

## ENTITY SHIELDING AND THE DEVELOPMENT OF BUSINESS FORMS: A COMPARATIVE PERSPECTIVE

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Responding to Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333 (2006).

The great contribution of this article, along with Henry Hansmann and Reinier Kraakman's previous work,<sup>1</sup> is to shift the focus of scholarship on the law of business forms from its preoccupation with "owner shielding" to what the authors call "entity shielding." Scholars have generally assumed that the most important advance in the organization of business enterprises has been the development of forms that grant all members of a firm limited liability, thus enabling them to protect their personal assets from claims against the enterprise. Hansmann, Kraakman, and Squire (hereafter HKS) argue, to the contrary, that the more significant development has been the emergence of forms that protect the assets of the enterprise from claims against the firm's individual owners.

The bulk of the article is devoted to tracing the glacial history of the emergence of strong entity shielding, starting in ancient Rome and climaxing in the late-twentieth-century United States. HKS emphasize that entity shielding entails costs, the most important of which is the ability of those in control of the firm to behave opportunistically toward creditors and minority owners.<sup>2</sup> Because of these costs, entity shielding was a long time coming. Other developments had to occur first to make it easier to protect the interests of noncontrolling shareholders and outside creditors: "[T]he new sources of protection appear to have been better information about firms, superior accounting and valuation methods, and greater sophistication of courts in arbitrating internal firm disputes."<sup>3</sup> In particular, HKS single out a number of changes that occurred in the United States in the twentieth century, such as the adoption of the corporate income tax in 1913, the promulgation of new disclosure rules by both stock exchanges and the gov-

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<sup>1</sup> See especially Henry Hansmann and Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000).

<sup>2</sup> Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1351 (2006).

<sup>3</sup> *Id.* at 1397.

ernment, the growing use of credit reporting agencies, and the expansion of judicial and statutory devices for protecting equity investors.<sup>4</sup>

One can argue, without doing too much violence to the subtleties of HKS's account, that the model that underlies their narrative is driven largely by increases in the skill levels of accountants, lawyers, and judges. But were these improvements in accounting practices, information flows, and judicial capabilities really exogenous causes that made the provision of entity shielding feasible? Or were they endogenous responses to the growing use by businesses of forms that entailed strong entity shielding? Or did these developments to a large extent occur independently? These kinds of questions are notoriously difficult to resolve, but comparative history can be a useful tool for sorting out causal relationships. HKS make a promising start in this direction — the first half of their account covers an impressive range of history, from ancient Rome to medieval Italy to early modern England — but when they get to the modern period they unaccountably narrow their focus to England and (especially) the United States.

This response will offer a broader comparative perspective on the development of business forms with strong entity shielding. There are two problems with HKS's thesis that derive from their narrow focus on specific periods of English and U.S. history. First, although England may have paved the way for the United States in the development of joint stock companies, it was far from the most innovative legal system in Europe between 1650 and 1825. Indeed, for much of this time England was still playing catch up to the Continent. Second, forms that offered strong entity shielding to small and medium enterprises (hereafter SMEs) without the costs attendant on incorporation emerged much earlier in Germany, Britain, France, and many other countries than in the United States. Large numbers of businesses adopted these forms before the accounting systems and judicial capabilities that HKS claim were so critical had developed.

One form that offered somewhat stronger entity shielding than the ordinary partnership was the limited partnership. Under the Napoleonic Code, which shaped enterprise law across Continental Europe and Latin America, businesses could organize as limited partnerships (*commandites*) as well as ordinary partnerships.<sup>5</sup> Limited partnerships

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<sup>4</sup> *Id.* at 1397–98.

<sup>5</sup> Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Legal Regime and Contractual Flexibility: A Comparison of Business's Organizational Choices in France and the United States During the Era of Industrialization*, 7 AM. L. & ECON. REV. 28, 33 (2005); Timothy Guinnane, Ron Harris, Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Business Organization in the Long Run: Private Limited Companies Rule!* (Aug. 9, 2006) (unpublished manuscript, on file with the Harvard Law School Library); Aurora Gómez-Galvarriato & Aldo Musacchio, *Larger Menus and Entrepreneurial Appetite: An Empirical Investigation of Organizational Choice in Mexico, 1886–1910* (May 30, 2006) (unpublished manuscript, on file with the Harvard Law School Library).

had to have at least one general partner who was unlimitedly liable for the firm's debts, but they could have any number of special partners whose liabilities were limited to their investments (and whose shares could also be traded).<sup>6</sup> Limited partnerships had strong shielding with respect to special partners whose investments were sunk for the duration of the partnership agreement and whose personal creditors had no claim to the special partner's interest in the partnership.<sup>7</sup> Although limited partnerships were only weakly shielded with respect to the general partners, it was possible under the Code to write clauses into the articles of association that constrained the general partners' ability to borrow on behalf of the firm. (This could be done for ordinary partnerships as well as for *commandites*.<sup>8</sup>) These agreements were enforceable against third parties and thus could limit the extent to which personal creditors of the general partners could lay claim to the assets of the firm.<sup>9</sup>

The limited partnership form was not available in Britain until 1907.<sup>10</sup> Most U.S. states passed enabling statutes for limited partnerships during the 1820s and 1830s, but the legislation was so restrictive and the courts interpreted the statutes so narrowly that the form was little used.<sup>11</sup> In Continental Europe, by contrast, the *commandite* form long predated Napoleon's 1807 Code.<sup>12</sup> Indeed, the provisions in the Code largely reenacted those embodied much earlier in Colbert's Ordinance of 1673, which in turn can be traced back to the Italian *commenda*,<sup>13</sup> which HKS do discuss.<sup>14</sup> Examples of the use of *commandites* in both mercantile and manufacturing ventures can be found in commentaries from the late seventeenth century,<sup>15</sup> but there is really no way of knowing how common such enterprises actually were until registration information became more readily available in the nineteenth century. Data we have collected on businesses organized in

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<sup>6</sup> Lamoreaux & Rosenthal, *supra* note 5, at 34.

<sup>7</sup> CH. LYON-CAEN & L. RENAULT, *MANUEL DE DROIT COMMERCIAL (Y COMPRIS LE DROIT MARITIME)* 143, 146 (1924).

<sup>8</sup> Lamoreaux & Rosenthal, *supra* note 5, at 38–40.

<sup>9</sup> *Id.*

<sup>10</sup> RON HARRIS, *INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720–1844*, at 20 (2000).

<sup>11</sup> See EDWARD H. WARREN, *CORPORATE ADVANTAGES WITHOUT INCORPORATION* 306 (1929); Stanley E. Howard, *The Limited Partnership in New Jersey*, 7 J. BUS. U. CHI. 296, 296, 316–17 (1934); William Draper Lewis, *The Uniform Limited Partnership Act*, 65 U. PA. L. REV. 715, 716–18 (1917).

<sup>12</sup> Lamoreaux & Rosenthal, *supra* note 5, at 33.

<sup>13</sup> Stanley E. Howard, *Business Partnerships in France Before 1807*, 7 ACCT. REV. 242, 242 (1932).

<sup>14</sup> See Hansmann, Kraakman & Squire, *supra* note 2, at 1372–74.

<sup>15</sup> See the examples offered by Jacques Savary, one of the drafters of Colbert's Ordinance, which are discussed in Howard, *supra* note 13, at 249–53.

Paris during the 1830s and 1840s indicate that one-third to one-half of all new firms took the *commandite* form.<sup>16</sup>

SMEs on the European Continent obtained access to a new form that provided both strong entity shielding and contractual flexibility as early as the late nineteenth or early twentieth century, depending on the country. Germany was the first mover. Its general incorporation law had been relatively late in coming (1870) and comparatively restrictive, and it became even more restrictive after the bursting of a speculative bubble led to legislation in 1884 that dramatically raised the cost and difficulty of organizing corporations.<sup>17</sup> Demands for a form of limited liability company more suitable to businesses that did not intend to raise capital on the markets led to the passage in 1892 of legislation creating the *Gesellschaft mit beschränkter Haftung* (GmbH), a form much like our modern LLC.<sup>18</sup> The popularity of the new form grew steadily over the next several decades, as the proportion of GmbHs in all new firms in Prussia rose from about ten percent in the late 1890s to about half in the early 1930s.<sup>19</sup>

France adopted similar legislation in 1925, after business people in the recently repatriated provinces of Alsace and Lorraine clamored to be allowed to continue to organize GmbHs.<sup>20</sup> The new form, the *société à responsabilité limitée* (SARL), immediately proved popular, accounting for sixty to seventy percent of registrations of new firms by the early 1930s.<sup>21</sup> Portugal passed enabling legislation for private limited liability companies as early as 1901, Austria did so in 1906, and most other western European countries followed by the mid-1930s.<sup>22</sup>

SMEs in Britain obtained access to strong entity shielding much earlier than did their counterparts in the United States because the general incorporation laws that Parliament passed in the middle of the nineteenth century (without limited liability in 1844 and then with lim-

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<sup>16</sup> Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Contractual Tradeoffs and SMEs' Choice of Organizational Form: A View from U.S. and French History, 1830–2000*, at 55 fig.2 (Nat'l Bureau of Econ. Research, Working Paper No. 12455, 2006). The data come from the *Paris Gazette des Tribunaux* and from the *Compte général de l'administration de la justice civile et commerciale*.

<sup>17</sup> Guinnane, Harris, Lamoreaux & Rosenthal, *supra* note 5, at 13–16.

<sup>18</sup> *Id.* at 20.

<sup>19</sup> *Id.* at 65. The figures on new firm registrations come from a published, weekly summary of the *Handelsregister*, which was maintained at the state level. The publication is called the *Königlich Preussischer Staats-Anzeiger* before 1871, and it continued as the *Reichsanzeiger* after 1871. The results are estimated by collecting data for the month of January for every fifth year.

<sup>20</sup> Lamoreaux & Rosenthal, *supra* note 5, at 51–53; Guinnane, Harris, Lamoreaux & Rosenthal, *supra* note 5, at 29–30.

<sup>21</sup> Lamoreaux & Rosenthal, *supra* note 5, at 51–53. The figures on new firm registrations are from *Compte général de l'administration de la justice civile et commerciale*.

<sup>22</sup> ARMAND LEHNARDT, QUELQUES POINTS DE COMPARAISON ENTRE LE REGIME FRANÇAIS ET LE REGIME ALLEMAND DES SOCIÉTÉS À RESPONSABILITÉ LIMITÉE 16–19 (1955).

ited liability in 1855–56) were extremely flexible.<sup>23</sup> The incorporation laws included a default set of governance rules but allowed incorporators freely to choose other rules in their articles of incorporation.<sup>24</sup> As a result, it was much easier in Britain for business people to choose both strong entity shielding and governance structures that protected them against oppression, and increasing numbers of SMEs organized as corporations.<sup>25</sup> An obvious testable implication of HKS's argument is that there should have been more corporations relative to partnerships in Britain than in the United States during the nineteenth century.

In 1900, however, complaints of abuses by corporations that issued shares to the public led Parliament to amend the general incorporation laws so as to require all new corporations to publish legally binding prospectuses that provided investors with detailed information about the enterprise and also subsequently to file annual returns that included balance sheets.<sup>26</sup> Directors whose companies did not conform to these and other provisions of the law were subject to personal liability.<sup>27</sup> The new law substantially raised the cost of organizing as a corporation and made the form much less attractive to firms that did not intend to sell shares to the public. Not surprisingly, the number of new corporations dropped dramatically.<sup>28</sup>

In response to this development and to the outcry that accompanied it, Parliament passed legislation in 1907 creating a new category of private limited companies that were exempted from the provisions of the 1900 amendments so long as they accepted restrictions on the transferability and liquidity of their shares.<sup>29</sup> Although there is no way of knowing what proportion of all firms adopted the form, data on company registrations show that the overwhelming majority (more than ninety percent) of the more than 200,000 corporations organized in Britain in the quarter century after 1907 were private companies.<sup>30</sup>

This evidence that SMEs in other countries were able to obtain strong entity shielding before their counterparts in the United States casts doubt on the causal explanation that HKS offer. Forms that offered stronger degrees of entity shielding than the ordinary partnership

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<sup>23</sup> L.C.B. Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV. 1369, 1371, 1376–77 (1956).

<sup>24</sup> *Id.* at 1376–77.

<sup>25</sup> Guinnane, Harris, Lamoreaux & Rosenthal, *supra* note 5, at 25.

<sup>26</sup> *Id.* at 26.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 27.

<sup>29</sup> *Id.* at 27–28.

<sup>30</sup> *See id.* at 66–67. The figures on new company registrations are from the *General Annual Report by the Board of Trade Under the Companies (Winding-up) Act of 1890* for 1908–1921 and the *Report of the Board of Trade* for subsequent years.

became available at different times in different places, but in many countries firms had access to them before the development of the accounting systems and judicial capabilities that HKS claim were important enabling factors. As we note above, French firms have been able to organize as limited partnerships for centuries, and we know that the *commandite* form was widely used in the early nineteenth century. Although much work remains to be done to explain the timing of the various enabling statutes for private limited liability companies, on the surface at least it seems that exogenous developments mobilized political support for the legislation: in the case of Germany and Britain, changes in the law that suddenly raised the costs of organizing corporations; in the case of France, the return of Alsace and Lorraine after World War I. Although take-up rates differed somewhat across countries, whenever the form became available in these countries, large numbers of SMEs took advantage of it.

A closer look at the data for the United States indicates that the patterns do not quite fit HKS's causal story either. Although there is good reason to believe that the passage of the income tax was a spur to the improvement of accounting practices, this improvement is difficult to connect temporally with changes in businesses' decisions about organizational form. As late as 1949, for example, the proportion of multi-owner firms in the U.S. economy that were organized as corporations was still less than forty percent.<sup>31</sup> Over the next thirty years the proportion would increase to about sixty-five percent,<sup>32</sup> but it is likely that the rise owed more to the high ratio of personal to corporate income tax rates after World War II than to anything else.<sup>33</sup> Moreover, the revisions to state incorporation laws and the changes in judicial practice that increased the suitability of the corporate form to SMEs were concentrated in the latter part of this period,<sup>34</sup> suggesting that it was the tax distortions that catalyzed efforts to change the law.

The broader comparative perspective we have offered in this comment raises the intriguing question of why SMEs in the United States had to wait so much longer than their counterparts in other countries for forms that would make strong entity shielding an attractive option.

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<sup>31</sup> See 3 HISTORICAL STATISTICS OF THE UNITED STATES 495–99 tbl.Ch1–18 (Susan B. Carter et al. eds., 2006).

<sup>32</sup> *Id.*

<sup>33</sup> On relative tax rates, see W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA 89–129 (1996).

<sup>34</sup> See generally F. Hodge O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW. 873 (1978) (discussing developments in post-World War II close corporation legislation); F. Hodge O'Neal, *Developments in the Regulation of the Close Corporation*, 50 CORNELL L.Q. 641 (1965) (discussing the post-World War II developments in close corporation law and practice with particular emphasis on the roles of lawyers, legal writers, legislatures, and courts).

Some tantalizing clues are provided by an early, failed attempt to introduce the private limited liability company in the United States. In 1874, nearly two decades before Germany created the GmbH, Pennsylvania passed an enabling statute for a very similar form called the Partnership Association.<sup>35</sup> Michigan followed suit in 1877, New Jersey in 1880, and Ohio in 1881.<sup>36</sup> Although some important firms organized as partnership associations — Carnegie Steel Company, Ltd., is the most famous — the form did not catch on. Not only did it fail to spread beyond the initial group of states, but even in those states it was not much used.<sup>37</sup>

Part of the problem seems to have been the precedent-based nature of the common law. Business people generally hesitate to adopt a new business form until there is a substantial body of case law establishing the extent to which and how essential contractual provisions will be enforced. A substantial body of case law, however, cannot be amassed unless businesses first experiment with the form.<sup>38</sup> Moreover, this “catch-22” situation was exacerbated by the decentralized character of business law in the United States. Because organizational forms are a matter of state rather than federal law, there is always uncertainty about how forms developed in one state will be interpreted by the courts of another. In a Massachusetts case, for example, a Pennsylvania partnership association was held to be a partnership, raising the possibility that Massachusetts courts would hold the members of such an association unlimitedly liable.<sup>39</sup> Given these uncertainties, it may have taken the severe tax distortions of the mid-twentieth century to induce businesses to bear the risk of trying out new organizational forms and novel contractual arrangements.

In their article, HKS trace the history of business organizational forms from ancient Rome to medieval Italy to early modern and modern England to the present-day United States. Although there is a cer-

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<sup>35</sup> Edward R. Schwartz, *The Limited Partnership Association — An Alternative to the Corporation for the Small Business with “Control” Problems?* 20 RUTGERS L. REV. 29, 29–30 (1965).

<sup>36</sup> *Id.* at 30–31. Virginia also passed a statute in 1874 but repealed it in 1918. *Id.* at 29 n.3.

<sup>37</sup> See James A. Matthews, Jr., Comment, *Business Associations — Registered Partnership, Partnership Association or the Corporation — Selection of the Suitable Form in Pennsylvania*, 2 VILL. L. REV. 385, 395 (1957); George E. Stransky, Jr., *The Limited Partnership Association in New Jersey*, 10 RUTGERS L. REV. 701, 701–02, 709, 714–15 (1956).

<sup>38</sup> Most of the litigation involving partnership associations occurred in Pennsylvania and Michigan, but the number of cases was still small. In New Jersey, there were only five cases in nearly a century! See Schwartz, *supra* note 35, at 31; Stransky, *supra* note 37, at 701. British businesses were spared this problem because the 1907 enabling statute for private limited companies was such a modest innovation. All the law did was exempt SMEs from the burdensome regulatory requirements imposed on public companies. The well-developed case law on corporations still applied.

<sup>39</sup> See *Edwards v. Warren Linoline & Gasoline Works*, 47 N.E. 502 (Mass. 1897); WARREN, *supra* note 11, at 517–19; Stransky, *supra* note 37, at 709–10.

tain logic to the linear pattern of legal inheritance that structures their narrative, they cannot make a convincing case for the innovative character of any of its individual elements without broadening the geographic scope of their study. As we have suggested, such a broadening would call their causal story into question. Nonetheless, we wish to conclude by emphasizing our agreement with the core of HKS's argument. Firms needed entity shielding to take on many of the economic activities that were important in advanced industrial economies. But because entity shielding increased the ability of those in control of the firm to behave opportunistically, members of SMEs generally eschewed the stronger versions of entity shielding until organizational forms developed that enabled minority owners to protect themselves against oppression. The extent to which SMEs have in fact been able to use the new forms to balance the costs and benefits of entity shielding, however, remains to be studied. Given the limited availability of data on the contractual choices made by businesses in the United States, this kind of knowledge can be developed only by shifting our attention to countries like France and Germany where these kinds of forms have long been available and where businesses' contractual choices have also long been a matter of public record.