal, mined and manufactured into coke, and transported to Pittsburgh; one half-pound of lime, mixed and transported to Pittsburgh — and these four pounds of materials manufactured into one pound of steel, for which he charged the consumer one cent.* [12]

This magnificent feat of production and organization could only be accomplished by a multi-million-dollar firm and Carnegie's companies eventually served the basis for the first billion-dollar corporation. To give another example, Henry Ford was able to reduce the price of his touring car from $2,800 to $360 over a ten-year period. But he could do this only because he increased the number of cars he sold each year, from 6,400 in 1907-08 to 730,000 in 1916-17. Because Ford was able to engage in what economists call the economies of large-scale production, he reduced the time spent building the chassis of his car from roughly twelve and one-half to one and one-half hours in just one year. Had they not controlled giant organizations, neither Carnegie nor Ford could have produced goods so cheaply or

12Quoted in Charles and Mary Beard, The Rise of American Civilization, The MacMillan Company, New York, 1930, p. 175.

passed the savings on to the public. Thus bigness serves both the business tycoons and the consumer. But questions arise when does bigness destroy competition at the expense of the consumer rather than creating savings from which consumers will benefit.

Suggested Student Exercises:

1. What are the three major differences between a partnership and a corporation?

2. Explain how trusts, pools, holding companies, and communities of interest work to reduce competition and to introduce 'economies of scale.'

3. Give examples of how Standard Oil participated in four of the above forms of business organization.