Putting the Corporation in its Place

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Putting the Corporation in its Place

The purpose of this article is to challenge the assumption pervasive in the literature that the corporate form of organization was indispensable to economic development.[1] This idea has taken a number of forms. For example, it has been argued that only the corporation could provide the lock-in of capital necessary to elicit long-term investments, the limited liability needed to raise capital from the broader public, the entity shielding that could protect the assets of an enterprise from the creditors of its owners, and the concentrated management required for effective governance of large-scale enterprises.[2] Although we recognize that the corporate form was important for enterprises such as railroads that had to raise enormous sums of capital on the market, we question whether it was so vital for the vast majority of firms. Indeed, when provided with a viable alternative—what we are calling the private limited liability company or PLLC—most businesses, including most industrial enterprises, chose not to organize as corporations.

As has long been recognized, the corporate form entailed costs as well as benefits. The combination of concentrated management and lock-in of capital that made the form

[1] We are deliberately echoing here Robert Fogel's famous study *Railroads and American Economic Growth: Essays in Econometric History* (Baltimore, 1964). For a statement of the critical importance of the corporate form for economic development, see Nathan Rosenberg and L. E. Birdzell, Jr., *How the West Grew Rich: The Economic Transformation of the Industrial World* (New York, 1986). Late passage of general incorporation has often been seen as causing economic retardation. See, for example, Charles E. Freedeman, *Joint-Stock Enterprise in France, 1807-1867: From Privileged Company to Modern Corporation* (Chapel Hill, 1979), and *The Triumph of Corporate Capitalism in France, 1867-1914* (Rochester, NY, 1993).

[2] Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business*. (Cambridge, Mass., 1977); Susan E. Woodward, "Limited Liability in the Theory of the Firm," *Journal of Institutional and Theoretical Economics* 141 (December 1985): 601-11; Robert C. Clark, *Corporate Law* (Boston, 1986); Margaret M. Blair, "Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century," *UCLA Law Review* 51 (Dec. 2003): 387-455; Henry Hansmann and Reinier Kraakman, "The Essential Role of Organizational Law," *Yale Law Journal* 110 (Dec. 2000): 387-440.

so useful for large-scale enterprises also enabled those in control of the firm to behave opportunistically toward minority shareholders and creditors. There is a large literature on corporate governance that addresses this problem. Focusing for the most part on protecting outside investors in corporations that raise funds from the general public, it examines a variety of potential solutions, including government regulation, private oversight by exchanges, monitoring by block holders, and compensation schemes that align managers' incentives with those of owners.[3]

Less attention has been paid to problems of corporate governance in small- and medium-sized enterprises (SMEs)—that is, in enterprises whose shares are neither sold to the public nor traded on the securities markets. Not only do most of the solutions posed in the literature have little relevance to their case, but, as we will show, many regulatory efforts to protect outside investors in public corporations actually made the form less viable for SMEs. Not surprisingly, therefore, when a new form was introduced (the PLLC) that allowed SMEs to obtain many of the advantages of incorporation without bearing all of the costs, it rapidly surpassed the corporation in popularity. The first mover was Germany, which passed enabling legislation for the *Gesellschaft mit beschränkter Haftung* (company with limited liability) or GmbH in 1892. Britain followed in 1907 with a new Companies Act that allowed business people to organize as

[3] The literature goes back, of course, to Adolf A. Berle, Jr., and Gardiner C. Means, *The Modern Corporation and Private Property* (New York, 1933). See, for example, Harold Demsetz, "Wealth Distribution and Ownership Rights," *Journal of Legal Studies* 1 (June 1972): 223-232; Demsetz and Kenneth Lehn, "The Structure of Corporate Ownership: Causes and Consequences," *Journal of Political Economy* 93 (Dec. 1985): 1155-77; Jeffrey Zweibel, "Block Investment and Partial Benefits of Corporate Control," *Review of Economic Studies* 62 (April 1995): 161-85; Patrick Bolton and Ernst-Ludwig Von Thadden, "Blocks, Liquidity and Corporate Control," *Journal of Finance* 53 (Feb. 1998): 1-25; Marco Pagano and Ailsa Roell, "The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and the Decision to Go Public," *Quarterly Journal of Economics* 113 (Feb. 1998): 187-225; Jean Tirole, "Corporate Governance," *Econometrica*, 69 (Jan. 2001): 1-35; Lucian Arye Bebchuk, "Asymmetric Information and the Choice of Corporate Arrangements," Harvard Law School Discussion Paper #398. (2002).

private limited companies. Other European countries adopted similar legislation in the decades that followed. France, for example, created the société à responsabilité limitée in 1925. The big exception was the United States. Business people in the US really had little choice but to organize as partnerships or corporations until the 1980s and 1990s. Although the corporate form did undergo some modification in the US so that it better met the needs of SMES, even those changes came rather late—for the most part in the third quarter of the twentieth century.

SMEs historically have been important sources of technological dynamism and employment growth, so it is as critical to encourage their formation as it is to promote investment in large, publicly traded corporations. For this reason we attempt in this paper to "put the corporation in its place" and shift the focus of attention to the PLLC—that is, to a form of organization which, we argue, better meets SMEs' contracting needs. In the next section, we describe in greater detail the relative advantages and disadvantages of alternative forms of organization in order to explain the PLLC's appeal. We then explore the history of the form and the extent to which firms took advantage of it in four important countries: Germany, the UK, France, and the US. We chose these countries because they were all successful economically and because their legal innovations have been influential around the world. The French and German civil and commercial codes form the basis for business law in many countries in Asia and South America, as well as elsewhere in Europe; the UK is widely recognized as the birthplace of the common law and has transplanted its legal system to many former British colonies; and US corporate law has been promoted as a model that other countries should imitate. We hope that by studying the ways in which firms operating under these different legal systems have successfully solved the organizational problems they faced, we can better help developing countries design business forms that will work within their particular institutional structures to encourage entrepreneurial investment and foster the growth of SMEs.[4]

The Advantages and Disadvantages of Different Organizational Forms

We start from the perspective of an entrepreneur who wants to establish a business. If she does not have enough wealth to finance the business on her own (or does not want to bear the risk of putting so much of her wealth in one enterprise), she must either borrow or seek an equity investment. Both alternatives involve transaction costs. Because we are interested in the choice of organizational form, we focus our attention on the costs involved in bringing investors into the firm.[5]

In all four of our countries businesses could readily organize as ordinary partnerships in the nineteenth century (see Table 1). Indeed, in the UK and the US all they had to do to be considered at law to be partnerships was to hold themselves out to

[4] In putting the corporation in its place we are also challenging an influential strain in the literature that touts the superiority of the Anglo-American common law over the German and especially the French commercial and civil codes. See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, "Legal Determinants of External Finance," *Journal of Finance* 52 (July 1997): 1131-50; "Law and Finance," *Journal of Political Economy* 106 (December 1998): 1113-55; and "The Quality of Government," *Journal of Law, Economics, and Organization* 15 (March 1999): 222-79.

[5] Duol Kim's study of businesses in the manufacturing sector in late nineteenth-century New England shows that proprietorships that took on partners grew significantly more rapidly than those that did not, suggesting that SMEs faced important credit constraints. New England was a capital abundant region during that period, so it is likely that businesses in developing economies would be even more constrained. In such a context, it is all the more important to reduce the magnitude of the transaction costs associated with the forming of multi-owner firms. See Kim, "Firm Financing, Ownership Structure and Market Competition in United States Manufacturing during the Nineteenth Century," unpublished Ph.D. dissertation, University of California, Los Angeles, 2003.

the world as such. There was no need even to write a partnership agreement.[6] In France and Germany partnerships also could be informal. If they were organized under the commercial code, however, they had to register their articles of association with the appropriate local authority. One advantage of such registration was that it allowed business people to modify the terms of the standard partnership contract so as to concentrate managerial authority in particular partners or require that all members of the firm agree to take on debt.[7]

The partnership form, of course, had serious disadvantages. Because all of the partners were unlimitedly liable for the enterprise's debts, business people hesitated to enter into such relationships unless they could extricate themselves when their partners proved untrustworthy or took the business in directions that seemed ill-advised. As a result, partnership agreements (even those that specified a term for the enterprise) were effectively at will.[8] Business people entering into such agreements could not credibly commit to stay in the enterprise, and so partnerships suffered from the possibility that disputes might arise among the firm's various owners that could force what was otherwise a successful enterprise to dissolve.[9]

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[6] Naomi R. Lamoreaux, "Constructing Firms: Partnerships and Alternative Contractual Arrangements in Early-Nineteenth-Century American Business," *Business and Economic History* 24 (Winter 1995): 43-71.

[7] In Britain and the US business people could write such contracts but they were not enforceable with respect to third parties. Naomi R. Lamoreaux and Jean-Laurent Rosenthal, "Legal Regime and Contractual Flexibility: A Comparison of Business's Organizational Choices in France and the United States during the Era of Industrialization," *American Law and Economics Review* 7 (Spring 2005): 28-61.

[8] A partner who pulled out of an agreement that had a specified term might face damages, but only if the action was without cause. Courts were reluctant to enforce partnership agreements where there was dissension among members of the firm. See Naomi R. Lamoreaux and Jean-Laurent Rosenthal, "Corporate Governance and the Plight of Minority Shareholders in the United States before the Great Depression," in *Corruption and Reform: Lessons from America's Economic History*, ed. Edward L. Glaeser and Claudia Goldin (Chicago, 2006), 133-33.

[9] Although dissolution does not necessarily entail liquidation, there is always the possibility that illiquid firm-specific assets will have to be sold at a loss to pay off creditors or to buy out members of the firm. Dissolution can also be forced by the creditors of one of the members of the firm if that member is

On the European continent firms had the alternative of organizing as limited partnerships in which one of more partners had limited liability but could not participate in the firm's management (see Table 1). These enterprises had somewhat more protection against untimely dissolution than did ordinary partnerships because the limited partners could not pull their investments out of the firm before the expiration of the agreed upon term. The disadvantage, however, was that the limited partners had no say in the way their investments were being used and hence were vulnerable to expropriation by the managing partners.[10]

In Britain there was no enabling statute for limited partnerships until 1907—long after the passage of general incorporation laws—and the courts effectively blocked all efforts to create limited or sleeping partnerships contractually.[11] The situation was similar in the US. Although most states passed laws during the 1820s and 1830s permitting the formation of limited partnerships, the courts construed these statutes so narrowly that they never provided a useful alternative to ordinary partnerships.[12]

The corporate form protected members of a firms from the risk of untimely dissolution. Shareholders might withdraw from the enterprise by selling their stakes, but they could not force the firm to dissolve or to refund their investments. But the corporate

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otherwise unable to pay off his or her debts. See Hansmann and Kraakman, "The Essential Role of Organizational Law"; and Henry Hansmann, Reinier Kraakman, and Richard Squire, "Law and the Rise of the Firm," *Harvard Law Review* 119 (March 2006): 1333-1403.

[10] Because the term of the enterprise was finite, however, limited partners were less vulnerablethan minority shareholders in corporations.

[11] Ron Harris, *Industrializing English Law: Entrepreneurship and Business Organization, 1720-1844* (Cambridge, 2000), 20.

[12] Stanley E. Howard, "The Limited Partnership in New Jersey," *Journal of Business of the University of Chicago* 7 (Oct. 1934): 296-317; William Draper Lewis, "The Uniform Limited Partnership Act," *University of Pennsylvania Law Review* 65 (June 1917), 716-18. In Britain and the US firms could also organize as joint stock companies and trusts. The former were legally partnerships and had many of the disadvantages of the form. In the latter investors had so completely to relinquish managerial authority to the trustees that they were more vulnerable to oppression than in any other form. Edward H. Warren, *Corporate Advantages without Incorporation* (New York, 1929), 306, 327-404. [##CHECK PAGE NUMBERS]

form subjected members to other risks. Corporations were run by officers and a board of directors duly elected by the firm's membership. Although in principle these officers and directors served at the pleasure of shareholders, during their terms in office they had considerable leeway to act as they saw fit. Moreover, because replacing management always required a substantial ownership stake—half the shares or more—disgruntled shareholders typically found them difficult to depose. As a result, whoever was in control could make decisions with little regard to the interests of other members of the firm and even expropriate some of the minority's earnings.[13]

The extent to which minority investors in corporations could protect their interests in corporations varied from one country to the next, depending on the extent to which the general incorporation statutes allowed organizers contractual flexibility. In Britain, for example, corporations could adopt the default set of governance rules included in the Companies Act, or they could write alternative rules that increased the voting power of minority shareholders.[14] In the US, by contrast, states tended to be increasingly prescriptive over time with many adopting the statutory requirement that directors be chosen in annual elections by simple majorities where each stockholder exercised one vote per share.[15] Regardless of the degree of contractual flexibility, however, the

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[13] Lamoreaux and Rosenthal "Corporate Governance and the Plight of Minority Shareholders"; and "Contractual Tradeoffs and SME's Choice of Organizational Form: A View from U.S. and French History," NBER Working Paper W12455.

[14] Colleen A. Dunlavy, "From Citizens to Plutocrats: Nineteenth-century Shareholder Voting Rights and Theories," in *Constructing Corporate America: History, Politics, Culture*, ed. Kenneth Lipartito and David B. Sicilia (New York, 2004), ##.

[15] For example, Pennsylvania law required directors to be chosen "by the vote of its stockholders holding a majority in interest of all of its stock" (Ardemus Stewart, compiler, *A Digest of the Statute Law of the State of Pennsylvania from the Year 17000 to 1903* [Philadelphia, 1905], 797). Ohio's general incorporation law included a similar rule, declaring "directors shall not be elected in any other manner" (William Herbert Page, ed., *New Annotated Ohio General Code* [Cincinnati, 1926], 8636). Both states allowed cumulative voting rules that gave minority shareholders somewhat more power. New Jersey's statute allowed incorporators to write their own governance rules (see *Compiled States of New Jersey* [Newark, 1911], 1606), but the courts nonetheless interpreted the statutory norms fairly narrowly and

requirement that corporate shares be transferable made the threat of oppression worse. One might trust the people with whom one originally went into business, but in a corporation there was always the possibility that outsiders—strangers—might one day buy control.[16]

By contrast, the shares in PLLCs by law were not tradable on the securities markets and, as we will see, organizers could restrict their transferability in a variety of other ways. Founders of PLLCs also generally had greater freedom to determine their governance rules—for example, to require super-majority votes (or even unanimous consent) for certain kinds of decisions. The more decisions that require super majorities, the more difficult minority oppression becomes. Yet this protection came at a cost, for super-majority voting rules can lead to stalemate when stakeholders have different beliefs about the optimal course of action for the firm. Similarly, firms could include provisions in their articles of association that made it more or less easy for their members to exit, but again there was a trade-off. Although ease of exit may be a useful way of disciplining management, locking in capital might be important for encouraging members to make non-contractible investments. The great advantage of the PLLC form is that it enabled firms to choose more or less risk of oppression and/or untimely dissolution as met the needs of their business.

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struck down some alternative governance schemes. See Edward R. Schwartz, "The Limited Partnership Association—An Alternative to the Corporation for the Small Business with 'Control' Problems?" *Rutgers Law Review* 20 (Fall 1965), 29. More generally, see Dunlavy, "From Citizens to Plutocrats," ##; George D. Hornstein, "Stockholders' Agreements in the Closely Held Corporation," *Yale Law Journal* 59 (May 1950), 1042, 1045; L. C. B. Gower, "Some Contrasts Between British and American Corporation Law," *Harvard Law Review* 69 (June 1956), 1376-77; Key cases that enforced standard governance rules include *Jackson v. Hooper*, 76 N.J. Eq. 592 (1910); *In the Matter of Boulevard Theatre and Realty Company*, 186 N.Y.S. (1921); and *Benintendi v. Kenton Hotel*, 294 NY 112 (1945).

[16] Hansmann, Kraakman, and Squire, "Law and the Rise of the Firm," 1396.

The underlying assumption of this article is that economies perform better when business people have the ability to protect themselves against the contracting problems they are most likely to face—problems which, if not mitigated, might induce them to invest suboptimal levels of effort and resources. All of the countries we are studying offer firms in the present day a high level of contractual flexibility. In the past, however, there were significant differences among them in the extent to which firms could minimize their contracting problems. In the next several sections we describe the menu of organizational forms in our four countries and how it evolved over time. We also present data on how firms responded to the changing menu of choices.[17]

Organizational Choice in Germany

Until the last third of the nineteenth century businesses in the various German states could freely choose among three basic organizational forms: the ordinary partnership (*Offene Handelsgesellschaft* or OHG), the simple limited partnership (*Kommanditgesellschaft* or KG), and the limited partnership with tradable shares (*Kommanditgesellschaft auf Aktien* or KGaA).[18] To organize as a corporation a business had to secure explicit permission from the government. Some states were relatively liberal in granting corporate charters, often seeking tax revenue or other favors from corporations that would do most of their business elsewhere in the region. Others learned the hard way that a restrictive policy would not prevent corporations from being created

[17] Today, of course, tax rules have significant effects on businesses' organizational choices. In some of our countries, there were no differences in the assessment of taxes across organizational form before mid century. Moreover, before World War II most taxes were low, and so even where there were differences in treatment across organizational forms, the effects were small. For the purposes of this paper we largely set aside tax issues, though we will return to the subject in subsequent work.

[18] After 1861 most German states agreed to adopt a common code of business law (the ADHG or *Allgemeine Deutsche Handelsgesetzbuch*), so most aspects of these forms were the same everywhere.

but rather would only lead to their being chartered in another German state.[19] The passage of general incorporation laws created similar, though even more intense pressures. The *Allgemeine Deutsche Handelsgesetzbuch* of 1861 maintained the concession system, but §249 permitted individual German states to adopt general incorporation. The North German Confederation (led by Prussia) took advantage of this provision in 1870, and it was carried over into Reich law in 1871. According to Horn, "numerous" states, including most of the Hanseatic cities, had adopted general incorporation before 1870.[20]

The passage of general incorporation laws spurred an increase in the number of new corporations. The upsurge was particularly large during the "*Gründerboom*" of 1871-73, when the rapid payment of the indemnity imposed after the Franco-Prussian war produced a short-lived stock-market bubble. In 1871 businesses registered 104 corporations in Berlin alone.[21] Many of the new enterprises reflected over-heated expectations or outright fraud, and the collapse of the bubble brought a number of them down. Of the 1,005 corporations formed during the period 1867-1873, 123 were in liquidation by September 1874, and another 37 were in bankruptcy.[22]

Fallout from the bubble's collapse led to the passage in 1884 of a set of legislative reforms intended to enhance the power of shareholders and prevent abuses in the formation of new enterprises. One set of reforms strengthened the role of the supervision committee (*Aufsichtsrat*) and required more detailed reporting of financial conditions.

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[19] Rondo Cameron, "The Founding of the Bank of Darmstadt," *Explorations in Entrepreneurial History* 8 (Feb. 1956): 112-130.

[20] Nobert Horn, "Aktienrechtliche Unternehmensorganisation in der Hochindustrialisierung (1860-1920)," in *Recht und Entwicklung der Grossunternehmen im 19. und frühen 20. Jahrhundert*, eds. Norbert Horn and Jürgen Kocka (Götting, 1979), 128, and note 22.

[21] Carsten Burhop, *Die Kreditbanken in der Gründerzeit* (Stuttgart, 2004), 25.

[22] Eduard Wagon, *Die finanzielle Entwicklung deutscher Aktiengesellschaften von 1870-1900 und die Gesellschaften mit beschränkter Haftung im Jahre 1900* (Halle, 1903), 3.

Other changes raised the minimum size of a share ten-fold, to 1000 Marks, and forbid new corporations from operating until all their shares had been subscribed. Firms that converted to the corporate form could not list their shares on the stock market until one year after the reorganization.[23]

These changes undoubtedly made the corporate form less attractive to entrepreneurs.[24] Although it is not at all remarkable that the number of new corporations declined dramatically after 1873 in response to the collapse of the market and the bad reputation the corporation had acquired, it is significant that the number never again exceeded 400 firms per year in the nineteenth century. Some enterprises that one would expect a priori to be organized as corporations chose another form. Jürgen Kocka and Hannes Siegrist report that 15 of the 100 largest industrial enterprises in Germany in 1887 were *Personengesellschaften* (either partnerships or single-owner firms). In 1907, the number was still 7 out of 100.[25] Even today, some of the largest German firms are organized as partnerships of one type or another. Merck's German headquarters company is a KGaA, for example.[26]

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[23] *Gesetz, betreffend die Kommanditgesellschaften auf Aktien und die Aktiengesellschaften, vom 18. Juli 1884* / Mit Erlauterung von Paul Kayser (Berlin, 1884). There was no external auditing of corporations until 1931; the supervision committee was supposed to act as a sort of internal auditor.

[24] As Timothy W. Guinnane has pointed out, the changes strengthened the role of the Great Banks in company formation with the result that profits from such activities were increasingly captured by bankers. See "Delegated Monitors, Large and Small: Germany's Banking System, 1800-1914," *Journal of Economic Literature* 40 (March 2002), pp.104-105. Caroline Fohlin also stresses the effect of the 1884 changes, but her focus is on the implications for banks. See "Regulation, Taxation, and the Development of the German Universal Banking System, 1884-1913," *European Review of Economic History* 6, no. 2 (Aug. 2002): 221-54.

[25] Jürgen Kocka and Hannes Siegrist, "Die hundert größten deutschen Industrieunternehmen im späten 19. und frühen 20. Jahrhundert," in *Recht und Entwicklung der Grossunternehmen im 19. und frühen 20. Jahrhundert : Wirtschafts-, sozial- und rechtshistorische Untersuchungen zur Industrialisierung in Deutschland, Frankreich, England und den USA*, eds. Norbert Horn and Jürgen Kocka (Göttingen, 1979), 80-81, Tables 1 and 2.

[26] The general partner is an OHG owned by the Merck family. Other large partnerships in Germany today include Henkel KGaA and the Oppenheim banking firm.

By the late 1880s many observers in Germany thought that the 1884 reforms had gone too far. By making the formation of new corporations so unattractive, they had created a barrier to entry for large-scale enterprise that was contributing to the growing concentration of economic power in Germany. Demands for change included calls for revising the AG as well as for the creation of a new form of enterprise. Formal consideration of the latter possibility began in 1888 when the Prussian Minister of Commerce asked the German Commercial Association to discuss the desirability of new corporate forms at its next meeting. After consultation with this and other interested groups, the Ministry of Justice circulated a draft version of the law. The Reichstag passed enabling legislation for the *Gesellschaft mit beschränkter Haftung* (company with limited liability, later usually abbreviated GmbH) in 1892. The form was later incorporated, with minor modifications, into the first post-unification commercial code (the *Handelsgesetzbuch* or HBG) of 1898.[27] Although some observers, such as Hans Crüger, saw the GmbH as a way for smaller enterprises to survive and prosper,[28] the new form did not meet with anything like universal approval. Legal thinking at the time made a sharp distinction between an association of people (*Personengesellschaft*) such as a partnership or limited partnership, on the one hand, and an association of capital (*Kapitalgesellschaft*) such as an AG on the other. By straddling this distinction the GmbH offended the sensibilities of the legal profession. Nonetheless, for all the

[27] Werner Schubert, "Die Gesellschaft mit beschränkter Haftung. Eine neue juristische Person," *Quaderni fiorentini per la storia del pensiero guiridico moderno* 11/12 (1982). [Tim, please supply page numbers.]

[28] Hans Crüger, *Die Gesellschaft mit beschränkter Haftung* (Berlin, 1912). Crüger was the leader of the urban branch of the cooperative movement.

complaints about the GmbH over the years, the form as used today remains virtually unchanged from 1892.[29]

A GmbH was created when legally valid articles of incorporation (*Gesellschaftsvertrag*) were entered in the relevant commercial register. The firm's legal name (*Firma*) had to include the phrase "with limited liability," but beyond that the law placed few constraints on the articles of incorporation.[30] A GmbH had to have an issued capital (*Stammkapital*) of at least 20,000 Marks.[31] The law implied that there had to be at least two shareholders (*Gesellschafter*) to register the firm, but that a legally valid GmbH could consist of a single shareholder once the enterprise was registered.[32] The total *Stammkapital* could be divided into (not necessarily equal) shares, but no share could be less than 500 Marks.[33] At least 25 percent of the capital had to be paid in before the GmbH could operate. An important difference between a GmbH and an AG was that transfer of a share in a GmbH required a notarial contract between the buyer and seller. As a result, the cost of transfers was higher, and shares could not trade on stock markets.

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[29] Karsten Schmidt, *Gesellschaftsrecht (*4th edn.; Berlin, 2002).

[30] A GmbH could be organized for any legal purpose, including not-for-profit activities, though in a few specialized activities (such as banking) firms faced special reporting requirements that we will not detail here. Any enterprise organized as a GmbH was automatically a commercial firm (*Handelsgesellschaft*) in the sense of the HGB, regardless of what it actually did. Although the 1892 law never actually defined what a GmbH was, it clearly stated that the GmbH is a legal person with the right to act its own name.

[31] In 1892, 20,000 Marks equaled £1,000, or about $4860. This was a large sum; per-capita GDP in Germany in 1892 was 470 Marks. Walther G. Hoffmann, *Das Wachstum der deutschen Wirtschaft seit der Mitte des 19. Jahrhunderts* (Berlin, 1965), 248, Table 1.

[32] As early as 1900 commentators were noticing the emergence of "one-man GmbHs" formed by arranging in advance for one shareholder to buy out the others. Edgar Guilini reported that 115 of the 1125 GmbHs operating in Berlin in 1905 had only one *Gesellschafter*. See *Die Gesellschaft mit beschränkter Haftung nach Vereinigung aller Geschäftsanteile in einer Hand* (Heidelberg, 1919), 4.

[33] The GmbH's shares are called *Anteilen* rather than *Aktien*, the term used for shares in a corporation. The terminology reflects the intention that ownership in a GmbH would not be traded in active markets as with the AG. Some writers refer in English to the GmbH's owners as "quota holders" rather than "shareholders" to capture the German distinction. (See, for example, Henry P. De Vries and Friedrich K. Jünger, "Limited Liability Contract: The GmbH," *Columbia Law Review* 64, no. 5 [May 1964]: 866-86. We think "quota-holder" is too awkward to justify any clarity it might bring.

Most important organizational matters were left to the firm's owners, although the law did stipulate some default rules, allowing the articles to be brief and simple. A GmbH could be formed for a limited period of time or without a specified term; in either case investors were protected against the threat of untimely dissolution by a default rule that required the approval of three-quarters by value of the shares to wind up the firm. Under the default rules, however, this protection came at the cost of an increased risk of minority oppression similar to that of a corporation. Each 100 Marks of invested capital was to be treated as a single vote, making it possible for owners representing 51 percent of the capital to impose their will on those owning 49 percent. But these were only default provisions; organizers could agree to other rules on these matters, trading off more risk of untimely dissolution against less danger of minority oppression, if they so chose.

The GmbH law required each firm to have one or more managers (*Gesellschaftsführer*), who might but did not have to be shareholders. Because the managers represented the firm legally, their names had to be entered in the commercial registry. A GmbH could also have a supervisory committee, but unlike an AG or KGaA, it did not have to have one. By law stockholders had an unequivocal right to dismiss managers. The articles of association could list the main reasons why a manager might be fired, but enumerating these reasons did not in any way alter the fact that dismissal was at the "whim" (*Willkür)* of the owners. This provision prevented the creation of a manager-as-dictator.[34]

[34] Max Hachenburg stresses that any provision of the firm's articles of association that would limit the firm's ability to fire its manager is invalid. Hachenburg's was the authoritative commentary on the GmbH law into the 1920s. "Whim" is his term. See Hachenburg, *Staub's Kommentar zum Gesetz, betreffend die Gesellschaften mit beschränkter Haftung* (4th edn; Berlin, 1913), 441-42.

Minority shareholders obtained addition protection from their ability to exit the firm. Shares had to be alienable and heritable. Although the articles of association could limit transferability, for example by requiring that the other owners to approve sales to outsiders, these provisions could not harm any shareholder's ability to exit. Conversely, GmbHs had the right to expel owners by buying back their shares. This provision was related to other sections of the law that permitted the firm to require shareholders to perform specific functions. Thus the articles of association might specify that certain shareholders must act as managers, inventors, or even creditors to the firm. The articles could also require them to make supplementary contributions to capital. Failure to adhere to such requirements was adequate reason to seize an owner's shares.

In Germany all firms that organized under the commercial code were required to draft formal written agreements and register the main details of these agreements with a local authority. The filings were published each business day in the *Anzeiger*, enabling us to track trends over time in the use of the different organizational forms.[35] Figure 1 reports estimates of the choices made by new firms that registered in Prussia at five-year intervals, starting with 1867. As the figure shows, the GmbH's popularity grew slowly during its first decade of existence, but by 1912 about one-third of new firms took the new form, and by 1932 GmbHs accounted for about half of all new registrations.

As might be expected, the advent of the GmbH had little effect on the proportion of new firms organized as AGs. Both before and after the 1892 legislation corporations were extremely rare; only about 20 were formed in Prussia each January between 1872

[35] The *Deutscher Reichsanzeiger and preussischer Staatsanzeiger* (before 1871, the *Königlich preussischer Staats-Anzeiger*) was an official publication used for official announcements, including entries in the commercial registries maintained across Germany. Firms could also use it to satisfy publicity requirements, such as the requirement that all corporations publish annual financial statements.

and 1912, despite considerable economic growth over the period. Because of the high cost of incorporation, only those businesses for which the form offered significant advantages were likely to take out charters.[36] Analysis of employment patterns from the 1907 census of firms and occupations bears out this argument. Corporations accounted for only 0.3 percent of all firms (7 percent of multi-owner firms), but they employed more than 12 percent of the workforce. Moreover, their average size (180 workers per firm) dwarfed that of the GmbH (49 workers per firm).[37]

The GmbH also had little effect on the *Kommandit*, which remained a reasonably constant 8 percent share of all registrations. Instead, the GmbH seems primarily to have displaced partnerships. The share of ordinary partnerships fell steadily after the GmbH was enacted, dropping in Prussia from nearly 90 percent in 1892 to less than 40 percent four decades later. The GmbH's primary impact, therefore, was to provide limited liability and a share-capital structure to firms that previously had decided to forego these advantages, either because the costs associated with forming an AG were too high or because of the greater risk of minority oppression that organizing as an AG or a KG entailed.

Organizational Choice in Britain

In Britain there was no law permitting limited partnerships until 1907, and the courts effectively blocked all efforts to create silent or sleeping partnerships contractually. British businesses, therefore, had only two organizational choices in the

[36] Not surprisingly, few AGs converted to GmbHs. Once a firm had born the costs of organizing as a corporation, it probably did not make much sense to give up the form.

[37] Richard Passow, "Der Anteil der verschiedenen privaten Unternehmungsformen und der öffentichen Betrieben am deutschen Wirtschaftsleben," *Jahrbücher für Nationalökonomie und Statistik N.F.* 96, no. 4 (1911): 506-25.

nineteenth century: the partnership and the corporation.[38] As was the case in Germany and elsewhere, incorporation initially required government approval, and lobbying by opponents, particularly competitors who sought to prevent rivals from obtaining special privileges, made corporate charters a rare and expensive commodity until Parliament enacted legislation providing for general incorporation in 1844. The Companies Act of that year permitted joint-stock enterprises to incorporate freely without limited liability. General incorporation with limited liability was made available in 1855-56.[39]

After the passage of these laws, forming a corporation in Britain was a relatively simple and inexpensive process, and the number firms that chose this option steadily increased. [Ron, could you give a few figures here on the total number of new corporate charters at different points of time up to the 1890s?] Many of the charters, of course, were taken out by large firms. Surveys of important industrial sectors, such as cotton spinning, iron and steel, and shipping, for years ranging from 1884 to 1891 suggest that 25 to 50 percent of all large enterprises took the corporate form. For the years 1900 to 1914 the percentage in comparable surveys and estimates rose to 80 to 90 percent.[40] At the same time, however, increasing numbers of SMEs also organized as corporations. Firms found ways to get around the legal requirement that they have a minimum of seven shareholders by recruiting dummy members to whom they would give a small number of shares. Even single-owner enterprises learned that they could organize as corporations

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[38] Innovations such as the (unincorporated) joint-stock company made investors' shares more liquid, but could not overcome the central defects of partnerships which they still were at law. One possible alternative, the trust, did not evolve sufficiently before the advent of general incorporation to provide businessmen with a real choice. The Companies Act of 1844, which introduced general incorporation, signified the end of the unincorporated company. It declared unregistered joint-stock companies illegal and prohibited the formation of partnerships with more than 25 members.

[39] See Harris, *Industrializing English Law*.

[40] B.J. Jefferys, "Trends in Business Organization in Great Britain since 1856," unpublished Ph.D. Dissertation, London University, 1938. [Ron, do you have a page number of this reference?]

by allotting one share each to six nominal members of the firm, the proprietor retaining the rest of the stock.[41]

For a while the formal statutory law did not adapt itself to this development. To the contrary, such changes as occurred in the law were responses to problems with corporations whose shares were publicly held and traded. Government policy makers were preoccupied with mounting criticism that free incorporation and general limited liability had made it both easier and more common for company promoters to swindle external investors, and they appointed the *Davey* Committee in 1895 as a response to this charge.[42] Based on the committee's recommendations, Parliament passed the Companies Act of 1900 regulating the offering of shares to the public. The law required each new corporation to publish a legally binding prospectus that would provide investors with detailed information about the enterprise. Corporations also had subsequently to file balance sheets with their annual returns. In addition, the law restricted companies' ability to allocate shares to organizers or others who did not pay for them fully in cash and required that they file detailed information about any such allotments as were made. Finally, the law subjected directors to personal liability if they failed to conform to its provisions. [Ron, please add a citation here.]

Although the purpose of the law was to protect investors in publicly held companies, it raised the costs of organizing all types of corporations, whether they issued

[41] The House of Lords sanctioned the procedure in the famous case of *Salomon v. Salomon* in 1897. When Salomon initially formed Salomon Ltd. around 1895, he, his wife, and five of their children each received one (£1) share of the company. Salomon then sold the new company his shoemaking business for £20,000 in shares (and a debenture). Eventually the business became insolvent and was liquidated. The case became famous because the House of Lords held that Salomon, the creditor of the company, was a separate entity from the company, and from Salomon, the shareholder, and thus had priority over other creditors. See *Salomon v. Salomon* (1897) A.C 22.

[42] *Parliamentary Papers*, 1895 Vol. LXXXVIII (C. 7779), p. 151. [Ron, I have no idea how E&S will want us to cite these documents, so perhaps it's best to wait and see what they tell us.]

shares to the public or not. The law thus made the corporate form less suitable to SMEs, and not surprisingly, led to a drop in the number of companies registered annually. [Ron, could provide some numbers here showing the magnitude of the drop?] This drop was one of the motivations for the appointment of the *Loreburn/Warmington* Committee in 1905. The recommendations of that committee led Parliament to enact an amendment to the Companies Act in 1907 creating the private limited company. [Ron, please add a citation here.]

It is interesting to note that the new form was not modeled on the GmbH. Although the 1895 *Davey* Committee had collected comparative information on organizational forms, in the case of Germany it was mainly interested in the AG and obtained only a brief description of the GmbH, which had been introduced just three years earlier.[43] Moreover, that Committee did not recommend enabling legislation for the PLLC. Intriguingly, the *Loreburn/Warmington* Committee of 1905, which did consider and recommend such legislation, made no reference in its report to the GmbH as a useful, or even as a negative, model. It took a different approach and instead simply created two separate classes of corporations.[44]

The 1907 Act distinguished public from private companies and subjected the former to stricter rules and higher disclosure requirements than the latter. According to Section 37(1) of the Act is, a private company "means a company which by its articles" 1) restricts the right to transfer its shares, 2) limits the number of its shareholders to fifty; and 3) prohibits any invitation to the public to subscribe for any shares or debentures of the company. [Ron, please add a citation here.] Whereas in Germany a company became

[43] *Parliamentary Papers*, 1895 Vol. LXXXVIII (C. 7779), pp. 24-26.
[44] *Parliamentary Papers*, 1906 Vol. XLIV (Cd. 3052).

private by organizing under a different law from a corporation, in Britain a company became private by including in its articles of association the above restrictions.

Most other Companies Act rules applied to both public and private corporations.[45] Thus business people registering under the 1907 law were offered a tradeoff. In exchange for exemption from the stringent disclosure provisions required for public companies, members of private companies had to accept restrictions on the liquidity and transferability of their shareholdings. These restrictions typically consisted of provisions that required the consent of the board or other shareholders to transfer shares or that mandated that the shares be offered to other members of the firm first. Although such provisions increased minority shareholders' vulnerability to oppression, business people could adopt governance rules that redressed the imbalance of power. [Ron, I deleted the footnote to *Foss v. Harbottle* because that case is only part of the story. Shareholders who could initiate common-law litigation did have a remedy at equity, and the details of that remedy are too complicated to review in this paper.] The organizers of a company could opt out of the default rule (one vote per share, majority wins) by including a different provision in the original articles of association, so it was possible for minority shareholders to protect themselves by requiring supermajority votes. Subsequent alterations to the articles of association required a supermajority of 75 percent, however, as did a voluntary winding up of the company. A company could be dissolved involuntarily by the court, but only for cause—for example, inability to pay debts or a finding that it was "just and equitable" to wind up the company. [Ron, please add a citation here.] By choosing the PLLC form over the partnership, therefore, the organizers

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[45] The main exception was that the minimum number of shareholders required for a private company was only two as opposed to seven for a public company.

of an enterprise were reducing the possibility of untimely dissolution but also assuming greater risk of minority oppression unless they built adequate protections into the company's initial articles of association.

Figure 2 reports the proportion of new companies that organized as corporations (public companies) companied to those that organized as PLLCs (private companies). As the figure shows, the PLLC form was enormously popular almost immediately. The number of new firms that organized as corporations plummeted from more than 4000 per year before the 1907 law [Ron, what years are being averaged together here? Perhaps it would be good to give a number for the 1890s and also one from 1901-1906] to less than 600 per year in 1921. [Ron, rather than the number for 1921, please report the average for the 1920s.] By contrast, the number of new firms that organized as PLLCs rose from xx to yy. [Ron, please supply figures here—perhaps an average for 1908-1914 and then one for the 1920s.] During the 1920s PLLCs constituted fully zz percent of new firms taking the company form. [Ron, please supply the average percentage for this decade.]

We do not have data on the number of new firms that formed as partnerships, so we cannot observe the effect that the advent of the PLLC had on that form.[46] Nevertheless, we can guess at the magnitude of the resulting decline. If the proportion of firms organized as partnerships were similar in the US and Great Britain, the number of partnerships formed annually in Britain should have been about 5,000 in 1908.[47] If we attribute all of the increase in the total number of new registered companies between

[46] Britain also passed an enabling law for limited partnerships in 1907, but few businesses registered under that statute.

[47] This number is most likely an underestimate. The US *Census of Manufactures* reports that 62 percent of firms taking multi-owner forms were partnerships in 1900 (1905, vol. 8, p. liv, Table VIII). This figure refers to the stock of firms. It is likely that partnerships' share of new firms taking multi-owner forms was quite a bit higher because their life span was much shorter than corporations'. Applying that number to Britain, where an average of 4,200 corporations were formed annually between 1900 and 1908, gives us a lower bound number of 6,900 new partnerships a year.

1907 and 1909 (about 1000) to a decline in the formation of partnerships, we obtain an upper-bound estimate of the decline in the number of new partnerships of 20 percent. Alternatively, if we assume that the total number of multi-owner firms per capita was similar in Prussia and in the UK, we can obtain an estimate of the number of new partnerships in Britain by subtracting from the projected total the actual number of registered companies.[48] This procedure suggests that the number of partnerships formed in Britain declined from approximately 5,300 the year before the law to about 4,200 the year after, a drop of 21 percent.[49] In Britain, unlike Germany, the PLLC seems mainly to have displaced corporations.

Organizational Choice in France

The *Code de Commerce* of 1807 offered business people in France two alternatives to the ordinary partnership (or *société en nom collectif*). These were essentially the same choices that we have already discussed for the German case—not surprising, because German law was heavily influenced by the French code. As in Germany, the limited partnership (*commandite simple*) allowed some partners to enjoy the protection of limited liability so long as they did not play an active role in management. Limited partnerships could also have tradable shares, and in France an active market for the equities of these *commandites par action* enabled business people to raise capital from the broader public without obtaining the special government permission that the corporate form required.

[48] In 1900 Prussia had some 39 million inhabitants and Great Britain, 41 million. In January 1902 there were 896 new registrations in Prussia. Hence the total for the year was 10,700, if we assume that January was representative.

[49] France had some 39 million inhabitants and registered 6000 new firms around 1900. Using it as a benchmark for Great Britain leads to a decline in the number of partnerships of nearly 50 percent.

France adopted full general incorporation in 1867. Until that point the government had granted corporate charters sparingly, approving less than 600 between 1820 and 1867.[50] Before 1857 the availability of the share *commandite* had muted the demand for general incorporation. In that year, however, growing complaints by minority shareholders and creditors about abuses by the *commandites*' general partners culminated in a set of regulatory reforms that made it much more costly to organize such enterprises. These reforms in turn led to efforts to secure more liberal incorporation rules. New legislation in 1863 permitted firms with a maximum capital of 20 million francs to organize as corporations without receiving special permission from the state. The act of 1867 removed the limit on capitalization.[51]

As was the case for Germany, we can track the organizational choices made by French firms because they were required to file their articles of association with a local commercial tribunal. As Figure 3 shows, after 1867 the corporation form slowly grew in popularity until it accounted for about 20 percent of new registrations in the 1910s. As late as the eve of World War I, however, there were still only about 13,000 corporations in France. That was considerably more than the 5,200 in Germany, but it was considerably less than the almost 63,000 in existence in the UK and the over 250,000 in the US.[52] [Jean, it seems to me that we should say something here about why corporations were less popular in France. Some of the answer is the availability of other organizational forms, but are we also suggesting that corporations were more costly?] As the popularity of corporations grew, ordinary partnerships became relatively less

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[50] Freedeman, *Joint-Stock Enterprise in France*, 27, 67, 81, 116.

[51] Freedeman, *Joint-Stock Enterprise in France*, and Freedeman, *The Triumph of Corporate Capitalism in France*.

[52] Freedeman, *The Triumph of Corporate Capitalism*, 21; Susan Carter, et al., *Historical Statistics of the United States: Millennial Edition* (New York, 2006), Vol. 3, Tables Ch1-18.

common, but they still accounted for at least 60 percent of all new firms. Some of the decline partnerships, moreover, reflected the renewed popularity of the *commandite simple* at the end of the nineteenth century. *Commandites par action* suffered a permanent decline, but even though they might be considered inferior substitutes for the corporation, they did not completely disappear. For example, Schneider, the large iron and steel works, remained a *commandite par action* until the 1960s, and Michelin is still one today.

Despite ongoing discussion of the desirability of reforming France's general incorporation law, little changed between 1867 and 1925. [Jean, we should say something about the content of these ongoing discussions. Were they just discussing protection of investors, or was there a desire to make the form more popular as well?] The end of World War I and the recovery of Alsace and Lorraine, however, created an impetus for innovation. Business people in the recovered territories had been able to avail themselves of the GmbH statute since 1892. There were at least 400 GmbHs operating in Alsace and Lorraine,[53] and their owners showed little interest in converting to partnerships, *commandites*, or corporations. Instead, they pressured Paris to enact an enabling law for GmbHs. In 1919 a bill that essentially translated the GmbH statute into French was introduced in the Assembly, but it faced staunch chauvinistic opposition and was withdrawn almost immediately: after four years in the trenches the victors did not want to imitate the losers. Although business people in Alsace and Lorraine were disappointed, the failure to pass a law galvanized more widespread support for reform. Local chambers of commerce throughout France urged the passage of some version of

[53] Doc parl 3348 Nov 1921. [Jean, please flesh out this citation and add the source to the reference list under government publications.]

the legislation, and a new bill was introduced in 1921 to create the Société à Responsabilité Limitée. For reasons that remain unclear, the bill lay dormant until 1925, when it was approved by a unanimous voice vote in the Assembly. After an expedited procedure, it was also unanimously approved in the Senate. Whatever the politics that led to the adoption of the law, when French legislators finally acted, they charted a course that was substantially different from that of either Germany or Britain.[54]

A SARL was created when legally valid articles of incorporation (*Statuts*) were entered in the relevant commercial register. Any enterprise that satisfied the registration requirements could become a SARL with the exception of holding companies in insurance and finance.[55] As in the German case there was emphasis on reducing disclosure and transactions costs. Hence although firms had to register, their articles of association could be drawn up private agreement—without the burden of notary fees. As in Germany there was a minimum capital, 25,000 francs, that had to be divided into shares of 100 francs or more each. Given the low value of the franc, this constraint was not onerous. Indeed, during the inflationary 1920s, 25,000 francs was less than per capita income.[56]

Unlike partnerships, SARLs were joint-stock firms. As a result, they were not dissolved by the death of an associate; the share simply passed on to member's heirs. Nor

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[54] 1921-1925 Documents Parlementaires. 1925-1966: Ripert Georges, Traité élémentaire de droit commercial 6. éd. Paris:Librairie Générale de Droit et de Jurisprudence, 1967-1970. [Jean, are these the right citations for the legislative history? If so, please flesh them out and add them to the appropriate sections of the reference list (I think government pubs for the first and books for the second.]

[55] Similar restrictions were added later to bar banks (1941), certain firms in the entertainment industry (1945), and mutual funds (1957) from organizing as SARLs. Any enterprise that organized as an SARL was automatically a commercial firm (*société de commerce*) regardless of what it actually did. Hence it was governed by the commercial rather than civil code. Moreover, its tax status was that of a partnership. [Jean, please add an appropriate citations here and in the reference list.]

[56] Documents Parlementaires. 1924, Annexe 712 Session of 12-16-1924 pp 691-699. [Jean, is this the citation to the statute? That is what we need here. If this is the correct citation, please add it to the reference list under gov pubs. Is there a place of publication?]

could a SARL be dissolved simply by the desire of a member to withdraw. SARLs thus seem to have solved the main problem faced by French partnerships: impermanence. As was the case for the GmbH and the private limited company in Britain, shares of SARLs could not be publicly traded. The French went further, however, and required private sales of equity to be approved by the other shareholders. From 1925 to 1966 the owners of a quarter of the shares could veto any trade. Unlike the German case, if a trade was approved, the sale could be finalized without recourse to a notary.[57]

As a general rule, shareholders in SARLs were more at risk of minority oppression than was the case for GmbHs in Germany or private limited companies in Britain. SARLs had to follow strict one-share-one-vote rules.[58] Unless all members of the firm owned the same number of shares, it was not possible to structure an SARL like a partnership where all owners had equal control rights. [Jean, could the articles require super majority votes for the election of officers and/or for important decisions?] SARLs could be set up so that managers were elected by, and served at the pleasure of, the majority of shareholders. But if the managers were named in the articles of association, they could not be removed except through litigation.[59]

Most subsequent changes in legal rules have focused on the extensive powers of management in SARLs. In the early years after the act's passage judges established precedents for removing entrenched managers, essentially creating standards whereby incompetent or fraudulent managers could be dismissed. Intervention by the legislative branch was largely limited to reinforcing these judicially imposed penalties for fraud, in

[57] In 1966 the shareholders' veto power was transformed into a preemption right [Jean, need a citation here for the whole paragraph. Also add the citation to the appropriate section of the reference list.]

[58] [Jean, perhaps it would be good to note here how the rules for corporations were different and how the greater flexibility in corporations was often use to entrench the controlling group?]

[59] [Jean, please add a citation here and make sure it is in the reference list.]

particular with respect to bankruptcy cases (1935 and 1953). [Jean, what are these dates?][60] In 1966, however, a major reform did away with the option of creating irrevocable managers. Managers could now be removed, though only for cause, with the list of permissible reasons echoing the judicial standards put in place earlier in the century.[61]

As Figure 3 shows, once the form became available in 1925, SARLs very quickly accounted for the vast majority of new enterprises registered in France. Unlike in Germany, the enactment of enabling legislation for SARLs significantly reduced the number of new corporations. This result is not at all surprising because the high cost of incorporation in Germany meant that only those enterprises that could really benefit from the corporation's advantages bothered to take out charters. Also unlike Germany, the advent of the SARL led French business people to all but abandon the limited partnership form. This result too is not surprising if one considers the position of managers with only minority stakes in their enterprises. Because such managers had to worry about whether they would be pushed out by dominant shareholders, in Germany the GmbH had relatively little appeal compared to a KG because shareholders in a GmbH could dismiss a manager at "whim." By contrast, managers in a similar position in France could entrench themselves in a SARL by registering their names along with the firm's articles of association. Hence it is not surprising that the SARL had a greater effect on the use of the *commandite* form than the GmbH had on the KG. Partnerships also experienced a much more dramatic collapse in France than in Germany, with new registrations in the former country falling as much as 90 percent by the mid 1930s. Part of the explanation

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[60] [Jean, please add a citation here and make sure it is in the reference list.]
[61] [Jean, please add a citation here and make sure it is in the reference list.]

may be the more stringent minimum capital requirement for the GmbH. Firms with capitalizations below 20,000 Marks had no choice in Germany but to organize as partnerships. Moreover, what data we do have on capitalization suggests that this constraint was likely to be binding. Of the nearly 120,000 GmbHs formed between 1904 and 1913 that were still in existence in 1915, the majority (51 percent) had capitalizations at the lower end of the scale (between 20,000 and 50,000 Marks).[62]

The US Outlier

Across our three European countries, the extent to which the PLLC reduced the number of new corporations thus seems to have been inversely correlated with the prior attractiveness of the corporate form. In Germany, where corporations were expensive and cumbersome to organize, the advent of GmbH had little effect on their numbers. Conversely, in Britain and to a somewhat lesser extent France, the number of new corporations fell dramatically after the PLLC became available. In the US, however, the situation was significantly different. For all practical purposes, business people had only two choices until late in the twentieth century: they could organize as partnerships or they could take out corporate charters. They could not trade off some of the advantages and disadvantages of each form but had to choose one or the other. That is, they had to choose either to bear the risk of untimely dissolution or suffer the possibility of minority oppression.

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[62] *Statistisches Jahrbuch für den Preussischen Staat* (Berlin, 1915), Vol. 12, Table VII - B1, p. 221.

The continued popularity of partnerships in the US deep into the twentieth century suggests that the disadvantages of the corporate form weighed heavily on SMEs. Data from the Census of Manufacturers show that as late as 1900 more than 60 percent of firms taking multi-owner forms organized as partnerships. Although the proportion of partnerships fell over time as the scale of enterprise rose, dropping to about 40 percent of multi-owner forms by 1920, partnerships retained considerable importance in the economy as a whole.[63] Indeed, according Internal Revenue Service (IRS) data, they constituted more than 60 percent of all multi-owner forms as late as 1947. Although, as Table 2 shows, the proportion organized as partnerships varied across industry groups, even in the manufacturing sector the figure still hovered around 40 percent. By the end of the twentieth century, however, the balance had shifted. For the economy as a whole fully 73 percent of firms taking multi-owner forms were corporations by 1997, and the proportion in manufacturing was 89 percent.

The increase in the second half of the twentieth century in the proportion of firms organized as corporations suggests that the form became more suitable to SMEs during this period. As we shall see, changes in state incorporation laws during the third quarter of the twentieth century did in fact increase the flexibility of the form, enabling "close corporations" to adopt governance rules that mimicked those of PLLCs. The intriguing question is why these changes were so late in coming. Why did SMEs in the US have to wait more than a half century after their German counterparts to secure the advantages of the PLLC form?

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[63] The data from the Census of Manufactures are analyzed in Lamoreaux and Rosenthal, "Contractual Tradeoffs and SME's Choice of Organizational Form."

As a matter of fact, there was an attempt to introduce the PLLC form in the US even earlier than in Germany. The origins of this effort are murky, but it seems to have been triggered by a debate during the 1870s in Pennsylvania's constitutional convention over whether the state's general incorporation laws should be liberalized or made more restrictive. In 1874 the Pennsylvania legislature passed two statutes that appealed to opposing sides of that discussion. One increased the liability of shareholders in corporations to double the par value of their shares. The other gave any three or more persons engaged in "any lawful business or occupation" the opportunity to organize as a "partnership association," a legal entity in which the "capital shall alone be liable for the debts of such association." In other words, it gave them the opportunity to organize a PLLC. Similar enabling legislation for partnership associations was soon adopted in Michigan (1877), New Jersey (1880), and Ohio (1881). Virginia also passed a statute in 1874 but repealed it in 1918.[64]

Partnership associations, like GmbHs and SARLs, could be formed simply by filing a document with a local (in this case county) official. The association had to include the word "limited" in its name and to register its name, total capital, and duration (which could not exceed twenty years), the names of its members, the amount of capital subscribed by each member (including the value of any contributions made in the form of

[64] Pennsylvania also subsequently passed enabling legislation for another form of PLLC, the so-called registered partnership, whose provisions were even more liberal. Warren, *Corporate Advantages without Incorporation*, ch. 4; L.I.M., "Notes: Business Associations in Pennsylvania," *University of Pennsylvania Law Review* 82 (Dec. 1933), 153; George E. Stransky, Jr. "The Limited Partnership Association in New Jersey," *Rutgers Law Review*, 10 (Summer 1956), 701-2; James A., Matthews, Jr., "Comments: Business Associations—Registered Partnership, Partnership Association or the Corporation—Selection of the Suitable Form in Pennsylvania," *Villanova Law Review* 2 (April 1957), 386-87; Schwartz, "The Limited Partnership Association," 30-33; Wayne M. Gazur and Neil M. Goff, "Assessing the Limited Liability Company," *Case Western Reserve Law Review* 41, no. 2 (1991), 393-94. These laws and subsequent amendments passed through 1899 are available in the microfilm collection *Session Laws of American States and Territories*. All references below to specific legislation refer to this collection and are cited simply by date.

real or personal property), and the names of the officers of the association. Any subsequent changes to these arrangements also had to be registered. A partnership association could only be dissolved before the end of its term by vote of a majority of the associates in number and value of interest, so its members were largely protected from the problem of untimely dissolution. This advantage over ordinary partnerships, however, came at the cost of some increased danger of minority oppression because management was concentrated in a board of managers elected annually by the members. The flexibility that partnerships associations had to adopt voting rules that protected the interests of minority shareholders varied somewhat from state to state. Associations in New Jersey and Ohio could adopt whatever voting rule they wished. A later supplement to the Pennsylvania law specified, however, that managers were to be elected by a majority in value of interest.[65] But minority shareholders in these states always had the ability to exit the firm if they disagreed with the actions of the majority. Although individuals who purchased shares could only participate in the business of the association if a "majority of the members in number and value of their interests" so voted, any transferee not admitted to the business would be reimbursed for his or her shares at a price that was either mutually agreed upon or, if no agreement could be reached, determined by the local Court of Common Pleas.

[65] The Pennsylvania voting rule was imposed on June 8, 1895. The original legislation of June 2, 1874 left the question open, as did the laws of New Jersey (March 12, 1880) and Ohio (April 20, 1881). In all three states minority shareholders received additional protection from provisions in the original laws that made it illegal for any association to "loan its credit, its name or its capital" to any member of the association. A May 10, 1889 amendment to the Pennsylvania law further limited the potential for minority oppression by declaring that (after the association had been in business for five years) its officers could not receive in compensation for their services "a sum in the aggregate greater than the amount of net earnings actually earned" during the previous year without the consent of "two thirds of all the members of the association."

Although partnership associations were simple and easy to organize compared to corporations,[66] the form was little used. Admittedly, some important firms were organized as partnership associations—Carnegie Steel Company, Ltd., is the most famous—but there is abundant evidence that the form did not catch on. In the first place, it did not spread beyond the initial group of states. Second, it generated relatively little case law. There were only five cases in New Jersey in nearly a century! Most of the litigation involving partnership associations occurred in Pennsylvania and Michigan, but even in these states the number of cases was low.[67] Third, periodic law-review articles called attorneys' attention to this "hidden" form and reminded them that it had the potential to help business people solve the contracting problems they confronted in choosing between partnerships and corporations, but these efforts seem to have had little effect.[68] About two decades after one such article was published, another writer found that in New Jersey only about 20 to 50 partnership associations were formed each year in populous Essex County, only about three a year in Union County, and virtually none in Camden, Burlington, and Gloucester Counties.[69] Another author surveyed lawyers practicing in Pennsylvania in the mid 1950s and found that they rarely advised their clients to organize partnership associations.[70]

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[66] According to Stransky, a partnership association could be formed in a couple of hours. "The Limited Partnership Association in New Jersey," 709.

[67] Stransky, "The Limited Partnership Association in New Jersey," 701; Schwartz, "The Limited Partnership Association," 31. According to Warren, not much advantage of the form "seems to have been taken in New Jersey, Ohio or Virginia." *Corporate Advantages Without Incorporation*, 523.

[68] L.I.M., "Business Associations in Pennsylvania"; Stransky, "The Limited Partnership Association in New Jersey"; Matthews, "Business Associations"; Schwartz, "The Limited Partnership Association."

[69] Nearly half of 50 partnership associations organized in Essex County in 1954 were in real estate Stransky, "The Limited Partnership Association in New Jersey," 715.

[70] Matthews, "Business Associations," 395.

An important factor inhibiting the use of the new form was the conservative character of the common law. Because precedents are so important in deciding court cases, business people hesitate to adopt new organizational forms until there is a substantial body of case law establishing the extent to which and how essential contractual provisions will be enforced.[71] But a substantial body of case law cannot be amassed unless enough businesses adopt the form to yield some litigation. This "Catch 22" situation makes it difficult to introduce new organizational forms in common-law countries. To make matters worse, when cases did come before the courts, judges interpreted the statutes in ways that made partnership associations a risky way of obtaining limited liability. In particular, they determined that if the registration document filed by a partnership association was incorrect in some material respect, or the list of the association's capital made it "difficult to judge of values" by lumping different items together, the association in effect had never formed and the members were fully liable for their enterprise's debts.[72] The court acknowledged that the rule for corporations was just the opposite: "in a suit brought upon an evidence of debt, either by or against a corporation de facto, the corporate existence and ability to contract cannot be questioned." But it justified the distinction by highlighting the ways in which partnership associations differed from corporations. Although for convenience, partnership associations were "clothed with many of the features and powers of a corporation, …no man can purchase the interest of a member and participate in the subsequent business,

[71] According to Stransky ("The Limited Partnership Association in New Jersey," 710), "New Jersey attorneys can't be sure how the courts of their own state will react to certain situations. There are far too many statutory provision which have not been judicially construed."

[72] For example, the court found the following impermissibly vague: "furniture, fixtures and all the goods, tools and chattels now on the premises of 208 Lackawanna avenue, Scranton city, now leased by said Martin Maloney, valuation $12,500." *Maloney v. Bruce*, 94 Pa. 249 (1880). See also *Appeal of Hite Natural Gas Co.*, 118 Pa. 436 (1888); *Vanhorn v. Corcoran*, 127 Pa. 255 (1889); *Sheble v. Strong*, 128 Pa. 315 (1889); *Gearing v. Carroll*, 151 Pa. 79 (1892).

unless by a vote of a majority of the members in number and value of their interests." The state did not grant a partnership association a charter; its privileges rested entirely on the statement submitted at the time of registration. As a result, it was "competent" for a plaintiff suing for payment of a debt "either to point to a fatal defect" in the statement "or to prove that an essential requisite, though formally stated, is falsely stated."[73]

This conservative tendency of the courts was exacerbated in the US by the decentralized character of business law. Organizational forms were governed by the states, not the federal government, though businesses often operated in many states at the same time. As a consequence, there was a great deal of uncertainty about how business forms developed in one state would be interpreted by the courts of another. In a California case, for example, a partnership association formed under Michigan law was treated like a corporation. In a Massachusetts case, however, a Pennsylvania partnership association was held to be a partnership.[74]

British companies, of course, were spared the uncertainties of federalism, but they could not escape the conservatism of the common law. The longstanding hostility of the courts to limited partnerships may explain why a 1907 law enabling that form had little consequence.[75] By contrast, the 1907 statute for private limited companies was successful because it was such a modest innovation. In effect all that the law did was exempt SMEs from the burdensome regulatory requirements that Parliament had imposed to prevent abuses by companies whose shares were publicly traded. Businesses that

[73] *Eliot v. Himrod*, 108 Pa. 569, 580-81 (1885). Similar strictures had essentially killed the limited partnership form in the US, and the lower court in this case had attempted to prevent partnership associations from suffering a similar fate by making the case that the legislature intended them to be treated like corporations rather than as limited partnerships. But the lower court was overruled on appeal.

[74] Stransky, "The Limited Partnership Association in New Jersey," ##; Warren, *Corporate Advantages Without Incorporation*, ##.

[75] [Ron, would you provide a citation or documentation?]

organized as private limited companies still benefited from a half century or more of case law on corporations.

The modification of state corporate statutes that occurred in the US during the second quarter of the twentieth century was much more successful at providing business people with the advantages of PLLCs than the early partnership association statutes had been. The impetus for the change seems to have come from the high level of personal relative to corporate income taxes in the post-World War II period. Corporations paid a flat tax on their income that dropped from a post-World War II peak of 52 percent to 46 percent on the eve the Tax Reform Act of 1986. Rates for the top personal income tax brackets were above this level (often substantially) during these years. In addition, whereas the flat corporate tax rate was unaffected by inflation, the progressive personal income tax subjected individual tax payers to bracket creep, forcing marginal rates relatively higher. In 1950 the amount of revenue raised by the corporate and personal income taxes had been about the same; by 1980 the personal income tax yielded four times the revenue of the corporate tax.[76]

Not surprisingly, during this period business people increasingly chose to organize their enterprises as corporations rather than partnerships (see Tables 2 and 3). Moreover, perhaps because this shift created the critical mass needed to push for change, states began to modify their laws to make the corporate form more suitable for SMEs. The first significant break occurred in North Carolina in 1955. Imbedded in that state's new Business Corporation Act were several provisions aimed specifically at small, closely held firms, including one declaring that agreements among all the shareholders of such corporations shall not, regardless of their form or purpose, "be invalidated on the

[76] W. Elliot Brownlee, *Federal Taxation in America: A Short History*. New York, 1996, ##.

ground that [their] effect is to make the parties partners among themselves." The North Carolina statute also contained a provision that made it possible for any stockholder to precipitate a judicial dissolution if the corporation's charter or any other written agreement among all the shareholders entitled "the complaining shareholder to liquidation or dissolution of the corporation at will or upon the occurrence of some event which has subsequently occurred."[77] In other words, North Carolina's law now permitted members of corporations to protect themselves against minority oppression by assuming a greater risk of untimely dissolution. About a dozen other states passed similar statutes over the next thirty years, and still others modified their corporate statutes in ways that increased the flexibility of the form.[78]

Legislation during Ronald Reagan's presidency reversed the tax calculus, first in 1981, by reducing the top personal tax rate to 50 percent, and then, with the Tax Reform Act of 1986, by reducing it to 28 percent (the 1986 Act also dropped the corporate rate from 46 to 34 percent). The impact of these changes on business people's organizational choices was to a large extent counteracted, however, by legislation liberalizing the rules under which small corporations could claim Subchapter S status, which essentially allowed them to be taxed as partnerships. Growing numbers of firms filed as s-corporations, and there was comparatively little shifting from the corporate to the partnership form.[79] Again, however, the changes in the tax law seem to have fostered the

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[77] F. Hodge O'Neal, "Developments in the Regulation of the Close Corporation," *Cornell Law Quarterly* 50 (Summer 1965), ##; and "Close Corporations: Existing Legislation and Recommended Reform," *The Business Lawyer* 33 (Jan. 1978), ##.

[78] Kelvin H. Dickinson, "Partners in a Corporate Cloak: The Emergence and Legitimacy of the Incorporated Partnership," *American University Law Review*, 33 (Spring 1984): 559-600; O'Neal, "Developments in the Regulation of the Close Corporation"; and O'Neal, "Close Corporations."

[79] Thomas B. Petska and Robert A. Wilson, "Trends in Business Structure and Activity, 1980-1990," *SOI Bulletin* 13 (Spring 1994): 27-72; and Petska, "Taxes and Organizational Choice: An Analysis of Trends, 1985-1992," *SOI Bulletin* 15 (Spring 1996): 86-102. It should be remembered that corporations

growth of interest groups that pressured state legislatures to expand the range of organizational choices available to small businesses. Wyoming, for example, passed enabling legislation for Limited Liability Companies (LLCs) as early as 1977, consciously designing the form so as to allow firms to acquire the privilege of limited liability without losing the tax status of partnerships. When the IRS confirmed in 1988 that LLCs would indeed have the tax advantages of partnerships, other states quickly passed similar statutes.[80]

There is no information on the number of businesses that organized under the close corporate statutes passed during the third quarter of the twentieth century or that took advantage of the increased contractual flexibility offered by many states' modifications of their general incorporation laws. We do know, however, the proportion of multi-owner firms organized as partnerships dropped from 60 percent in 1949 to 34 percent in 1979 (see Table 3). Although this decline could be taken as evidence that businesses responded to the liberalization by shifting toward the corporate form, the fall could also have resulted from the more favorable tax treatment afforded corporations during those years. We do know that business people displayed considerable enthusiasm for the new LLC form created at the end of the twentieth century. According to the IRS, in 1993 (the first year for which figures are available), there were only about 17,000

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that did not file under Subchapter S were subject to double taxation to the extent that shareholders had to pay taxes on earnings paid out as dividends.

[80] Gazur and Goff, "Assessing the Limited Liability Company," ##. A second wave of statutes for Limited Liability Partnerships (LLPs) quickly followed. Although the initial Texas legislation creating the LLP form was apparently "a response to astronomical losses threatening lawyers and accountants as a result of their partners' involvement in the savings and loan crises of the late 1980s," the rapid spread of the form to other states owed more to tax considerations. See Fallany O. Stover and Susan Pace Hamill, "The LLC Versus LLP Conundrum: Advice for Businesses Contemplating the Choice," *Alabama Law Review* 50 (Spring 1999): 813-47. Additional statutes enacted around the same time further expanded the menu of options. The most notable was Delaware's 1988 law on statutory business trusts which gave business people an extraordinary degree of contractual freedom in organizing their enterprises. The legislation did not even specify any default provisions. See Hansmann, Kraakman, and Squire, "Law and the Rise of the Firm," 1397.

LLCs in the US. By 1997 the number was nearly 350,000, and by 2002 it exceeded 946,000. There is no way of knowing what proportion of new firms organized as LLCs, but in 2002 LLCs constituted 12 percent of all multi-owner enterprises in the US economy, up from around considerably less than 1 percent in 1993. Most of this gain seem to have come at the expense of ordinary partnerships, whose proportion of the total declined from 22 percent in 1993 to 12 percent in 2002 (the share of limited partnerships actually increased from about 4 to 6 percent). By contrast, the proportion of multi-owner firms organized as corporations dropped only slightly, from 73 percent in 1993 to 70 percent in 2002. The relatively small decline in the proportion of corporations suggests that the changes states made to their incorporation statutes after World War II did in fact considerably increase business people's contractual freedom, remedying most of the disadvantages of corporations that had enabled partnerships to remain so popular for so long.

Conclusion

Most studies of organizational forms recount the history of the corporation in the United States and then track the diffusion of this form in the rest of the world, giving high marks to countries that passed general incorporation laws early on and low marks to those that were late in enacting this important legislation. In this article, we have taken a different tack. Although we recognize that most very large enterprises are best organized as corporations, we argue that the corporate form has disadvantages that limit its utility for many SMEs. Instead, we argue, SMEs may be better off if they can adopt a more flexible form of organization that allows them to trade off the advantages and disadvantages of both corporations and partnerships as suits their particular type of business. The PLLC was such a form, and the bulk of our article is devoted to tracing its emergence and diffusion first in Germany, then in Britain and France, and finally in the United States.

In challenging the conventional idea that the corporation is a globally superior form of business organization, we have also cast doubt on the related notion that Anglo-American legal institutions are superior to French and German ones—that is, that common-law regimes provide an inherently better environment for business than the code-based legal regimes of the European continent. If one looks at history from the vantage point of the PLLC rather than the corporation, then Germany, a code-based country, was the key legal pioneer, with Britain, a common-law country, following a decade and a half later. France, a code-based country, was a distant third, but if rapidity of diffusion is a good indicator of a form's ability to satisfy businesses' contracting needs, then it may have been the most successful innovator. Ultimately, US enterprises obtained a similar degree of contractual freedom, but not until the second half twentieth century. For most of US history the common law's reliance on precedent, in combination with the peculiarities of federalism, seems to have constrained legal innovation. As a result, businesses were forced to make do with a much more limited set of organizational options than their European counterparts until the second half of the twentieth century.

At this point we have only scratched the surface of what we hope to be able to accomplish. The information we report here successfully demonstrates the uneven popularity of the corporation and its relative decline after the introduction of the PLLC, but there is much more to be learned from detailed statistical evidence that illuminates patterns in the use of alternative organizational forms both across and within industries. Moreover, by collecting a samples for our countries of the partnership agreements and articles of association under which firms of different types actually operated, we will be able to study the extent to which and how they were able to adapt the default rules of the various organizational forms to their particular contracting needs. Finally, by tracking businesses' conversions from one type of organizational form to another whenever the menu of choices abruptly expanded we hope to understand which types of businesses were most likely to be disadvantaged by a constrained set of options. The end result will be a better sense of how particular legal rules matter for economic growth—knowledge that we hope will yield more realistic policy initiatives toward developing countries.

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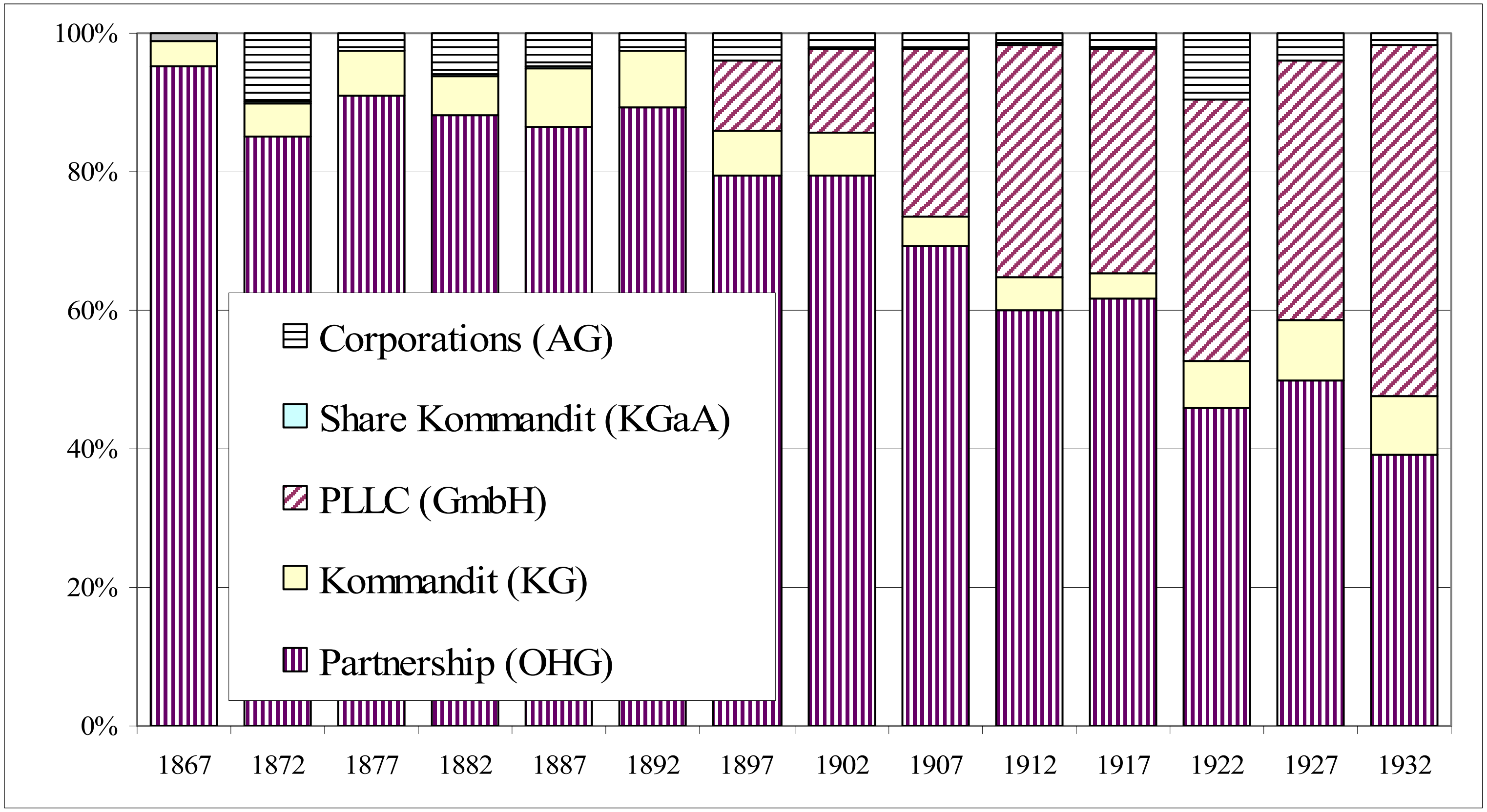
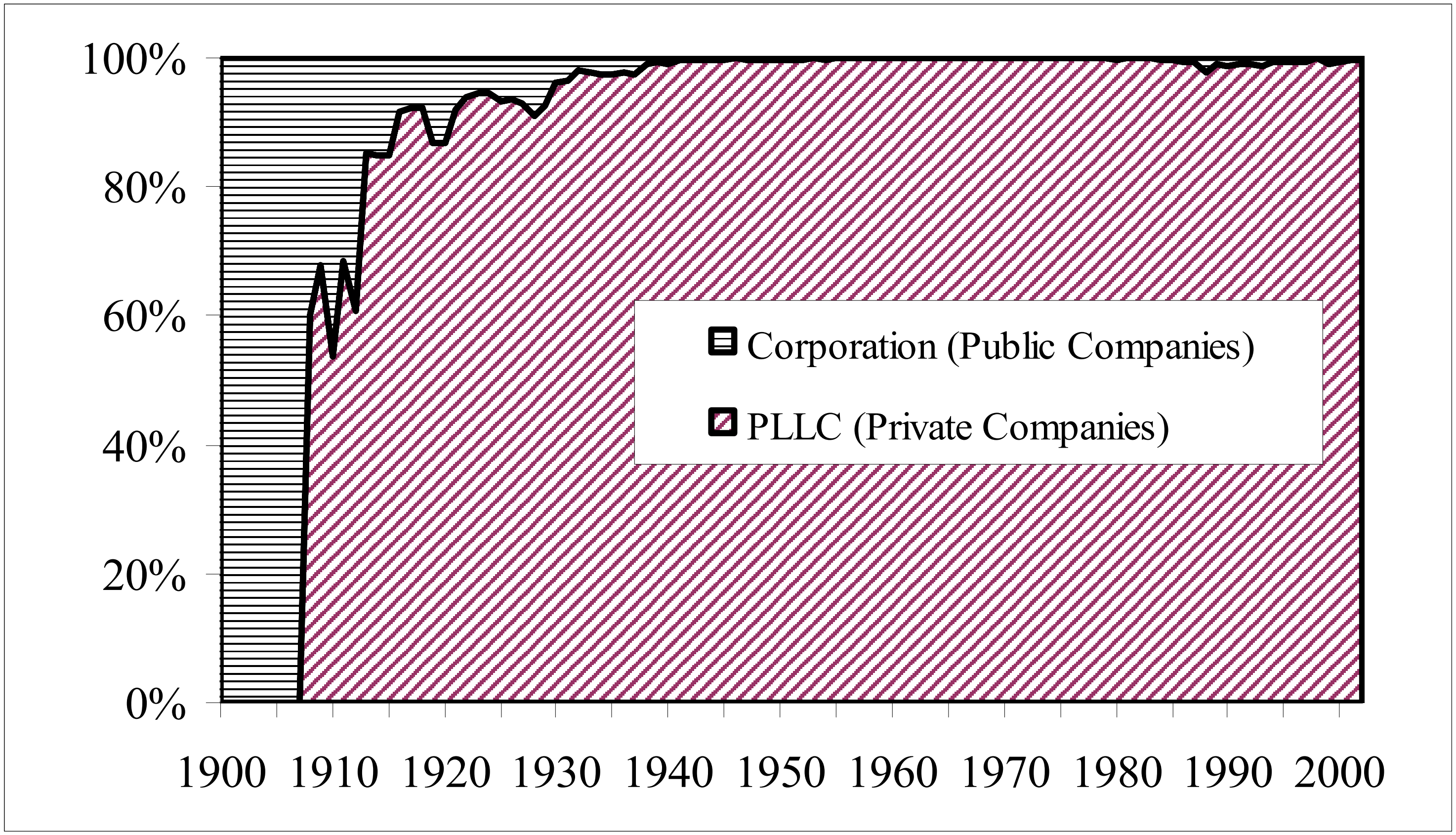
Figure 1. Distribution of New Firms Among Multi-Owner Organizational Forms: Prussia, 1867-1932



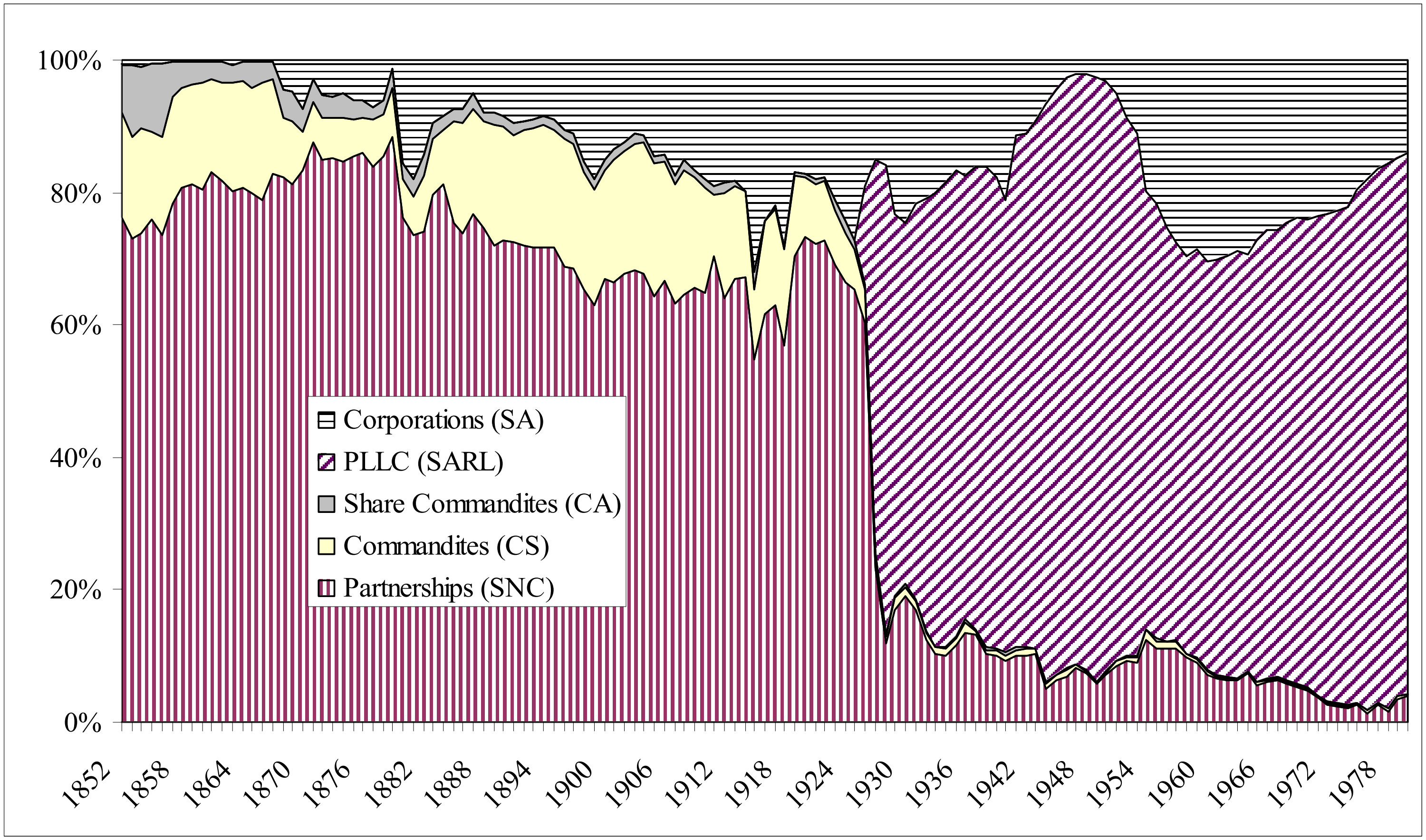
Source: Data were compiled from the *Königlich preussischer Staats-Anzeiger (until 1871) and the Deutscher Reichsanzeiger and preussischer Staatsanzeiger* (after 1871). We counted every new firm announced by a commercial registry in Januaries of the years reported. Note that the source pertains to Prussia only.

Figure 2. Ratio of New Private to All New Limited Companies in Britain, 1900-2000



Source: U.K. Board of Trade, *General Annual Report under the Companies (Winding-up) Act of 1890* (1900-1921); U.K. Board of Trade, *Report* (1922-2000). [Ron, are these citations correct? Also please provide places of publication.]

Figure 3. Distribution of New Firms Among Multi-Owner Organization Forms, France, 1852-1978



Source: Annuaire de la Justice. [Jean, please provide complete citation and add to reference list under government pubs.]
Note: Figures for the years 1914-1914 were interpolated using totals for Paris collected at the Archives de Paris.

Table 1. The Menu of Organizational Choices

Type of Form	Definition of Form	Availability?
Ordinary Partnership	Two or more partners, all unlimitedly liable	Yes in all four countries
Limited Partnership	One or more general partners with unlimited liability, and one or more special partners who cannot participate in management but who have limited liability	France: yes Germany: yes UK: only after 1907 US: yes, but in an unattractive form
Limited Partnership with Tradable Shares	Same as limited partnership, except special partners' shares can be bought and sold on the market	France: yes Germany: yes UK: no US: no
Corporation	All members have limited liability and their shares are tradable	Required special permission until: France: 1867 Germany: 1860s-1870, varied by state UK: 1844 without limited liability and 1855-56 with limited liability US: mostly middle third of 19th century, varied by state
Private Limited Liability Company	All members have limited liability but their shares are not tradable	France: 1925 Germany: 1892 UK: 1907 U.S.: 1870s-1880s for a few states, but unattractive; laws in 1950s-1970s allowed close corporations to mimic; 1980s-1990s

Table 2. Distribution of Partnerships and Corporations in the US, by Industry, 1947 and 1997

Industry	Year	Number of Partnerships	Number of Corporations	Corporations as Percent of Multi-Owner Forms
All	1947	888,862	551,807	0.38
	1997	1,758,627	4,710,083	0.73
Agriculture, Forestry, and Fishing	1947	120,402	7,329	0.06
	1997	127,060	163,114	0.56
Mining	1947	13,579	8,294	0.38
	1997	28,045	32,996	0.54
Construction	1947	52,592	20,287	0.28
	1997	72,098	487,783	0.87
Manufacturing	1947	74,978	112,184	0.60
	1997	40,022	325,045	0.89
Transportation, Communications, and Utilities	1947	20,776	23,729	0.53
	1997	30,917	209,402	0.87
Wholesale and Retail Trade	1947	372,212	177,297	0.32
	1997	173,009	1,149,132	0.87
Finance, Insurance, and Real Estate	1947	87,647	151,043	0.63
	1997	974,223	744,545	0.43
Services	1947	130,954	45,975	0.26
	1997	310,990	1,592,854	0.84
Other	1947	15,722	5,669	0.27
	1997	2,263	5,201	0.70

Source: Susan Carter, et al., *Historical Statistics of the United States: Millennial Edition* (New York, 2006), Vol. 3, Tables Ch1-192.

Table 3. Distribution of Organizational Forms in the US, 1949 to 2002

Year	Partnerships	Corporations	LLCs
1949	61	39	--
1963	41	59	--
1979	34	66	--
1993	26	73	1
2002	18	70	12

Sources: Carter, et al., *Historical Statistics of the United States*, Vol. 3, Tables Ch 193-204; *SOI Bulletin*, various issues.

Note: The figures for ordinary partnerships include limited partnerships. Their proportion of multi-owner forms has grown in recent years from about 4 percent in 1993 to about 6 percent in 2002, so the table understates the drop in ordinary partnerships.