

Business Organization in the Long Run:

Private Limited Companies Rule!

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by

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Abstract

A long tradition in the economics, corporate law, and corporate finance literatures presumes the general superiority of the corporation as a form of business organization. A more recent tradition claims that the Anglo-American legal tradition affords greater protection for business than do civil-law traditions. This paper, which is the first in a larger project, challenges both claims. We focus on the introduction of the private limited-liability company (the PLLC) in France, Germany, the United Kingdom and the United States in the late nineteenth and twentieth centuries. The PLLC combined the advantages of legal personhood and joint stock with a very flexible internal organizational structure. The PLLC allowed business people to avoid the threat of untimely dissolution inherent in partnerships without taking on the full danger of minority oppression that came with the corporation. The PLLC was introduced first, and most easily, in a code country, and last in a common-law country. Common-law judges resisted this institutional innovation, while parliaments in France and Germany simply introduced what became a very popular form. This important example contradicts the widespread claims in the literature that the common law provides a legal setting that is more flexible and responsive to the needs of business. Using data on the number of firms organized under various enterprise forms, we show that the initial popularity of the PLLC depended both on the expense and difficulty of organizing a corporation, on the one hand, and on the types of partnerships allowed, on the other.

1. Introduction

This paper challenges two assumptions that have characterized much of the current scholarship: the general superiority of the corporation as a form of business organization; and the greater support and protection that Anglo-American legal institutions afforded business. These assumptions are perhaps understandable, given the dominance of the US economy in the late twentieth century and the predominance of the corporate form in the US during that period, but a broader view of the empirical record calls them into question. Even in the US, the corporation was not the most prevalent organizational form until perhaps a century after the spread of general incorporation laws across the country. During the late nineteenth and early twentieth centuries European governments created alternative forms—what we are collectively labeling the private limited liability company (PLLC). Whenever these forms became available, they quickly swamped the corporation in popularity. Most US firms did not have a similar option until the second half of the twentieth century.¹

Although their specific features vary across countries, PLLCs are all joint stock, limited liability enterprises whose capital cannot be raised from the public or traded in organized markets. In addition, they all benefit from low fees and minimal disclosure requirements. Limited liability might seem to be a sufficient advantage to explain why PLLCs often displace partnerships, and low fees and low disclosure requirements might well explain their popularity relative to corporations. We argue, however, that these common characteristics, while important, cannot in and of themselves explain why the

¹ As we will show, US firms in the states of Pennsylvania, Michigan, New Jersey, and Ohio obtained the ability to adopt a type of PLLC in the 1870s and early 1880s, but the form did not have much appeal and did not spread to other states.

PLLC spread so rapidly in most of the countries under study. Instead, we suggest, the capacity of PLLCs to expand the menu of governance options available to entrepreneurs forming enterprises was critical to their success.

To develop this argument, we offer an alternative understanding of the determinants of organizational choice that conceives of businesses as trading off one kind of contracting problem against another.² Although the partnership form has clear disadvantages, so does the corporation. Firms with large numbers of owners who want their investments to be tradable have little choice but to organize as corporations. But most small- and medium-size enterprises (SMEs) have few owners and their equity does not trade; hence they may be less willing to incur the corporation's disadvantages.

During the nineteenth century the only way that owners of SMEs in the US and Britain could avoid these drawbacks was by bearing the costs of partnerships. In France and Germany, the availability of a third alternative, the limited partnership, enabled business people to moderate the terms of the tradeoff to some extent. Subsequently, the passage of enabling legislation for PLLCs (the GmbH in Germany in 1892, the PLLC in Great Britain in 1908, the SARL in France in 1925, and the close corporation in the US after World War II), gave entrepreneurs additional flexibility to mix and match attributes of both partnerships and corporations.³

In this paper we trace the emergence and use of the PLLC form in these four countries over the past two centuries. We first lay out the rationale for our focus on the PLLC and then explore alternative hypotheses to account for differences across the four

² This paper focuses on the organizational choices made by multi-owner firms. We set aside, for the time being, questions related to the legal rules governing single-owner enterprises and also decisions that affect whether or not an enterprise has multiple owners.

³ The appendix table summarizes the names and abbreviations of all enterprise forms discussed in this paper.

countries in the popularity of the form. We pursue this agenda by compiling a record of the organizational choices available in each country and how these changed over time, by gathering preliminary estimates for each country of the take-up rate of PLLCs after the form became available, and by assessing the impact of the PLLC on the use of alternative organizational forms (for example, partnerships or corporations).

We have chosen our four countries because they were all key legal innovators and all economically successful. The French and German civil and commercial codes formed the basis of 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 the US, another important common-law country, is credited with democratizing the corporation. Although current scholarship suggests that common-law countries have better legal environments for business than code-law countries (see especially La Porta et al. 1997, 1998, and 1999), our investigation of organizational forms reveals no such simple dichotomy. We hope, therefore, that our work will ultimately lead to more realistic policy recommendations than those that have come out of the literature on legal regimes. By studying the ways in which firms operating under different legal systems and institutions have successfully solved the organizational problems they faced, we can help put the profession in better position to advise developing countries about how to make their institutional heritages work to support economic growth.

2. The Key Issues

The presumption in the literature that the corporation is the superior form of business organization stems from the notion that only the corporation can support the

capital deepening—and, in particular, the growing importance of fixed assets in production—required for modern economic growth. This argument takes a number of forms. For example, it has been argued that only the corporate form provides the lock-in of capital necessary to elicit long-term investments, the limited liability needed to raise capital from the broader public, and the concentrated management that the effective government of large-scale enterprises requires (Blair 2003; Chandler 1977; Clark 1986; Rosenberg and Birdsall 1986; and Woodward 1985; but see also Landes 1972).

Although much of the literature focuses on large firms, scholars have generally regarded the corporation as a superior form for other multi-owner enterprises as well. Problems of untimely dissolution plague SMEs as well as large enterprises (Blair 2003). Concentrated management is better than joint ownership at preventing shirking by members of the firm (Alchian and Demsetz 1972) and at eliciting their investments (Hart 1995). And corporations provide stronger “entity shielding” than partnerships. That is, they do a better job of protecting the assets of a firm from the personal creditors of its owners (Hansmann, Kraakman, and Squire 2006).⁴

To the extent that entrepreneurs sought corporate charters because they anticipated carrying out IPOs or because they wanted to provide their shareholders with the benefits of liquidity in public secondary markets, then the special charter system should have sufficed. After all, very few companies actually listed their shares. To the extent that the corporation was a superior organizational form for SMEs as well, however, general incorporation laws would have been much more important. Indeed, one

⁴ Hansmann, Kraakman, and Squire recognize that, until recently, the corporate form had many features that limited its utility for SMEs. Their work parallels ours in emphasizing the development of new organizational forms that enabled business people to benefit from both entity shielding and owner shielding (limited liability) without bearing all the costs of incorporation. They do not, however, recognize the extent to which these forms were available in Europe long before they developed in the US.

should find the corporation pushing out other forms just as soon as such laws were passed. As we have already suggested (and will demonstrate in detail below), this was not the case in any of our four countries. Indeed, outside the US it was the PLLC—not the corporation—that became the dominant choice for all but the largest firms. Of course, it is possible that the source of the problem was restrictive general incorporation statutes and regulations, not the corporate form itself. For example, it is possible that fees and other costs associated with taking out corporate charters were high enough to discourage use of the form or that tax rates discriminated against corporations relative to other forms.⁵ It is also possible that reporting requirements or laws mandating the public disclosure of business information imposed a sufficiently onerous burden to suppress the number of corporations.

We will explore these possibilities, but we will also explore the alternative hypothesis that the corporate form was not as advantageous as the theory might suggest. Our starting point is an observation that heretofore has not been adequately appreciated in the literature—that is, that the advantages of the corporate form all came at significant costs. For example, limited liability typically raised a firm’s borrowing costs because the assets of the individual owners no longer served as security for its debts. Indeed, a firm with limited liability might find it difficult to borrow unless its shareholders were willing personally to endorse its obligations (Greulich 1906; Hurst 1970; Woodward 1985; Forbes 1986; Lamoreaux 2004).⁶ More importantly, the two other major advantages of

⁵ Today, of course, tax rules have significant effects on businesses’ organizational choices. Prior to the early twentieth century, however, most taxes were low, and only at the margin were there differences in the treatment of partnerships and other entities. As a result, for the purposes of this paper we largely set aside tax issues, though we will return to the subject in subsequent work.

⁶ Moreover, even members of ordinary partnerships could limit their liabilities contractually, especially in France, Germany, and other countries governed by legal codes that required partnerships to register with the commercial court. Although it has generally been assumed that limited liability was a necessary

the corporate form—concentrated management and perpetual life—entailed costs that were likely to be particularly salient for corporations whose shares were closely held. Because the only members of a corporation who could make decisions on behalf of the firm were officers who had been duly elected by its shareholders, any coalition that determined the election of officers also controlled the firm. The coalition could then use its power to benefit its members at the expense of other shareholders, and there was little that the minority could do to about it. They could not make the majority change its policies; nor could they force the firm to dissolve (Lamoreaux and Rosenthal 2006a).

According to this view, therefore, the choice of organizing a business as a corporation rather than a partnership entailed tradeoffs. For some types of businesses, the costs associated with untimely dissolution were higher than the costs associated with minority oppression. All other things being equal, those businesses would prefer to organize as corporations than as partnerships. For other businesses, however, the situation was just the reverse. We hypothesize that the availability of the limited partnership form in France and Germany in the nineteenth century mitigated these tradeoffs to some extent. But we hypothesize that the appeal of the PLLC stemmed from the greater flexibility it offered businesses to resolve the kinds of contracting problems they were most likely to face by trading off the risk of minority oppression against untimely dissolution.

For example, firms organizing as PLLCs had greater freedom to determine the kinds of decisions that would require super-majority votes (or even unanimous consent) and which only simple majorities. The more dimensions that require super majorities, the

condition for the development of a liquid market in a firm's shares (Woodward 1985), there are important counterexamples. See Weinstein 2005; and Hickson, Turner, and McCann 2005.

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. Here 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 underlying assumption of this paper 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, would induce them to invest suboptimal levels of effort and resources. All of the countries we are studying offer firms a high level of contractual flexibility in the present day. 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 how this divergence occurred and discuss its implications for the evolution of business forms in our four countries.

3. Before the PLLC

The timing of the PLLC's introduction into a country and the rate at which it subsequently diffused were affected to a large extent by the set of preexisting organizational choices.⁷ Although these choices varied a great deal from one country to

⁷ In the discussion that follows, we ignore several types of business organization that are not central to this paper's focus, but which will receive attention in the larger project: special forms of multi-owner enterprises that were available early on to mining companies, special forms available under maritime law;

the next, in all four of our cases formation of a corporation required specific permission from the government until some point in the nineteenth century. Because in most jurisdictions such permission was rarely granted, other forms of organization were quite important. In all of our four countries, the main alternative to the corporation was the ordinary partnership in which all of members of the firm bore unlimited liability. Partnerships had no legal existence independent of their owners, so such firms always faced a threat of untimely dissolution if one or more partners died or wished to withdraw from the enterprise. Another problem with partnerships was that one or more members of the firm could “hold up” the others as a condition for continuing their investment whenever the term of the contract came to its stipulated end.⁸

In France the *Code de Commerce* of 1807 offered business people two alternatives to the ordinary partnership (or *société en nom collectif*). 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. In addition, business people could organize *commandites par action*, limited partnerships in which the shares of the limited partners were tradable. An active market in these shares enabled *commandites par action* to secure many of the advantages of corporations without obtaining special government permission.

German law, which was heavily influenced by French thinking, offered businesses essentially the same three choices: the ordinary partnership (*Offene Handelsgesellschaft* or OHG), the simple limited partnership (*Kommanditgesellschaft* or

and silent partnerships in which investors had limited liability so long as their identity and connection to the enterprise remained unknown.

⁸ Under Anglo-American common law partnerships were not legal persons. On the European continent they were *sociétés de personnes* as opposed to *sociétés de capitaux*.

KG), and the limited partnership with tradable shares (*Kommanditgesellschaft auf Aktien* or KGaA). 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.⁹ (The ADHG did, however, allow individual states to opt out of certain provisions, such as general incorporation.)

In both France and Germany all firms that organized under their respective codes were required to draft formal written agreements and register the main details of these agreements with a local authority. Because this information was publicly available, the contracts were fully enforceable and binding with respect to creditors and other third parties. Unlimited partners in French and German enterprises thus had the ability to control to some extent the liabilities to which they were exposed by restricting the number of partners who could act as agents of the firm and also the amount of debt the firm could take on without their explicit approval.

In Britain and the US partners did not have this ability. Although they often negotiated co-partnership agreements that included such constraints, the contracts were not public documents and hence were not enforceable vis-à-vis third parties who did not have knowledge of their terms. Nor did business people in the US or the UK have access to the alternative forms available to their French and German counterparts. 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 (Harris 2000).¹⁰ The situation was similar

⁹ The first common business law for the Reich was passed in 1898, but the ADHG covered most aspects of business organization at issue here.

¹⁰ Innovations such as the (unincorporated) joint-stock company made investors' shares more liquid, but could not overcome the central defects of the partnership, which they still were at law. One possible

in the US. Although most states passed laws during the 1820s and 1830s permitting the formation of limited partnerships modeled on the *commandite*, the courts construed these statutes so narrowly that they never provided a useful alternative to ordinary partnerships (Lamoreaux and Rosenthal 2005).

General incorporation, or the right to form a corporation without seeking specific permission from the state, came to each country at a different time. Perhaps because of the paucity of alternative forms, Britain and the US led the way. In Britain lobbying by opponents, particularly competitors who sought to prevent rivals from obtaining corporate privileges, made corporate charters a rare and expensive commodity until the passage of general incorporation laws. Parliament enacted legislation providing for general incorporation 1844 and limited liability in 1855-56. The first consolidated Companies Act was passed in 1862.

These acts replaced control of the state over incorporation with three main substitutes intended to protect potential investors, shareholders, and creditors: disclosure; declared purpose; and locked-in capital. The company was required to disclose its status as a limited company and register its articles of association, the names of its directors, and any mortgages it assumed. The company could not act *ultra vires*—that is, it could not engage in other than its declared business purpose. And the paid-up capital of the company (the money remitted by shareholders in payment for their shares) could not be returned to the owners until all creditors of the firm had been paid in full. Once a company satisfied the requirements aimed at providing basic protection to shareholders

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, also 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. See Harris 2000.

and creditors, its organizers could determine among themselves other features of the enterprise, for example how it was to be governed. The various Companies Acts offered incorporators a set of default rules that they could either adopt as is in their articles of association or contract around by drafting tailor-made rules.

In the United States, the federal Constitution left incorporation to the states. Massachusetts and New York passed general incorporation laws for manufacturing as early as 1809 and 1811 respectively—as part of a patriotic effort to stimulate domestic industry in the run-up to the War of 1812. Over the next four decades the number of such laws increased dramatically. Although many states, especially in New England, had been quite liberal in granting charters by special legislative act, efforts to democratize corporate privileges—to make them available to all rather than a favored few—spurred the passage of general incorporation laws. By the early 1850s most states had made obtaining a corporate charter for most types of businesses a simple administrative process (Hurst 1970; Maier 1993; Hamill 1999; Blair 2003). As time went on, states imposed fewer and fewer regulatory or disclosure costs on incorporators,¹¹ but they also made the form more rigid. During the special charter period, when legislatures passed individual acts for each and every corporation, there was considerable heterogeneity in governance rules and other provisions across corporations. The move to general incorporation laws reduced this heterogeneity, and (in direct contrast to the experience in the UK) there was an increasing tendency for states to impose uniform, one-vote-per-share, majority-wins voting rules (Dunlavy 2004; Wallis 2003).

¹¹ Although some early general incorporation laws had required corporations to submit annual financial statements, reporting requirements became more and more lax over time. The creation of the Securities and Exchange Commission in the 1930s changed this situation, but only for corporations whose shares were traded publicly (Kuhn 1912; Dodd 1936; Cadman 1949; Gower 1956; Hawkins 1986).

France adopted full general incorporation in 1867. Until that point the government had granted corporate charters sparingly, approving only 642 between 1800 and 1867 (Freedeman 1979 and 1993). By way of comparison, Massachusetts alone had chartered 2062 corporations by special act between 1800 and 1862 (Kessler 1948). Prior to 1857, however, the demand for general incorporation had been muted by the availability of the share *commandite* form. Growing complaints by minority shareholders and creditors about abuses by the *commandites'* general partners led to a set of regulatory reforms in 1857 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 (Freedeman 1979, pp. 132-35).

In Germany the ADHG left the matter of corporations to the individual states, which adopted general incorporation at different times. The Hanseatic cities were the first to allow general incorporation. Prussia followed in 1867 (Horn 1979, p. 128 note 22). Two types of pressures played a role in the shift to general incorporation. First, governments recognized that tight control of corporate charters had not prevented the creation of large-scale enterprises because business people were able to use the device of the *KGaA* successfully to raise capital on the market. For example, the Disconto-Gesellschaft took the form of a *KGaA* during the years 1856-67, when it was also the largest bank in Germany (Burhop 2004, p.84). Second, prior to general incorporation some states had been relatively liberal in granting corporate charters, often seeking tax revenue or other favors from corporations that would be legally sited in their territory but

actually do most of their business elsewhere in the *Zollverein*. State governments learned the hard way that a restrictive policy would not prevent corporations from being created but rather and would only lead to their being chartered in another German state (Cameron 1956).

The slow take-up of the corporate form

If the corporation really was the obviously superior form that the literature makes it out to be, we should observe large increases in the number of corporations after the passage of general incorporation legislation. In both France and Germany, however, the corporation proved to be much less popular than in the US or the UK. Indeed, as late as the eve of World War I there were still only about 5,200 corporations in Germany and 13,000 in France, compared to almost 63,000 in the UK and over 250,000 in the US (Freedeman 1993, p. 21; Carter et al. 2006, Table Ch1-18).

Figure 1 displays the distribution across enterprise forms of new multi-owner firms in France for the period 1852-1978. The passage of the 1867 general incorporation led to a surge of new corporate formations, but except for a brief boom during the late 1870s, the corporation never accounted for more than 10 percent of all new multi-owner firms before World War I. Partnerships became relatively less common during this period, but they still accounted for at least 60 percent of all new firms. Some of the decline in ordinary 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 they did not completely disappear, even though they might be considered inferior substitutes for the corporation. For example, Schneider, the

large iron and steel works, remained a *commandite par action* until the 1960s, and Michelin is still one today.

Figure 2 reports the organizational forms adopted by new firms registered in Prussia from 1867-1932.¹² General incorporation brought a brief upsurge in the corporation's popularity as Prussian entrepreneurs quickly took advantage of their new freedom.¹³ However, as in France, the corporation did not replace the ordinary partnership, which continued to dominate the registration of new multi-owner firms. For every new corporation formed, there were at least 16 new partnerships of all types in 1882 and as many as 41 in 1892. The KG also remained a popular form of organization for new firms. Indeed, when an ordinary partnership changed its legal form, the new entity was more likely to be a KG than a corporation.

The number of new corporations 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.¹⁴ In 1871, for example, business people registered 104 corporations in Berlin alone (Burhop 2004, p.25). Many

¹² The first all-German statistics on forms of enterprise date from the early twentieth century. Before then only Prussia published much information on the matter. Our detailed investigation of new firms comes from a published, weekly summary of the *Handelsregister*, which was maintained at the state level. The publication is called the *Königlich Preussischer Staats-Anzeiger* pre-1871 and continues as the *Reichsanzeiger* after 1871. We have entered the complete matrix of formations, dissolutions, and transformations for all firm types for January of years ending in “2” or “7” for the period 1867-1932 and for all months in 1891 and 1892. There do not seem to be major issues of seasonality in the number or types of firms formed, judging from those two years. Prussia comprised a large majority of the population, territory, and economic activity of the *Reich* formed in 1871. Of the 4712 corporations existing in Germany in 1912, 2619 were in Prussia. Another 384 were in Bavaria, 454 in Saxony, and 140 in Württemberg (Bayern 1913, p.22*). Prussia's share in corporations is slightly less than its weight in Germany's overall population, and even smaller in proportion to its share of GNP.

¹³ Engel (1875) presents a detailed look at the corporations formed in Prussia in the first few years of the new regime. By his count, 410 corporations formed under the old rules survived to 1870. About one-fourth of these were in the iron and steel industry, and another 60 were in insurance. Only 4 were banks (Table A). In 1871, 225 new corporations were formed. The distribution across industries suggests where the limitations had been binding under the old system. Only 15 of the new corporations were in iron and steel. 29 were breweries, and 42 were banks (Table B).

¹⁴ Burhop (2004, Abbildung 1) reports a stock market index (1870=100) that rose to a peak of 186 in November 1872 and fell below 100 by May 1875.

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 (Wagon 1903, p. 3).

Fallout from the bubble's collapse led in 1884 to the passage 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.¹⁵ 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.¹⁶

These changes undoubtedly made the corporate form less attractive to entrepreneurs, not least because, as Guinnane (2002, pp.104-105) has argued, they strengthened the role of the Great Banks in company formation with the result that profits from such activities were increasingly captured by bankers.¹⁷ While 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 retained another form. Kocka and Siegrist (1979, Tables 1 and 2) report that

¹⁵ There was no external auditing of corporations until 1931; the supervision committee was supposed to act as a sort of internal auditor.

¹⁶ *Gesetz, betreffend die Kommanditgesellschaften auf Aktien und die Aktiengesellschaften, vom 18. Juli 1884 / Mit Erläuterung von Paul Kayser Berlin : H. W. Müller , 1884 -S.*

¹⁷ Fohlin (2002) stresses the effect of later changes, but her focus is on the implications for the banks.

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. Even today, some of the largest German firms are organized as partnerships or one type or another. Merck's German headquarters company is a KGaA, for example.¹⁸

An over-reaction to the 1873 collapse might explain why so many German firms continued to organize as partnerships, but the continued popularity of the partnership form in France is more difficult to understand. Still more puzzling is business's ongoing resort to partnerships in the US and the UK. Data from the US Census of Manufacturers reveal that as late as 1900 partnerships constituted more than 60 percent of multi-owner firms in the manufacturing sector, despite the early advent of general incorporation in the US and the low cost of securing a corporate charter (Lamoreaux and Rosenthal 2006b). Although the proportion of manufacturing firms organized as partnerships fell over time as the scale of enterprise rose, dropping to about 40 percent by 1920, partnerships retained considerable importance in the economy as a whole. Indeed, according Internal Revenue Service (IRS) data, they constituted about 60 percent of all multi-owner firms as late as 1949 (Carter et al. 2006, Table Ch1-18).

Although there are no similar datasets for Britain, such estimates as are available show partnerships to be similarly persistent. In 1872 the Committee on Partnerships considered the practicability of requiring registration of trade partnership contracts. An interested witness who appeared before the committee estimated that 200,000 to 300,000 partnerships would be affected. A more conservative estimate from 1885 put the number

¹⁸ 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.

of “important partnerships” at about 100,000 and calculated that limited liability companies accounted for at the most 5 to 10 percent of “important business organizations,” excluding one-man concerns. 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 company form. For the years 1900 to 1914 the percentage in comparable surveys and estimates rose to 80 to 90 percent. Hence it took fifty years or more after the enactment of general incorporation for the corporate form to dominate the organization of large-scale industrial enterprises (Jefferys 1938). Estimates of the organizational forms adopted by SMEs are both scarcer and less reliable, yet it seems quite safe to conclude that most of these enterprises were still partnerships at the time of the introduction of the PLLC in Britain.

The response of businesses to the enactment of general incorporation laws in each of our four countries thus seems to have been a function of the existing menu of organizational choices and of the costs of adopting the corporate form. In countries like France and Germany, where there were already alternatives to ordinary partnerships, entrepreneurs displayed less enthusiasm for the corporate form than in the US and Britain, where there were fewer organizational choices. In Germany, moreover, the appeal of incorporation was greatly reduced by the 1884 reforms that significantly raised the costs of organizing as a corporation.

Even in the US and Britain, however, corporations did not dominate to the extent the literature would suggest. The continued popularity of partnerships in the US is particularly striking, given that states imposed few regulatory or other burdens on organizers of corporations. This popularity in and of itself is evidence that many

business people shied away from organizing as corporations because of the contractual disadvantages of the form. In the next two sections we explore this possibility further by comparing the response of entrepreneurs in each of our four countries to the advent of the PLLC.

4. The PLLC

In the discussion that follows we describe the passage of enabling legislation for PLLCs in chronological order, taking Germany (1892) first, Britain (1907) second, and France (1925) third. We leave the US for last. Even though Pennsylvania and a small number of other states passed enabling legislation before Germany, these acts had little practical consequence. It was not until the post-World War II period that US businesses obtained a viable approximation of the PLLC.

As we will show, the statutory histories for each country have a path-dependent character. Follower countries did not slavishly imitate their predecessor's innovations, though they were well aware of them. Rather, both the timing and the specific details of the statutes were shaped by circumstances that were peculiar to each country.

4.a. Germany

By the late 1880s many observers in Germany thought the 1884 reforms of the general incorporation law had gone too far. The reforms had deliberately made the formation of a new AG more difficult, creating a barrier to entry for large-scale enterprise that, many worried, 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 enterprise form altogether. 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 *Gesellschaft mit beschränkter Haftung* (company with limited liability, later usually abbreviated GmbH) was enabled by an Act of the Reichstag in 1892. The form was later incorporated, with minor modifications, into the commercial code (HBG) of 1898 (Schubert 1982). Although some observers, such as Crüger (1912), saw the GmbH as a way for smaller enterprises to survive and prosper, 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. The GmbH's straddling of this distinction offended the sensibilities of the legal profession. Nonetheless, for all the complaints about the GmbH over the years, the form as used today remains virtually unchanged from 1892 (Schmidt 2002).

The law

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. 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 organized for any legal

purpose, including not-for-profit activities. Any enterprise organized as a GmbH was automatically a commercial firm (*Handelsgesellschaft*) in the sense of the HGB, regardless of what it actually did.¹⁹ 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.

A GmbH had to have an issued capital (*Stammkapital*) of at least 20,000 Marks.²⁰ 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.²¹ The total *Stammkapital* could be divided into (not necessarily equal) shares, but no share could be less than 500 Marks.²² At least 25 percent of the capital had to be paid in before the GmbH could operate. (A similar rule applied to AGs, but, unless the organizers had a special waiver, shares in an AG had to be at least 1000 Marks.) 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 such transfers was higher, and shares could not trade on stock markets.

A GmbH could be formed for a specific period of time or without term; in either case investors were protected against the threat of untimely dissolution by a default rule

¹⁹ Firms organized as GmbHs in a few specialized activities such as banking faced special reporting requirements that we will not detail here.

²⁰ 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 (Hoffman 1965, Table 1, p.248).

²¹ 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. Guilini (1919) reports that 115 of the 1125 GmbHs operating in Berlin in 1905 had only one *Gesellschafter*. The empirical basis of this assertion is unclear; our sense is that many discussions of the GmbH that stress that most are one-man firms, or family firms, are simply recitations of assumptions.

²² 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 (for example, De Vries and Jünger 1964) refer in English to the GmbH’s owners as “quota holders” rather than “shareholders” to capture the German distinction. We think “quota-holder” is too awkward to justify any clarity it might bring.

that required the approval of three-quarters by value of the shares to wind up the firm. At the same time, the default rules implied the possibility of severe minority oppression. 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. The managers had the right to represent the firm legally, so their names had to be entered in the commercial registry. The law required that managers be freely dismissible. The articles of association could list the main reasons why a manager might be fired, but enumerating these reasons could 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.²³ A GmbH could have a supervisory committee, but did not have to have one (unlike an AG or *KGaA*).²⁴ Unless the articles of association specified otherwise, the owners had a right to yearly financial statements.

Minority shareholders obtained additional protection from their ability to exit the firm. Shares had to be alienable and heritable. Although the articles of association could limit transferability in several ways, for example by requiring agreement of the other

²³ Hachenburg (1913, pp. 441-442) 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 Hachenburg’s term.

²⁴ Under the co-determination laws, a post-World War II phenomenon, some very large GmbHs must have worker representation in the firm’s management. This is most often carried out through seats on a supervision committee.

owners if a share was to be sold to someone not currently an owner,²⁵ these provisions could not be such as to harm any shareholder's ability to sell. Conversely, GmbHs had the right to expel owners by buying back their shares. This provision was related to others that permitted the firm to require shareholders to perform specific functions. Thus shareholders might be required by the articles of association to 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.

Concerns about creditors

The GmbH's introduction did not end discussion of or objection to the new form. One strand of opposition was based on a fear that a GmbH's creditors could not be adequately protected.²⁶ Some noted that the GmbH was more likely than the AG to end up in bankruptcy, although there was considerable debate over which form's creditors actually fared better. The form acquired a reputation as the bastion for swindlers, and even modern legal texts acknowledge that the GmbH is well-suited to this end. But the take-up rates we report show that this initial reputation reflected, in part, uncertainty about how the new form would actually function.

Contemporary discussion suggests that lenders were indeed leery of the GmbH, at least at first. Sometimes the firm's owners were asked to sign personal pledges to guarantee a loan to the firm. Greulich (1908, p. 236) notes that many of the largest German banks had lent to GmbHs by the time he wrote, but the borrowers he lists are

²⁵ Any feature of this type introduced by the firm was in addition to the requirement that shares be sold via a notarial contract.

²⁶ Falkenhausen and Steefel (1961, pp. 418) note that "German courts generally see their most important task in the field of company law to [be to] protect corporate creditors."

relatively large firms, and he does not say how many of them were forced to offer the additional security of owner guarantees. Some discussion argued that limited liability was fine for an enterprise with the AG's reporting requirements, but dangerous for one with no reporting requirements, such as the GmbH. Greulich argues that neither the KG nor OHG faced reporting requirements. As a result, when such firms came to bankruptcy proceedings, their creditors often learned the hard way that the owners had no real assets. He claims that the GmbH offered better protection. Many of the specific features of the law dealt with the *Stammkapital*, which legislators clearly saw as protecting creditors. Thus managers could not do anything that might reduce the *Stammkapital's* value, for example make "excessive" dividend payments to owners. If they did so, the GmbH's owners faced unlimited liability. In addition, the law applied unlimited, pro-rata liability for the unpaid portion of the *Stammkapital*. A similar rule applied to any in-kind portions of the *Stammkapital*, such as land or machinery. That is, if the GmbH was playing by the rules, its limited but clear liability was better protection for a lender than the unlimited liability of owners of a KG or OHG.²⁷

We see in the GmbH an important step that mitigates the trade-off between the threat of untimely dissolution on the one hand and minority oppression on the other.²⁸ As a legal person the GmbH did not face the dissolution threat inherent in a partnership. On the other hand, the GmbH statute permitted a wide variety of agreements concerning voting and other matters of internal governance. Minority investors who feared abuse by

²⁷ He claims that most GmbHs were in fact family firms (he guesses that of the 9000 GmbHs in Germany at the time he wrote, all but 500 or so were family firms). This is a common and plausible assertion, but again lacks firm empirical foundation. The logic of his argument is also weak: he claims that a family GmbH's failure would be devastating for the family, producing much of the incentives underlying unlimited liability. But presumably the failure of a family KG or OHG would have the same effect.

²⁸ Again, we are focusing on multi-owner firms. To the extent a GmbH was in practice a one-owner enterprise, its primary advantage over the OHG was limited liability.

the majority could simply insist on governance rules that would protect their interests being written into the articles of association.

4.b. Britain

The basic assumption underlying the General Incorporation Act of 1844, the Limited Liability Acts of 1855-1856, and the consolidating Companies Act of 1862 was that the enterprises that registered under them would be public corporations in the sense that they would raise capital from a large number of external investors. It was envisioned that investors would be matched with corporations seeking capital either formally through share markets such as the London Stock Exchange (LSE) and the provincial exchanges, or informally through newspaper advertisements, through intermediaries such as bankers, brokers, and solicitors, or through social networks. It was envisioned that a typical corporation would have hundreds of shareholders if not more, most of them passive investors, and that it would raise tens or hundreds of pounds in capital, if not more.

Over the next half century, however, increasing numbers of partnerships, family firms, and sole proprietorships were organizing as corporations.²⁹ A partnership consisting of three partners could convert into a company quite easily, for example. The newly formed company would allot four nominal members one share each. To the three real partners it would allot shares according to their original stakes in the partnership. Similarly, a sole proprietorship could convert to a company by allotting six nominal

²⁹ We still do not have reliable figures for the conversion of each of these organizational types into corporations. However contemporary sources, such as Committee Reports, court cases and legal literature document the existence of all three types of conversion.

members one share each, the proprietor retaining the rest of the shares. The often cited *Salomon v. Salomon* case dealt with such a company, Salomon Ltd., which was formed around 1895. Initially Mr. Salomon, his wife, and five of their children were issued one share for one pound each. Then Mr. Salomon sold to the new company his shoe making business (of which he was a sole proprietor) for £20,000 in shares (and a debenture). This use of the corporate form was challenged in the courts and was eventually authorized in a famous decision by the House of Lords in 1897.³⁰

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, in particular the perception that the introduction of free incorporation and general limited liability had made the swindling of external investors by company promoters both easier and more common. The *Davey* Committee was appointed in 1895 as a response to this growing criticism.³¹ Based on its recommendations, the 1900 Companies Act regulated the offering of shares to the public. The law required new companies to publish a legally binding prospectus that would provide investors with detailed information about the enterprise and subsequently to file balance sheets with their annual returns. It also restricted companies' ability to allocate shares to vendors and organizers 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.

³⁰ 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.

³¹ Parliamentary Papers, 1895 Vol. LXXXVIII (C. 7779), p. 151.

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 shares to the public or not. The law thus made the form less suitable to SMEs, and not surprisingly, led to a drop in the number of companies registered annually. 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.

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.³² 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 recommended features that were indigenously British.³³

The law

The 1907 Act created for the first time a clear distinction between public and 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”:

³² Parliamentary Papers, 1895 Vol. LXXXVIII (C. 7779), pp. 24-26.

³³ Parliamentary Papers, 1906 Vol. XLIV (Cd. 3052).

- a) restricts the right to transfer its shares; and
- b) limits the number of its members (exclusive of persons who are in the employment of the company) to fifty; and
- c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

Whereas in Germany a company became 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 Companies Act rules applied to both public and private corporations. The obvious exceptions, of course, were that private companies were exempt from the requirement to issue a prospectus and file annual balance sheets and also from the restrictions on allotment of shares that were not fully paid for in cash. In addition, the minimum number of members of a private company was reduced to two as opposed to seven for a public company. In exchange for these more lenient provisions, members of private companies had to accept restrictions on the liquidity and transferability of their shareholdings that increased their vulnerability to oppression by controlling shareholders.³⁴ These restrictions typically consisted of provisions that either required the consent of the board or of other shareholders to transfer shares or that mandated that the shares be offered to other members of the firm.

By 1907 the default voting rule under the Companies Act was one share one vote, majority wins for polls under most circumstances. The organizers of a company could opt out of this rule by including a different provision in the original articles of association, so

³⁴ The famous rule of *Foss v. Harbottle* made things worse by depriving the minority of the ability to initiate litigation on behalf of the company against directors and officers who breached their duties. *Foss v. Harbottle*, 2 Hare 461 (1843).

it was possible for minority shareholders to protect themselves by requiring supermajority votes. Alterations of the articles of association, however, required a supermajority of 75 percent, 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. By choosing the PLLC form over the partnership, therefore, the organizers of an enterprise were reducing the possibility of untimely dissolution but also assuming greater risk of minority oppression.

4.c. France

Despite ongoing discussion of the desirability of reforming France’s general incorporation law, little changed between 1867 and 1925. 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 (Doc parl 3348 Nov 1921) operating in Alsace and Lorraine, 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 the reform. Local chambers of commerce throughout France urged the passage of some

version of the legislation; all but one supported the creation of a new form of association targeting SMEs and in particular family firms. As a result, a new bill was introduced in 1921 to create Sociétés à Responsabilité Limitée.³⁵ For reasons that remain unclear, the bill lay dormant for four years 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.

The law

A SARL was created when legally valid articles of incorporation (*Statuts*) were entered in the relevant commercial register (art 12). Any enterprise that satisfied the registration requirements could become an SARL with the exception of holding companies in insurance and finance (art 2). 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 (art 3). Moreover, its tax status was that of a partnership—SARLs were not liable for corporate taxes.³⁶

As in the German case there was emphasis on reducing disclosure and on reducing 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

³⁵ 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.

³⁶ Documents Parlementaires. 1924, Annexe 712 Session of 12-16-1924 pp 691-699.

in Germany there was a minimum capital, 25000 francs, but given the low value of the franc, this constraint too was not onerous. The capital had to be divided into shares of 100 francs or more each.

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 could an 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 PLC, shares of SARLs could not be publicly traded. The French went further, however, and subjected private sales of shares to the approval of other shareholders. From 1925 to 1966 the owners of a quarter of the shares could veto any trade; in 1966 this veto power was transformed into a preemption right. Unlike the German case, if a trade was approved, the sale could be finalized without recourse to a notary.

As a general rule, shareholders in SARLs were more at risk of minority oppression than was the case for GmbHs in Germany or private companies in Britain. SARLs had to follow strict one-share-one-vote rules. They 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. Shareholders could not vote them out but instead only had recourse to litigation. Consider the case of an SARL with no dominant shareholder. Then depending on how the company's articles of association were written, the firm could either be structured like a private corporation where management could be voted out, or like a *commandite* simple where the managers could not be removed without dissolving the firm. It was not

possible to structure an SARL like a partnership where all members of the firm have equal control rights.

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 particular with respect to bankruptcy cases (1935 and 1953). In 1966, however, a major reform did away with the option of creating irrevocable managers, empowering the owners of a majority of the shares in any SARL to elect its management. Managers could now be removed, though only for cause, and the list of permissible reasons echoed the judicial standards put in place earlier in the century. Before 1966 shareholders had to litigate to remove entrenched managers; after 1966 the legal burden shifted to managers. If they were fired without sufficient cause, they could sue.

4.d. The US

In the US three waves of statutes gave firms the option of organizing either as a PLLC or a form with similar attributes. The first wave occurred during the 1870s and early 1880s—more than a decade before Germany created the GmbH—but was confined to the states of Pennsylvania, Virginia, Michigan, New Jersey, and Ohio. These states passed legislation for a type of PLLC called a “partnership association.” The second wave crested during the third quarter of the twentieth century when a much larger number of states modified their general incorporation laws so as to permit close corporations to

adopt governance provisions that mimicked the PLLC form. Finally, in the last decade and a half of the twentieth century most states passed enabling legislation for limited liability companies (LLCs), limited liability partnerships (LLPs), and other similar forms.

Partnership Associations

Pennsylvania was the first state to permit firms to organize as partnership associations. The origins of the statute are murky, but the legislation followed closely upon the heels of a debate in Pennsylvania's state constitutional convention over whether its 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 (Warren 1929). 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." Similar legislation was soon adopted in Michigan (1877), New Jersey (1880), and Ohio (1881). Virginia also passed a statute in 1874 but repealed it in 1918 (Schwartz 1965).³⁷

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

³⁷ There were minor differences in these statutes. In Ohio, for example, partnership associations could not own real estate and could not have more than 25 members. In Michigan associates were personally liable for wages to the company's workers. Pennsylvania also subsequently passed enabling legislation for another form of PLLC, the so-called registered partnership, whose provisions were even more liberal (L.I.M. 1933; Stransky 1956; Matthews 1957). Pennsylvania repealed its partnership association statute in 1970. New Jersey prohibited the formation of any new partnership associations after 1988 (Gazur and Goff 1991).

(which could not exceed twenty years), the names of its members, the amount of capital subscribed by each member, and the names of the officers of the association. Any subsequent changes to these arrangements also had to be registered.³⁸ 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.³⁹ This advantage over ordinary partnerships, however, came at the cost of an increased danger of minority oppression. The association was governed by an annually elected board of managers, including a chairman, a treasurer, and a secretary (the latter two offices could be combined), of three to five members elected annually.⁴⁰ The voting rules for these elections were not specified in the initial Pennsylvania legislation, but an 1895 amendment reduced the power of minority shareholders by specifying that managers were to be elected by a majority in value of interest (with proxy votes allowed). The same amendment indicated, however, that changes to the bylaws required a majority of the members in number as well as in value of interest. A Michigan amendment in 1905 advantaged minority shareholders by requiring cumulative voting in elections for managers (Stransky 1956).

Minority shareholders had the ability to exit the firm if they disagreed with the actions of the majority. Shares in partnership associations were transferable “under such

³⁸ In New Jersey, partnership associations had to maintain a subscription book showing the amounts paid in that was open to the inspection of creditors (Stransky 1956). An 1876 amendment to the Pennsylvania act made it possible for members to contribute capital in the form of real or personal estate “at a valuation to be approved by all the members subscribing to the capital” so long as this information was registered along with the other required information. New Jersey had a similar provision.

³⁹ An 1895 amendment to the Pennsylvania law specified that the term of an association could be renewed for a period not to exceed twenty years if so desired by a majority of the associates in number and value of interest. Members not desiring to continue in the business were entitled to receive their interest “at a price and upon terms to be mutually agreed upon” or else determined by an appraiser appointed by the county’s Court of Common Pleas.

⁴⁰ The maximum size of the board was increased to nine in an 1895 amendment, with the number determined by majority vote of the members in number and value of interest.

rules and regulations as the association may prescribe,” but individuals who inherited or 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. An 1885 amendment to the Pennsylvania law made this rule the default in the absence of other “rules and regulations” governing the transfer of shares. 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.

Minority shareholders were also protected by a provision of the law that made it illegal for any association to “loan its credit, its name or its capital to any member of said association.” Any such loans to outsiders required the approval of a majority of the members both in number and value of interest. An 1889 amendment to the Pennsylvania law put some additional limits on 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.” This provision, of course, also protected creditors, as did the rule in the original legislation specifying that managers would be personally liable for any dividends they voted for that impaired the association’s capital.

Close Corporations

Over the course of the nineteenth and early twentieth centuries general incorporations statutes evolved in the US in ways that increased the vulnerability of minority shareholders to oppression. Not only was there a convergence toward one-vote-per-share governance rules, but toward rules that made simple majorities sufficient for all

corporate purposes, including amendments to the articles of association or resolutions that effectively disposed of all the assets of the enterprise. The result, as one legal writer put it, was to place the individual stockholder “in the position of holding a ‘pig-in-a-poke’”—to make him or her “more dependent with each new statute upon the desires of the management and the majority which often is only another name for the management” (Rutledge 1937; see also Berle and Means 1933; Carney 1980; Dunlavy 2004).⁴¹

Although incorporators might write into their agreements provisions that bolstered the power of minority shareholders, the courts were reluctant to enforce any such provisions that conflicted with statutory prescriptions. For example, there was a high probability that agreements that aimed to protect minority interests by requiring shareholders’ unanimity (or even a supermajority vote) for corporate decisions would be overturned by the courts (Hornstein 1950 and 1953; Cary 1953; O’Neal 1953, 1958, and 1965; Gower 1956; Dickinson 1984). For example, in 1945 the New York State Court of Appeals struck down a corporate bylaw requiring stockholders’ unanimous consent for the election of directors on the grounds that “the State, granting to individuals the privilege of limiting their individual liabilities for business debts by forming themselves into an entity separate and distinct from the persons who own it, demands in turn that the entity take a prescribed form and conduct itself, procedurally, according to fixed rules” (*Benintendi v. Kenton Hotel*, 294 NY 112, 118 [1945]).⁴²

⁴¹ There were some counter tendencies, the most important of which was cumulative voting for directors.

⁴² As Dickinson (1984) has pointed out, there were contrary decisions, most notably *Clark v. Dodge* (269 NY 410 [1935]) which articulated the view that a contract among stockholders that deviated from statutory norms might be upheld so long as it “damaged nobody.” But the important point is that such contracts were surrounded by a great deal of legal uncertainty, as the same court’s later decision in *Benintendi* underscored.

This decision marked something of a turning point, however, for the New York legislature responded to the case by passing a law granting stockholders liberty to set high voting and quorum requirements for corporate decisions. Over the next decade there was a sprinkling of cases in which judges showed “a somewhat greater readiness than formerly to treat close corporations differently from publicly held corporations,” to use the words of F. Hodge O’Neal (1958, Vol. 1, p. 31), the foremost legal scholar of the problem. A more 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 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” (O’Neal 1965 and 1978). 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 (Dickinson 1984). Still others modified their general incorporation laws in ways that increased the flexibility of the form and/or gave judges greater power to intervene in, and even dissolve, closely held corporations in which there were problems of internal dissension or minority oppression (O’Neal 1965 and 1978). Nonetheless, as late as the

1980s legal scholars were still voicing the opinion that much more needed to be done in the US to free “close corporations from the restraints of rigid corporate norms,” to give members of these firms more flexibility to intermix attributes of both the partnership and corporate forms in organizing their enterprises (Dickinson 1984; see also Hillman 1982; von Sternberg 1982).

LLCs, LLPs and beyond

After World War II the increasingly burdensome character of the income tax played a greater role in determining business people’s organizational choices, pushing them to adopt forms that they otherwise would have considered suboptimal and encouraging them as a consequence to agitate for changes in the laws governing organizational forms. Initially, tax rates favored corporations. 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 (Brownlee 1996). Not surprisingly, during this period business people increasingly chose to organize their enterprises as corporations rather than partnerships (Carter et al. 2006, Table Ch1-18). Moreover, it was during this period that states made the greatest efforts to modify their laws to make the corporate form more suitable for SMEs.

Legislation during Ronald Reagan's presidency reversed this situation, 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 (Petska and Wilson 1994; Petska 1996).

The changes in the tax law did, however, foster the 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 (Gazur and Goff 1991). A second wave of statutes for Limited Liability Partnerships (LLPs) quickly followed.⁴³ The latter laws permitted all members of an ordinary partnership to limit their liability for their firm's future debts simply by filing appropriate notice.

Although LLCs and LLPs are in many respects similar, the two forms differ in the way they trade off untimely dissolution and minority oppression. LLPs are more like

⁴³ 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 Stover and Hamill (1999).

partnerships in the sense that members can easily exit at will. LLCs are more like close corporations: Except where the firm's governing agreement explicitly provides for exit, members are stuck unless internal dissension or oppression becomes severe enough to secure the intervention of the courts (Miller 1994; Bishop 1995; Ribstein 1996; Stover and Hamill 1999). Nonetheless, despite these restrictions, the forms greatly increased the contractual choices available to business people in the US. Moreover, other 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 complete contractual freedom in organizing their enterprises. The legislation did not even specify any default provisions (Hansmann, Kraakman, and Squire 2006).

5. Patterns of Diffusion.

Insight into the motives that led business people to organize their firms as private limited liability companies can be gained by investigating the forms that the PLLC displaced. In France and Germany all firms created under the commercial code were required to file information about their articles of association with a local authority, and this registration data enables us to track firms' organizational choices over time. For Britain we can only observe the relative numbers of enterprises that organized as private versus public companies, but by making some reasonable assumptions about the proportion of partnerships in the economy we can obtain an estimate of the effect of the PLLC on the popularity of the partnership form. There are no similar data on registrations for the US, but statistics compiled by the Internal Revenue Service provide

at least a crude sense of how the stock of different organizational forms in the economy changed in the second half of the twentieth century.

We begin with Germany because it was the first to enact a special PLLC statute. Figure 2 reports the number of new firms that registered in Prussia at five-year intervals, starting with 1867. In its first decade the GmbH's popularity grew slowly, 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 Figure 1 shows, the pattern for France was somewhat different with SARLs very quickly accounting for the vast majority of new enterprises once the form became available in 1925. Similarly, in Britain the private limited company form almost immediately established its popularity (Figure 3), at least relative to the public corporation.

In order to compare the experience of these three countries with each other, we must adopt a uniform time frame and correct for differences in the type of data to which we have access. Measuring from the year in which the initial enabling legislation for PLLCs was passed, we use two different standards of comparison. The first is the share of all joint-stock firms that chose the PLLC form, where we count as joint-stock firms all corporations, limited partnerships with tradable shares, and, of course, PLLCs. The second is the share of all multi-owner firms that chose to organize as PLLCs.⁴⁴

Figure 4 shows that, according to our first measure, the Prussian, British and French patterns all look rather similar. After the passage of enabling legislation, an overwhelming fraction of new joint-stock firms in all three countries organized as PLLCs. Nevertheless, as the comparison with all multi-owner firms in France and

⁴⁴ For this measure we define all firms that were not sole proprietorships as multi-owner enterprises. We recognize, however, that there were PLLCs and corporations that for all practical purposes had only one owner.

Prussia suggests (Figure 5), this similarity hides substantial differences among these countries.

In Germany the GmbH had little effect on the proportion of new firms organized as corporations and instead 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 (see Figure 2). By contrast, the advent of the GmbH had little effect on the *Kommandit*, which remained a reasonably constant 8 percent share of all registrations. It also had little effect on the formation of AGs. Both before and after the 1892 legislation corporations were extremely rare; only about 20 were formed in Prussia each January between 1872 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 organize as corporations. 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 rather than bear the costs associated with forming an AG.⁴⁵ Analysis of employment patterns from the 1907 census of firms and occupations bears out this argument. Corporations were rare; they accounted for only .3 percent of all firms and 7 percent of multi-owner firms. But AGs employed more than 12 percent of the workforce; their average firm size of 180 workers dwarfed the GmbH, at about 49 workers per firm.⁴⁶

After the enactment of general incorporation, the costs of organizing a corporation in France were much lower than in Germany and relatively more corporations were

⁴⁵ Few AGs converted to GmbHs. Once a firm had born the costs of organizing as an AG, it probably did not make much sense to give up the form.

⁴⁶ The source is Passow (1911), which relies on extracts from the 1907 census of firms and occupations.

formed. Each year between 1867 and 1914 the French created between two and four times as many SAs as Prussians formed AGs. Perhaps it is not surprising, therefore, that the enactment of enabling legislation for SARLs significantly reduced the number of corporations formed in France (see Figure 1). At the same time, business people all but abandoned the two limited partnership forms. Although they had accounted for about 10 percent of all registrations in the immediate post-World War I period, after 1925 limited partnerships rarely amounted to more than 2.5 percent of new registrations. Partnerships experienced an equally dramatic collapse, with registrations falling 90 percent by the mid 1930s.

The corporate form was even more popular in Britain than in France before the advent of the PLLC. According to the Davey Committee, in 1894 the capital of companies registered in the UK (£1,035,029,835) was more than double that in France (£420,000,000 including both SAs and *commandites*) and from three to five times that in Germany (estimates arranged between £200,000,000 and £300,000,000).⁴⁷ Between 1900 and 1908, moreover, there were five British corporations registered for every French one. And it was in Britain that the PLLC had the most dramatic effect on the number of corporations. The number of new firms that organized as corporations plummeted from more than 4000 per year before the 1907 law to less than 600 per year in 1921. 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. 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 in Great Britain, the number of

⁴⁷ Davey Committee Report, p. vi.

partnerships formed annually in Britain should have been about 5,000 in 1908.⁴⁸ If we attribute all of the increase in the total number of new registered companies between 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.⁴⁹ 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.⁵⁰ In Britain the PLLC seems mainly to have displaced corporations.⁵¹

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 substantially after the PLLC became available.

⁴⁸ In order to show that the private limited company statute had little effect on partnerships, we need to minimize our estimate of the number of partnerships in Britain. The US Census of Manufactures reports that 62% of all multi-owner firms were partnerships in 1900 (US Census 1905, vol. 8, Table VIII, p. liv). This is a stock figure and partnerships share in new formation was likely to be quite a bit higher because they had a short life span relative to corporations. Therefore, 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.

⁴⁹ 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.

⁵⁰ 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%.

⁵¹ Britain also passed an enabling law for limited partnerships in 1907, but few businesses organized under that statute.

In the US, however, the situation was dramatically different. Although there were as many or more corporations per capita in the US as in Britain, business people displayed little interest in the early PLLCs made possible by the partnership association laws of Pennsylvania, Virginia, Michigan, New Jersey, and Ohio. Admittedly, some important firms 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 (Schwartz 1965). 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 (L.I.M. 1933; Stransky 1956; Matthews 1957; Schwartz 1965), but these efforts seem to have had little effect. 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 (Stransky 1956).⁵² Another author surveyed lawyers practicing in Pennsylvania in the mid 1950s and found that they rarely advised their clients to organize partnership associations (Matthews 1957).⁵³

⁵² Nearly half of 50 partnership associations organized in Essex County in 1954 were in real estate (Stransky 1956).

⁵³ Of course, by this period tax incentives mattered. In most cases, partnership associations were taxed as corporations (L.I.M. 1933; Stransky 1956; Matthews 1957).

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 1980 (Carter et al. 2006, Table Ch1-18). 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 LLCs in the US. By 1997 the number was nearly 350,000, and by 2002 it exceeded 946,000.⁵⁴ 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 other types of limited partnerships held steady at about 5 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

⁵⁴ Other kinds of limited partnerships also increased during this period, but not nearly so steeply. Their numbers rose from 275,000 in 1993 to 377,000 in 2002. Recent figures on business organizational forms come from various issues of the *SOI Bulletin*, published by the IRS. For earlier figures, see Carter et al. 2006, Table Ch193-204.

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.

6. Law, Economics, and the PLLC

The history of the PLLC does not support a neat division of the world into countries with common-law versus code-based legal regimes. Germany, a code country, was the first mover, though German firms were relatively slow to take advantage of the new form after it was introduced in 1892. The next country to adopt the PLLC (in 1907) was the UK, a common-law country. British business people rapidly substituted the PLLC for the corporation, but partnerships remained a popular organizational form. France, a code country, followed in 1925, and the PLLC quickly became the form of choice, displacing both partnerships and corporations as well as other forms such as limited partnerships. Similarly, in the common-law US, once businesses finally obtained the equivalent of the PLLC in the second half of the twentieth century, they seem to have adopted it to the virtual exclusion of all non-joint-stock forms of organization.

Much of the variation across countries in the timing of the innovation owed to events and path-dependent process that were specific to each case. The German reforms of 1884, themselves a reaction to the *Gründerboom* of 1871-73, made the corporation so unattractive to all but the largest firms that it stimulated a movement to provide SMEs with an alternative. In Britain liberal general incorporation laws made the corporate increasingly attractive to SMEs. The restrictive 1900 Companies Act, a response to worries about abuses by large public companies, generated demands for a form more

suitable to businesses that did not intend to sell their equities publicly. In France, the story was very different. The recovery of Alsace and Lorraine from Germany brought into France firms that were organized as GmbHs and unwilling to give up the advantages of the form. In the US it is likely that relative tax rates encouraged firms to incorporate and also, as a result, to push for changes that would make the corporate form more suitable for their businesses.

We are less concerned here with the timing of the innovation than with understanding the different patterns across our countries of the diffusion of the PLLC after the form was enacted. The evidence we have presented suggests, first of all, that the menu of forms available before the advent of the PLLC played an important role in determining its impact. In particular, the take-up of the PLLC seems to have been affected by the relative cost (including the burden of conforming to regulatory requirements) of forming a corporation. Figures 7 and 8 diagram the argument. Both figures are based on the assumption that partnerships are most appropriate for firms with only two members and that, as the number of partners increases, the costs associated with the risk of untimely dissolution increase. Figure 7 is drawn to capture the idea that corporations (like AGs in Germany) are so costly to organize that the form will be used only by firms with large numbers of members (in the drawing more than six). As a result, the PLLC will displace relatively few corporations once it becomes available. In Figure 8, by contrast, the corporation as drawn is relatively inexpensive to form (as it was France or even more so in Britain before the 1900 act). As a result, it will be adopted by

relatively smaller firms (in the drawing those with more than four members), and more corporations will be displaced by the PLLC.⁵⁵

Our evidence suggests that diffusion patterns were also shaped by differences across our four countries in the organizational flexibility that the various enabling statutes granted to PLLCs. A good example is the effect that the GmbH had on the KG compared to the SARL on the *commandite* simple. Managers who had only a minority stake in the enterprise had to worry about whether they would be pushed out by dominant shareholders. For such managers in a KG, the GmbH had relatively little appeal because shareholders in a GmbH could dismiss a manager at “whim.” By contrast, managers in a similar position in a *commandite* simple could entrench themselves in an SARL by registering their names along with the firm’s articles of association. As a consequence, 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. The greater contractual flexibility of the SARL allowed organizers to choose whether or not to protect managers who were minority owners, whereas GmbH contracts that entrenched particular managers were not enforceable.

One would expect that the more contractual flexibility the PLLC granted organizers, the more it would displace alternative forms, leading to an economy where all but the largest and smallest enterprises took the PLLC form. France quickly moved to such a distribution of organization forms after 1925, as (it seems) did the US during the second half of the twentieth century. In both Germany and Britain, however, partnerships held on much longer. Although it is possible that this difference can be explained by

⁵⁵ Several discussions of the GmbH argue that its lack of reporting requirements made it attractive to firms in innovative industries where financial statements might convey information to competitors. Passow (1911)’s summary suggests an avenue for future research: the GmbH was most important, as a fraction of all firms, in the chemical industry.

restrictions in the PLLC form, it is also possible that the persistence of partnerships in these countries owed to relative tax rates, to features of the financial or bankruptcy systems that lessened the advantages of limited liability, or to other factors as yet unknown. Understanding these patterns more fully is a goal for future research.

Also for future research is understanding why the early form of PLLC that was introduced by Pennsylvania, Michigan, New Jersey, Ohio, and Virginia in the 1870s and early 1880s never took off. At this point, it seems likely that the spread of the innovation was limited by two features of the American legal system: the precedent-base nature of the common law; and federalism. Because precedents are so important in deciding court cases, business people hesitate to adopt new business forms until there is a substantial body of case law establishing the extent to which and how essential contractual provisions will be enforced. But a substantial body of case law cannot be amassed unless businesses first experiment with the form.⁵⁶ This “Catch 22” situation makes it difficult to introduce new organizational forms in common-law countries. In the US, moreover, this basic conservative tendency was exacerbated by 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 (Stransky 1956; Warren 1929). British companies, of course, were spared the

⁵⁶ According to Stransky (1956, p. 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.”

uncertainties of federalism, but they could not escape the conservatism of the common law. It is likely, however, the 1907 enabling 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 imposed to prevent abuses by companies whose shares were publicly traded. Businesses that organized as private limited companies still benefited from over a half century or more of case law on corporations. By contrast, few firms took advantage of another 1907 law permitting limited partnerships, most likely because there was no similar build up of precedents.

7. Conclusions

Most studies of organizational form 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 paper, 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 paper is devoted to tracing its emergence and diffusion first in Germany, then in Britain and France, and finally in the United States.

In the process we have not only challenged 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 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. Before that, it seems, the reliance of the common law on precedent, in combination with the peculiarities of federalism, constrained legal innovation. As a result, US businesses were long forced to make do with a much more limited set of organizational options than their European counterparts.

Our ability to move beyond the conventional narrative of US advantage and corporate supremacy required us to pursue a specific method of research in which we simultaneously extended the theory of the firm, reconstructed the history of commercial law in the four countries under study, and documented how business people in these countries responded to specific legal changes. As we have shown, no history of a single country, whether it be the US or France or Britain or Germany, is sufficient to capture the full picture of legal innovation. Nor is it enough simply to record the details of the legal rules without looking at how businesses actually made use of them. Given the richness of

the data and the variety of the legal record, moreover, a theoretical structure is necessary to guide the overall project. The current theory of the firm, based as it is on late-twentieth-century American law, cannot explain the process of legal change and the distribution of organizational forms over the past two hundred years. Hence we have had to sketch an alternative view in which partnerships and corporations each have important disadvantages which firms seek to contract around.

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 gain a clearer sense of what types of businesses were most likely to be disadvantaged by a more 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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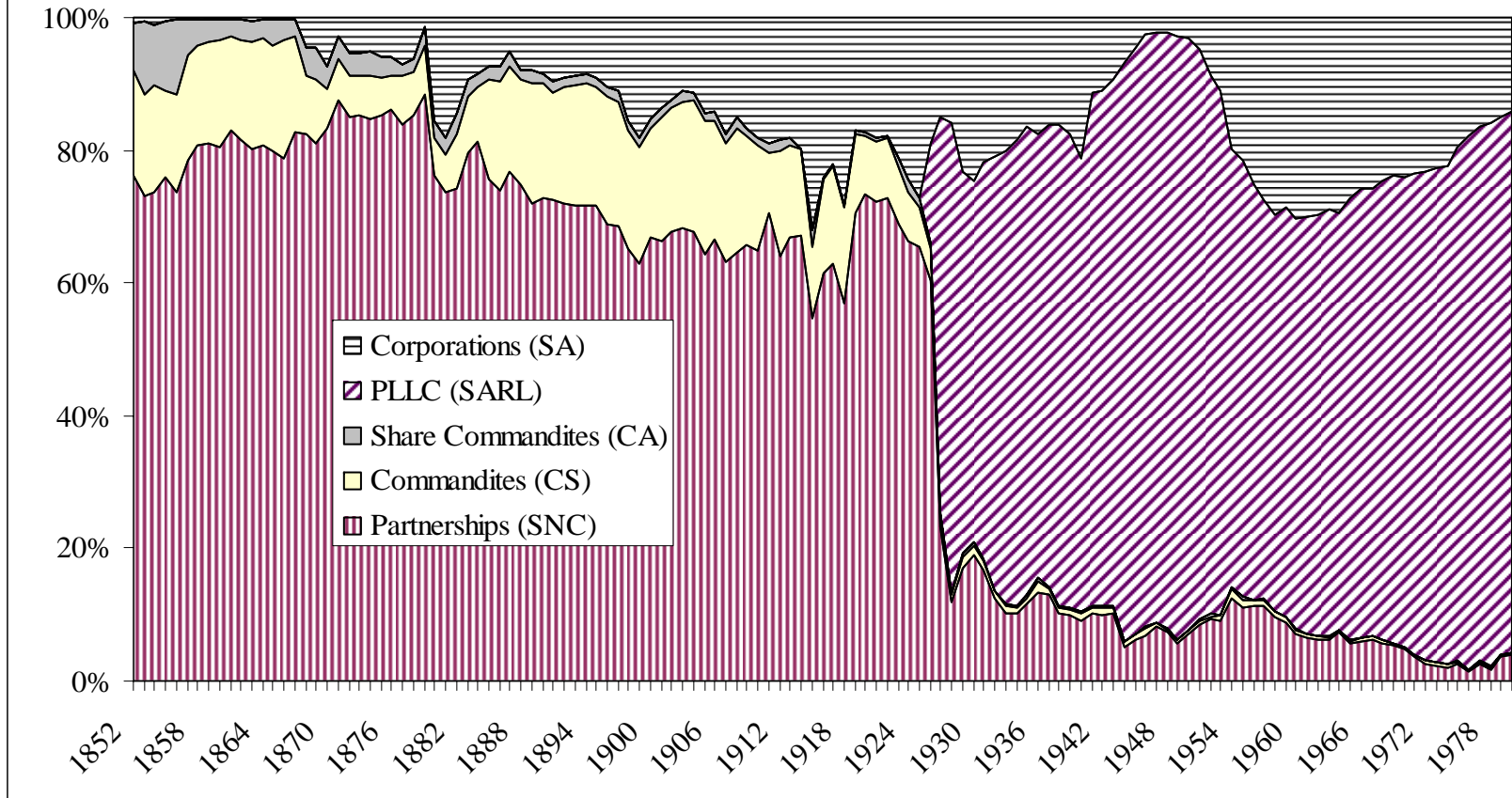
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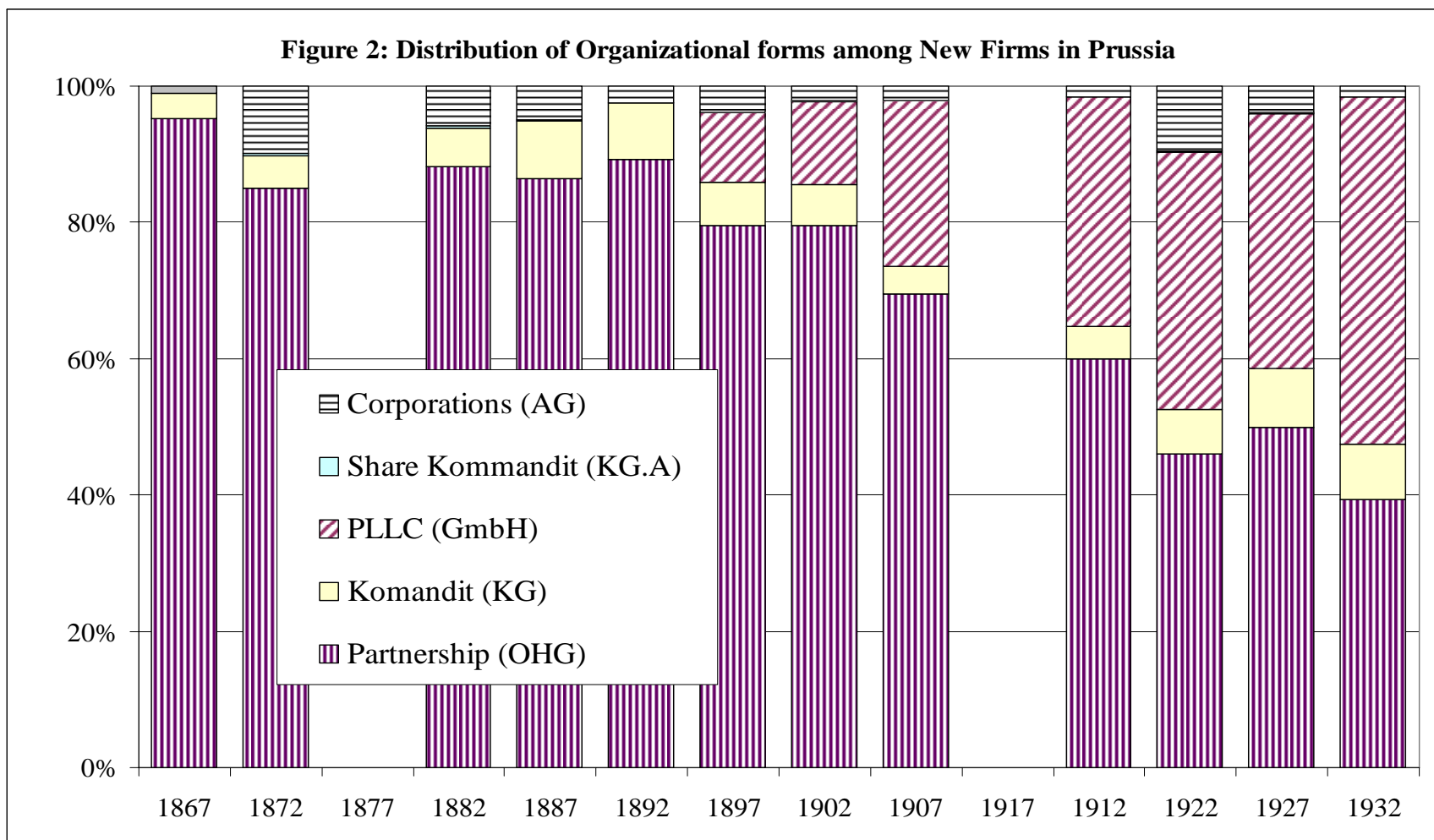
Figure 1: Distribution of Organizational Forms among New Multi-Owner Firms in France



Source: Annuaire de la Justice,

Note: 1914-1918 was interpolated using total for Paris collected at the Archives de Paris

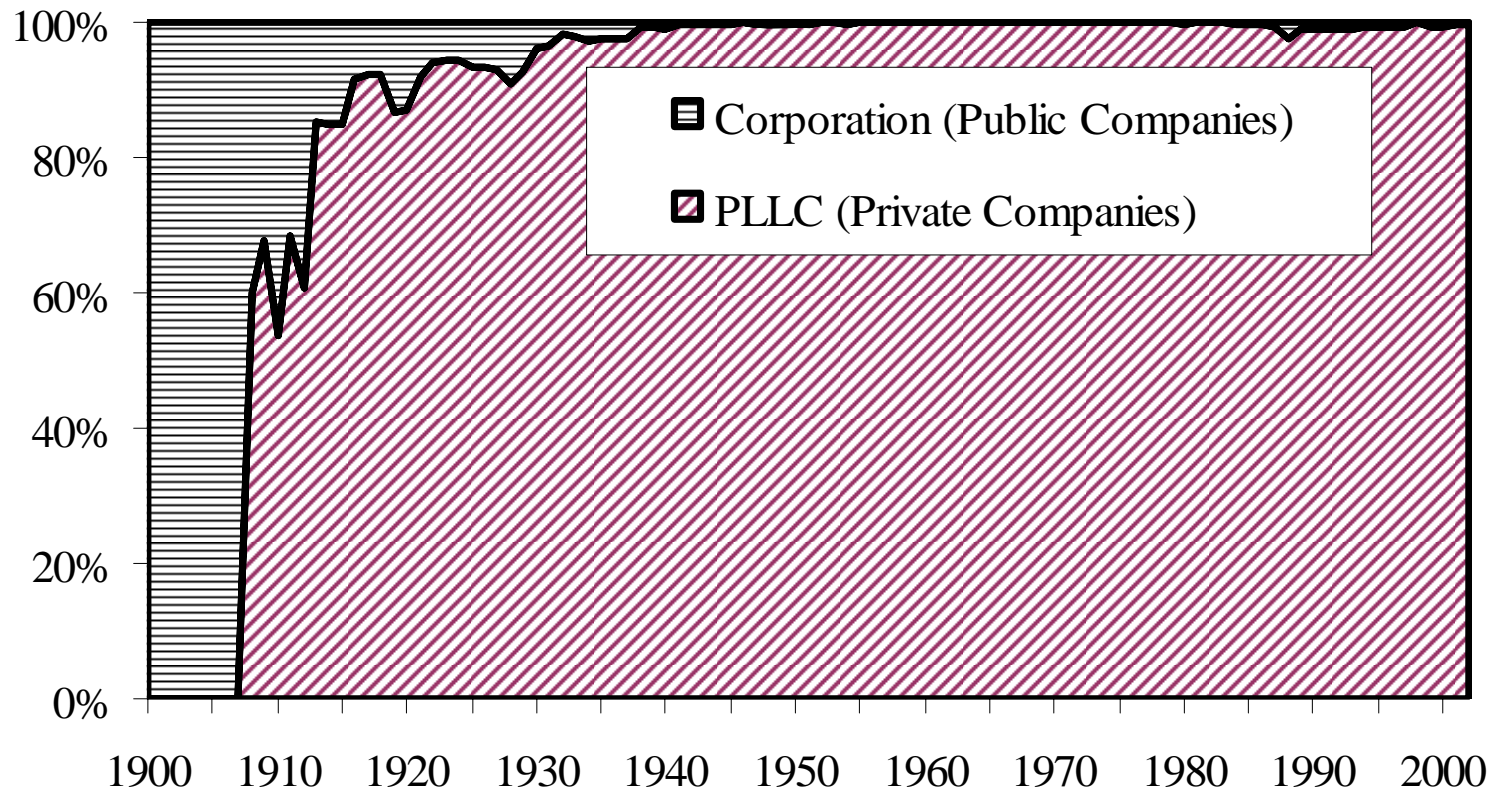
Figure 2: Distribution of Organizational forms among New Firms in Prussia



Source: Anzeiger

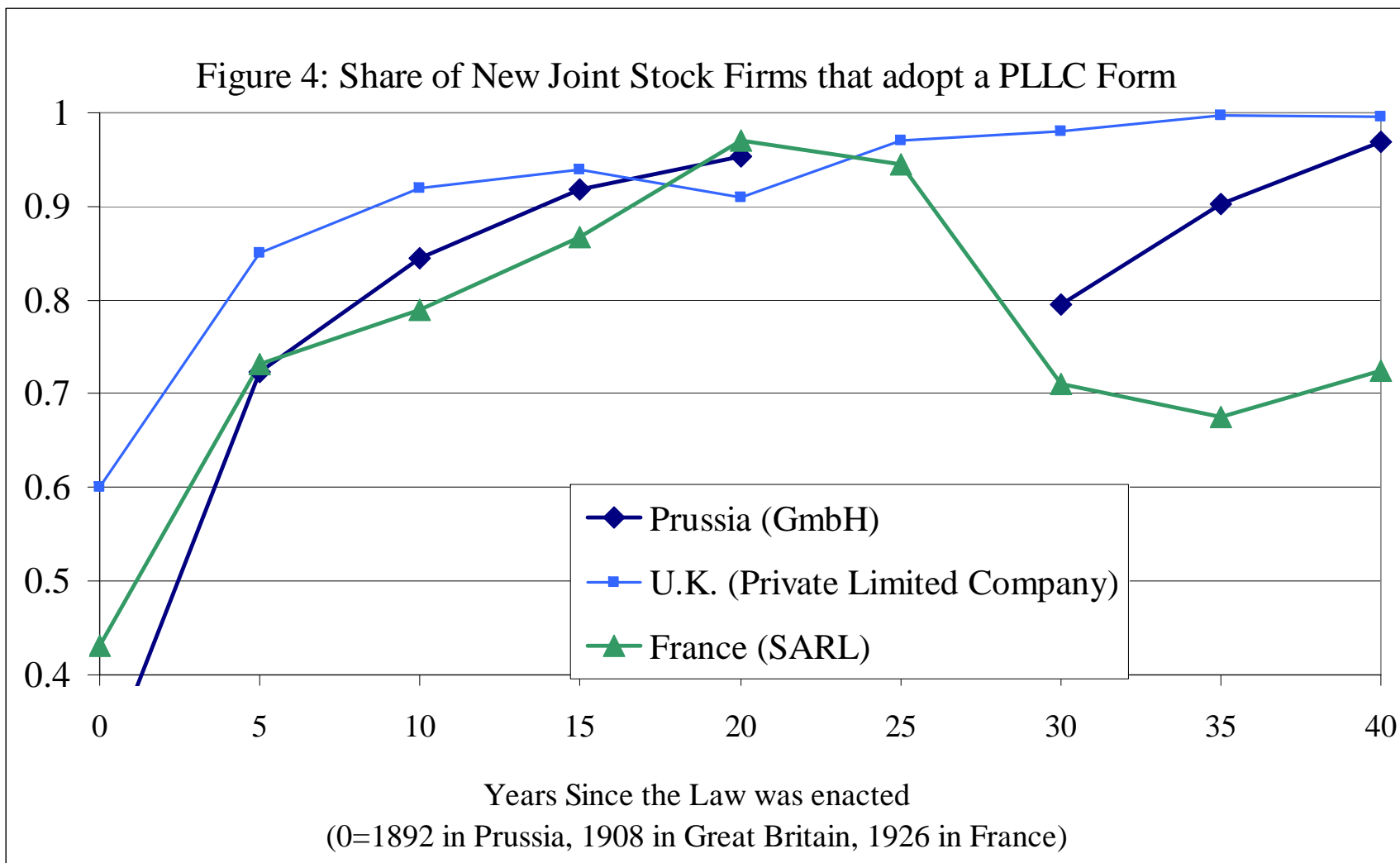
Note: proportions are derived from counting all the firms that registered in January of the relevant years

Figure 3: Distribution of Organizational forms among New Firms in Great Britain



Source:
Note:

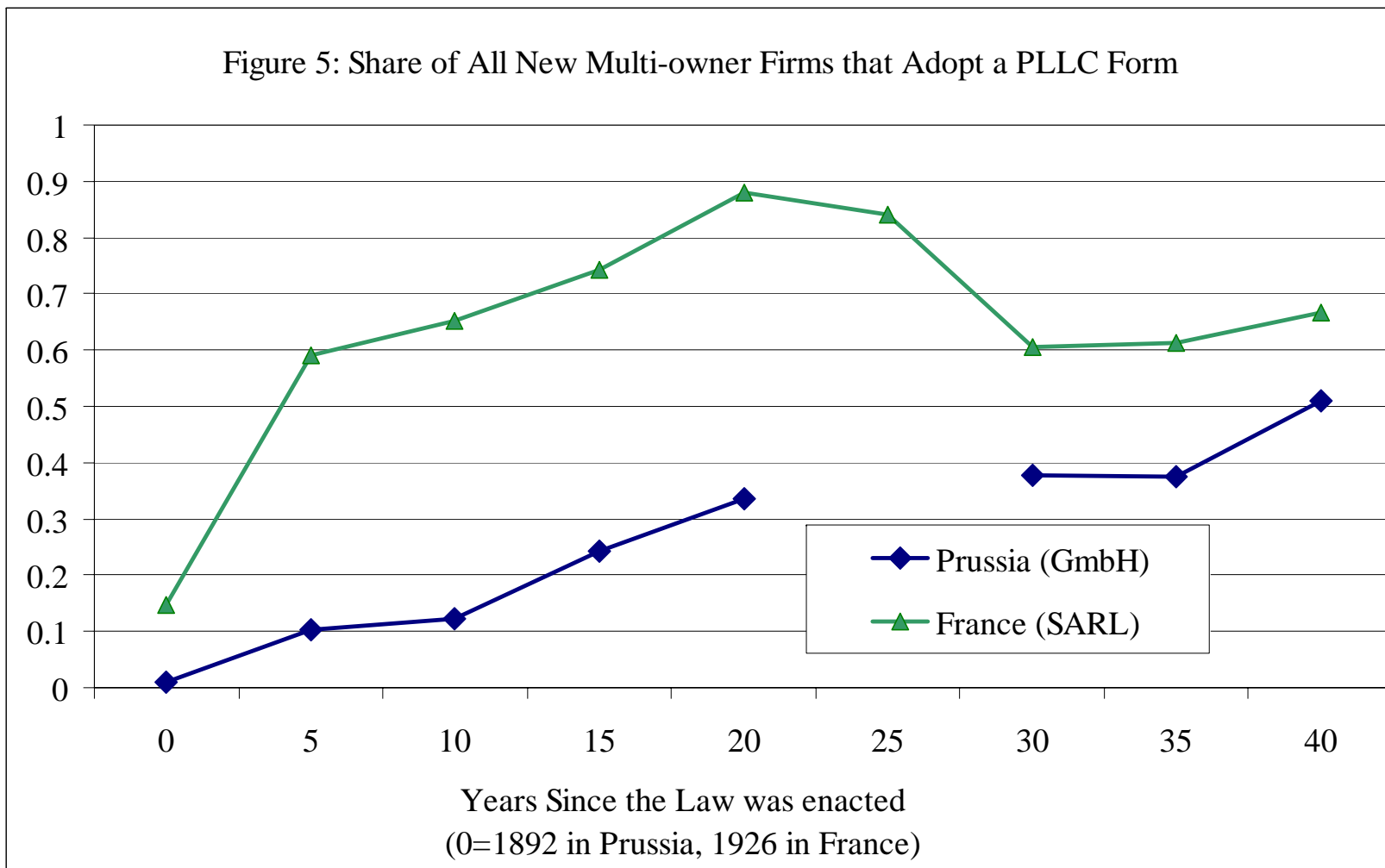
Figure 4: Share of New Joint Stock Firms that adopt a PLLC Form



Source: See Figures 1-3

Note

Figure 5: Share of All New Multi-owner Firms that Adopt a PLLC Form



Source: See Figures 1-3

Note

Figure 6: Impact of PLLC innovation when incorporation is cheap

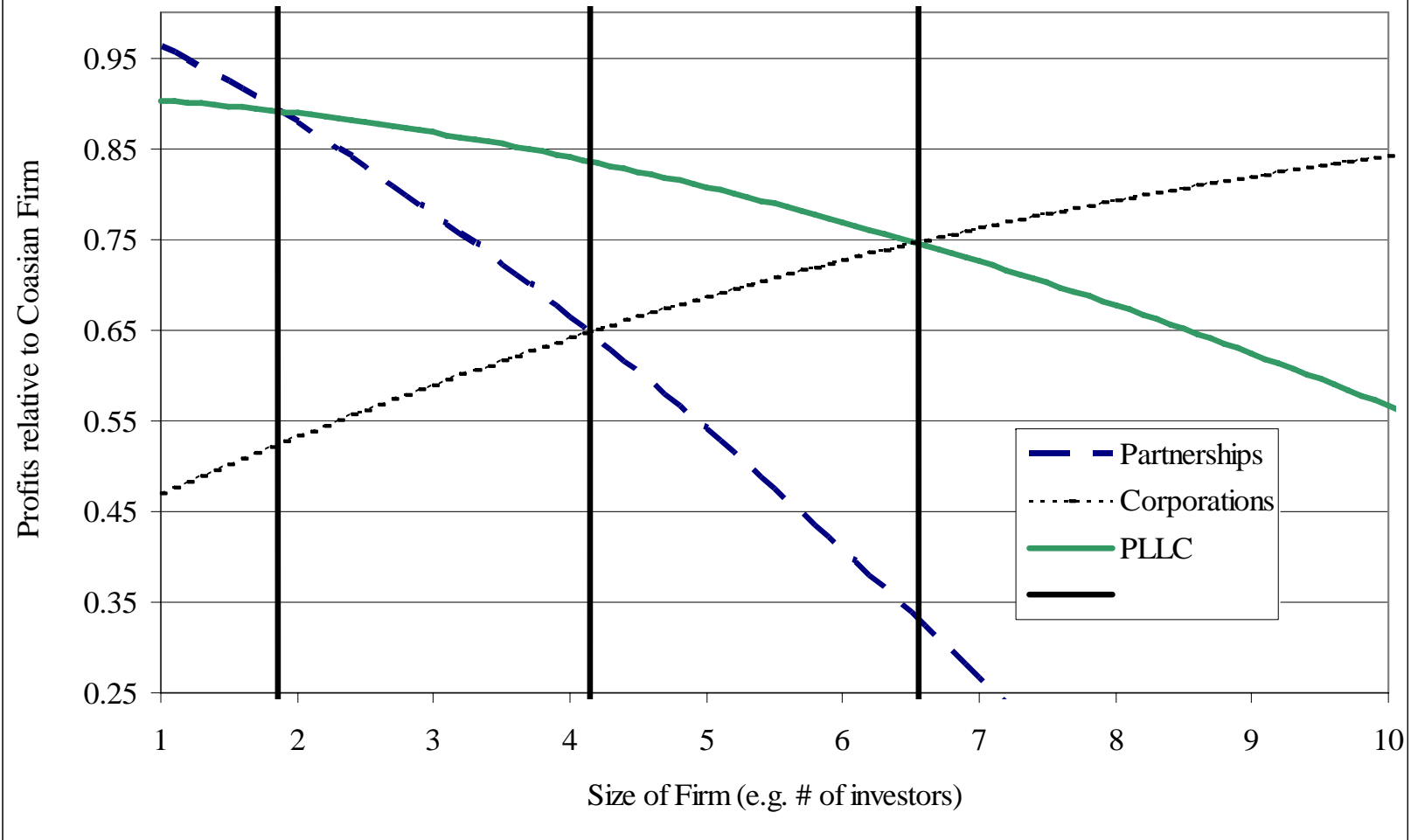
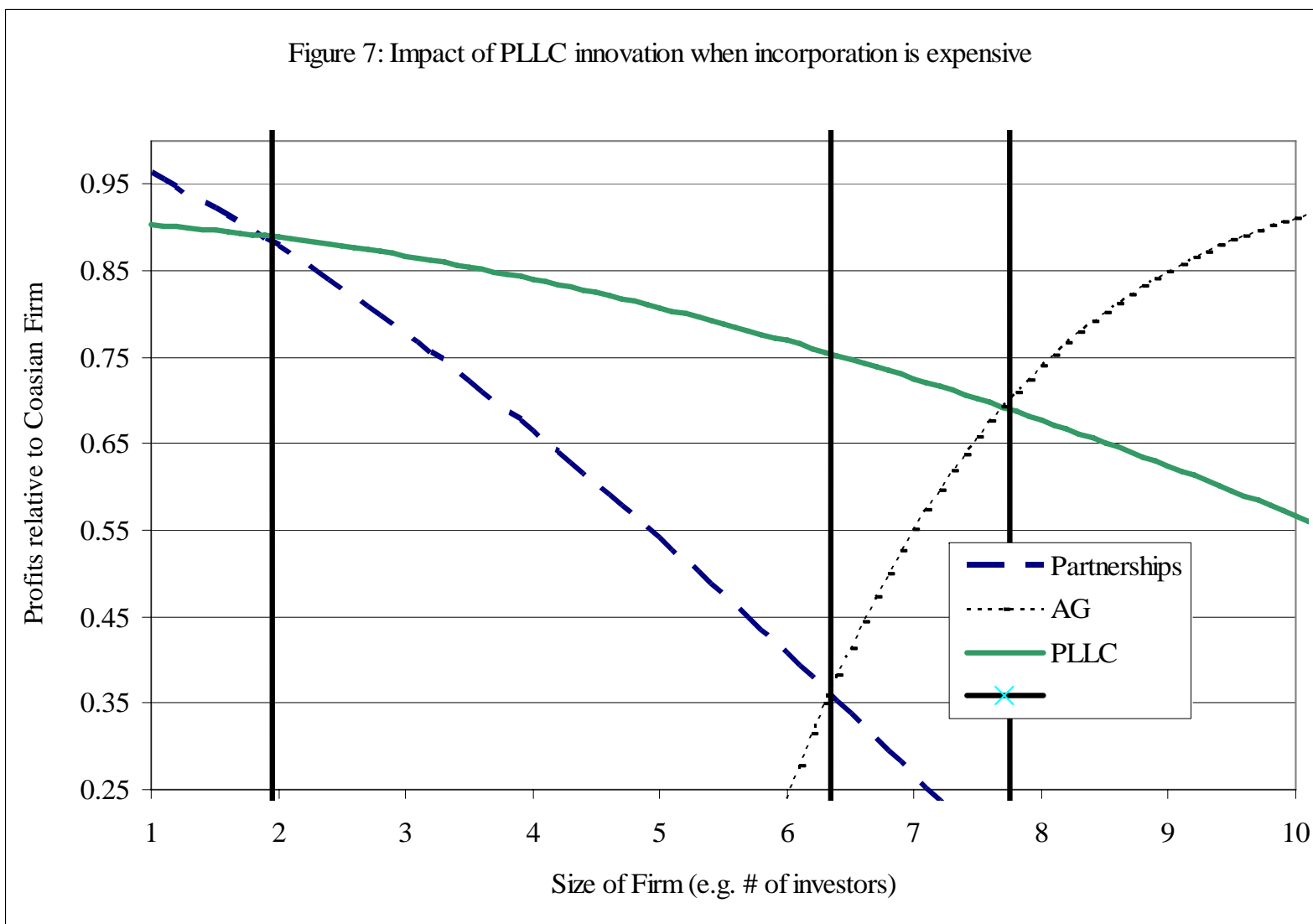


Figure 7: Impact of PLLC innovation when incorporation is expensive



Appendix table: summary of terminology and abbreviations

<u>Abbreviation</u>	<u>Country</u>	<u>Form</u>	<u>Full name</u>
AG	Germany	Corporation	Aktiengesellschaft
Commandite simple	France	Limited partnership	Société en commandite
Commandite par action	France	Limited partnership with tradable shares	Société en commandite par action
GmbH	Germany	Private limited company	Gesellschaft mit beschränkter Haftung
Kommandit	Germany	Limited partnership	Kommanditgesellschaft
KaA	Germany	Limited partnership with tradable shares	Kommanditgesellschaft auf Aktien
OHG	Germany	Ordinary partnership	Offene Handelsgesellschaft
PA	US (some states)	Private limited company	Partnership association
PLLC	United Kingdom	Private limited company	Private limited company
PLLC	Umbrella term for private limited companies, that is, UK's PLLC, GmbH, and SARL		
SA	France	Corporation	Société anonyme
SARL	France	Private limited company	Société á Responsabilité Limitée