The Design and Redesign of Organizational Form

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There exists a whole spectrum of organizational forms ranging from "mom and pop" grocery stores to large conglomerates, from financial mutuals, such as insurance companies and mutual funds, to nonprofits, such as hospitals and universities. The three most typical organizational forms used in the business sector are proprietorships, partnerships, and corporations.¹

Surprisingly little attention outside of legal arguments has been given to the type of organizational form a firm should adopt. In recent years, however, firms in a number of industries have redesigned their form. Twenty-five years ago most major investment banks were partnerships. Now, with the exception of Goldman Sachs, they are all corporations or divisions of corporations. Highly visible legal suits against law and accounting partnerships have called into question whether their current organizational form is best. This concern was highlighted by the recent bankruptcy of the accounting partnership Laventhol and Horwath and the requirements for partners to meet liability payments. For many other service industries, organizational form is an important issue.

Even among manufacturing firms, the type of organizational form is a design and redesign issue. It would be surprising if General Motors became a partnership, even though this form would save the firm several billion dollars a year in taxes. In Japan, though, the automobile industry is structured very differently with a considerable amount of outsourcing to firms that are proprietorships and partnerships rather than corporations.

We therefore propose a theory that offers a framework for guiding senior executives in making strategic decisions on the design and redesign of organizational form. We argue that organizational form determines the capabilities and

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capacities of a firm to compete in the marketplace. Proprietorships foster quality; corporations foster efficiency; partnerships do some of both. In a proprietorship, the owner’s human and financial resources are dedicated to the firm in the sense that they cannot be easily removed without dissolving the firm. This provides strong incentives to provide quality. The owner will directly suffer the future consequences if poor quality is provided today. In a corporation this is not the case. Top managers are not tied to a firm nor are financial resources. The advantage of the corporate form is precisely this fluidity or mobility of resources. Production can be organized efficiently because of the lack of ties between the organization and resources.

Our theory predicts that corporations will be the predominant organizational form when quality can be guaranteed in a specific way, such as an explicit warranty. Proprietorships and partnerships will exist where explicit warranties or some other way of guaranteeing quality are not feasible.

An interesting illustration of our thesis is provided by the restaurant industry where explicit guarantees are difficult if not impossible to provide. Forty years ago relatively inexpensive restaurant meals were provided by diners, which were mostly proprietorships. Quality was guaranteed because the owners’ resources were dedicated. One important innovation provided by the fast-food chains was to guarantee quality by providing raw materials and standardization. The efficiencies associated with the corporate form allowed them to dominate the market, and now diners are relegated to the fringe of the industry.

Our theory builds on the work in many fields of academicians who have sought to explain organizational form—accounting, finance and economics (Fama and Jansen, 1983a, 1983b; Williamson 1985; Scholes and Wolfson 1992), law (Klein and Coffee 1983), and organization theory and human resources (Hannan and Freeman 1983; Salancik and Leblebici 1988; Sherer 1993). Much of this literature focuses either on finances or on human resources.

Fama and Jensen (1983a, 1983b), in a series of influential papers, argued that firms determine their organizational form by trading off the benefits and risks of financial and decision making responsibility. As organizations become larger and their operations become more complex, proprietorship no longer remains an attractive and efficient organizational form. The owner must be wealthy enough to finance the operation and bear all the financial risk, as well as possess all the necessary expertise to run the firm. However, the benefits of separating these functions must be weighed against the risk that management may pursue their own interest rather than the interests of the owners. For Fama and Jensen, the ideal organizational form for a company is the one that insures that the interests of management are aligned with the interests of the principals.
None of these theories adequately explains the choice of organizational form, however. Neither human nor financial resources alone is a sufficient explanation of organizational form. Fama and Jensen do well to discuss the principal-agent problem in the context of organizational form. Unfortunately, their explanation does not recognize the role organizational form has in a firm's ability to supply its products and services to customers. A better theory must account for all of these factors.

Every firm—no matter how it is organized—needs to obtain certain capabilities if it is to meet the most important goals it has chosen. It may desire to expand and seek new customers, or it may focus its efforts on maintaining long-term relationships with existing customers. It may attempt to enter new markets or concentrate on the markets in which it already competes.

Firms use their human and financial resources to generate the capabilities required to meet their goals. Firms may differ in their financial requirements and the degree of risk they are willing to accept. But they all must possess the ability to obtain financing, manage resources in a way that maximizes return while minimizing risk, and meet their responsibilities to creditors. The same is true for a firm's human resources. Firms must obtain and retain people capable of successfully running the business and insure that they further the interests of the firm.

It is our view that a firm chooses a particular organizational form or ownership structure in the belief that it will best help it obtain and maintain the capabilities it seeks in terms of providing quality and operating efficiently. Marshalling the human and financial resources required to achieve these capabilities requires striking a difficult balancing act between having access to those resources and dedicating them to the interests of the firm. Organizational form is an important part of finding that balance.

Differentiating among the Three Organizational Forms

To understand how organizational form affects a firm's capabilities, and its implications for managing financial and human assets, it is important to consider the differences between the three basic organizational forms. Proprietorships, partnerships, and corporations are fundamentally defined by ownership and control, liability, and claimants.

A proprietorship is owned and controlled by one person, often with the help of family members. The owner is the manager. The proprietor has unlimited liability for his or her debts and is the sole residual claimant (that is, an individual or individuals with rights to the balance of revenues less costs).
Partnerships have two or more joint owners. Partners are liable to an unlimited degree for their debts, just as proprietors are. But partnerships allow expertise and risks to be pooled, and tasks, including the task of day-to-day management, to be divided among the partners according to their skills. In larger partnerships, an executive committee composed of only a subset of partners may run the firm.

In its purest form, partnerships equally divide profit and losses, the right to make decisions and control the firm, and to contribute to and control the firm's capital. The best-known variation of this pure form is the limited partnership where "active" or "general" partners have responsibility for running the firm and unlimited liability for the partnership's debts, while "silent" or "limited" partners simply provide financial capital and have neither responsibility for running the firm nor any financial risk beyond the amount they invest.

Corporations have their origins in Roman law. Because of its vast empire and trade, the Romans found they needed to define a body or a whole (the corpus) that had legal rights separate from its individual members. Modern corporations can own property in their own right, issue transferable shares, and live indefinitely. Corporations have unlimited liability for their debts, but shareholders are only liable for the equity they have invested.

In corporations, the role of ownership and control are separated. Shareholders own the corporation, but corporations are controlled by a board of directors and officers who, while obliged to act on behalf of the shareholders, are not necessarily shareholders. Shares are not necessarily traded freely. In publicly held corporations, shares are held by a relatively large number of people (Hamilton, 1991) and are traded on the securities exchange. Closely held corporations involve relatively few shareholders and are not traded on the outside market, as the transferability of shares is restricted. Most of these shareholders participate in running the firm, similar to owners in a partnership.

As summarized in Table 8.1, these differences in control and ownership, claimants and liabilities result in other distinguishing characteristics that affect a company's capabilities:

**Compensation**

In a proprietorship the risks and rewards are borne by the owner who also supplies the skills needed to run the company. The proprietor is the residual claimant. In a partnership, the general partners supply most of the entrepreneurial, professional, and managerial skills; if there are limited partners, they provide financial capital. In this case, the risks and rewards are shared and partners are the sole residual claimants. In a corporation the risks and rewards are borne by the shareholders and the managers bear a relatively small amount of the risk. Therefore, in a proprietorship the role of the owner extends to the management of the firm, whereas in a partnership shareholders do not necessarily participate in the management of the firm. In a corporation shareholders elect or hire a management team (CEO, COO, CFO, COO, etc.), who are responsible for running the firm. In a partnership, the partners are the management team. In a proprietorship, the owner is the management team.

**Table 8.1**

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<thead>
<tr>
<th>Ownership/control</th>
<th>Compensation</th>
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<tr>
<td>Access to human capital</td>
<td>selective managers</td>
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<tr>
<td>Access to financial capital</td>
<td>Monitoring management</td>
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TABLE 8.1. Characteristics of Pure Organizational Forms

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<th>Proprietorship</th>
<th>Partnership</th>
<th>Corporation</th>
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<tbody>
<tr>
<td>Ownership/control</td>
<td>Owner manager</td>
<td>Partners managers</td>
<td>Ownership management separated</td>
</tr>
<tr>
<td>Compensation</td>
<td>Owner claims residual</td>
<td>Partners claim residual</td>
<td>Shareholders claim most of residual</td>
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<tr>
<td>Access to human capital: selecting managers</td>
<td>Owner usually selects self</td>
<td>Partners select themselves</td>
<td>Board of directors selects managers</td>
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<tr>
<td>Access to financial capital</td>
<td>Very limited access</td>
<td>Limited access</td>
<td>Ready access</td>
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<tr>
<td>Monitoring management</td>
<td>Rudimentary</td>
<td>Mutual monitoring</td>
<td>Elaborate internal and market systems</td>
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of the risk. They thus typically receive a significant portion of their compensation as a guaranteed salary, and they are, consequently, fixed claimants.

Selection of Managers

In a proprietorship, the selection of managers is not an issue; the owner selects him or herself on the basis of having the capital for forming the business. In a partnership, new partners must be approved by the existing partners. Partners are required to pay capital into the firm as a basis for entry into the firm. While this often takes the form of equity capital, it is also in many other partnerships, an individual must also possess or “pay in” particular human capital such as a law degree in order to gain entry into the firm. Such skills, though of importance to the firm’s operation, do not necessarily relate to managing it. In a corporation the top managers are selected, presumably for their expertise as managers, by the board of directors acting on behalf of owners of shares; the shareholders can simply buy votes in the marketplace.

Access to Financing

Proprietorships, particularly small ones, have limited access to capital markets. They primarily rely on the funds generated by the business to finance new investments. To the extent outside funds are needed, they are borrowed from banks, family, or friends. Once committed, funds are illiquid. Owners must
either sell the business in its entirety or go public. Lenders such as banks can either wait for their funds to be paid back or force bankruptcy and acquire the assets of the firm.

Partnerships also have limited access to capital. Most of their funds are raised from partners. Banks, family, or friends are the most usual sources of outside funds. Some partnerships do have access to the public capital markets, but this is fairly rare. As in proprietorships, capital is illiquid. Usually partners can only withdraw their ownership interest when they retire. Other lenders must wait for their loans to be repaid over time or face bankruptcy.

Corporations have the best access to capital markets. They can issue both equity and debt in the public markets and they can also borrow from banks. Lenders of both equity and debt capital can sell their interest quickly with little effect on price.

**Monitoring Management**

In a proprietorship there is no mechanism for monitoring management: the owner is the manager and makes all the decisions in his or her own interest.

In a partnership, mutual monitoring is operative. Each partner is expected to expend effort and exercise judgment in overseeing what the other partners are doing.

When the partnership involves co-ownership, and the parties share the profits relatively equally, there is a great deal of mutual monitoring, consultation, and internal information. Partnerships may divide the organization into units, such as divisions or departments, where to a large extent partners are rewarded for the performance of that unit.

In a corporation, there is separation of ownership from management. Typically, there is a hierarchical structure with the board of directors at the top of the pyramid. Legally, managers of the corporation are employees who are responsible to the Board. This means that extensive information is required. Extensive accounting information helps shareholders verify that managers are not defrauding them, making unnecessary expenditures, or taking unwarranted risks.

The differences in monitoring and information flows thus lead to a difference in the centralization of management. In the proprietorship, all decisions go to the proprietor. In a partnership, the structure is more diffuse; many decisions are made by the individual partner, by the team, or department. In the corporation, there is much greater centralization, so that virtually all important decisions must go through major committees, the CEO, and the Board. The need to report encourages a hierarchical structure, which simplifies information flows; each level is able to report only the important information to the next level.
However, the most critical difference between proprietorships, partnerships, and corporations is the extent to which both human and financial resources are committed solely to the firm, or are free to be invested, or work in other ventures. The degree to which these resources are fluid or dedicated to the firm affects both the firm's capacity to provide goods and services, and its ability to generate the capabilities required to meet its goals. The mobility of a company's human and financial resources may be the fundamental factor determining compensation, the selection of managers, how management is monitored, and access to financing.

A proprietorship is an extreme example of dedicated resources. The owner cannot be fired; he or she is an integral part of the organization. It is usually not possible to withdraw either the human or financial capital without terminating the organization in its current form. For example, when the proprietors of a "mom and pop" grocery store wish to retire, the business often closes. One way to provide continuity is to pass the business on to the next generation, keeping the firm attached to the family. Nevertheless, the resources remain dedicated since they cannot be easily withdrawn.

A corporation, in contrast, is an extreme example of fluid resources. In general, human and financial resources are highly mobile; employees can be hired and fired with few restrictions; financial resources can be readily obtained from the outside. The information flows, which are an integral part of the corporate organizational form, allow this mobility of resources to be well utilized. When a profitable opportunity appears, this fluidity allows the firm to exploit it. It can raise capital and hire people with relative ease. Similarly, resources can be withdrawn or disposed of readily. If a person's skills are no longer needed, the person can be dismissed. Shareholders and managers may change frequently, but the corporation continues indefinitely.

A partnership combines dedicated and fluid resources. It is dedicated in the sense that partners are tied to the firm and are guaranteed significant tenure. It is fluid in the sense that access to capital markets is better than in a comparable proprietorship. New partners can be added with only some difficulties, and existing partners can only be removed with great difficulty. In many partnerships, the expectation is that once a person has obtained the rank of partner, he or she will not move to another firm; it is usually not possible to leave before retirement without forfeiting human and equity capital. The fact that the partners are tied to the firm means that mutual monitoring can be effective without sophisticated information systems or great cost. If a partner wastes the firm's resources or takes unwarranted risks, they are the first to bear the costs. They need to take a long-term view when they make decisions and take actions bearing in mind the consequences to themselves. The unlimited liability feature means they may be called to account for their actions even after they have
retired. The main disadvantage partnerships have relative to corporations is that they are not very fluid. It is very difficult, for example, to fire partners if their skills are no longer needed. In comparison to corporations, their access to capital markets is limited.

The Significance of Organizational Forms for Capabilities

Differences in the mobility of human and financial resources mean that different organizational forms have distinct capabilities. The dedicated nature of proprietorships suggests that they are well equipped to deal with situations where long-term horizons and relationships with customers are important. They provide assurance against opportunistic behavior because of the attachment of the proprietor to the firm. This form will be used in situations where the objective observation of the quality of a product or service is difficult. If the firm provides a bad product or service, it is the proprietor who will suffer the penalty. To the extent the horizon of the firm can be increased by making it a family concern, the incentives will be improved.

Partnerships are similar to proprietorships in that the top people are dedicated to the firm. This means they have the capability of allowing long-term relationships and providing some protection against opportunistic behavior. The advantage partnerships have over proprietorships is that they allow a combination of a range of skills and access to greater financial resources. This means that they tend to have more sophisticated capabilities than proprietorships. In comparison to corporations, they have limited access to capital markets so that raising large amounts of capital in a short period is difficult.

Our theory suggests that partnerships should be used where long-term relationships are important and customers are susceptible to opportunistic behavior. They are also likely to be used where a range of services or products is needed, but the ability to raise large quantities of capital quickly is unnecessary. Partnerships are almost universal in the accounting and legal firms where these capabilities are important. These professional partnerships typically offer a range of services, which would be difficult for a proprietorship to provide. Law and accounting firms do not need to raise capital quickly; therefore, access to capital markets is relatively unimportant to them.

Corporations have the advantage of being able to raise large amounts of capital quickly and hire and fire their top employees easily. Their disadvantage is that the top employees are not as dedicated to the firm as those in proprietorships or partnerships. The fact that capital is supplied by other people means that their interests are not fully aligned with those of the firm. As a result,
corporations will be most effective where opportunistic behavior is not a major problem and the quality of products and services can be contractually guaranteed. Their main capability is therefore to undertake well-specified tasks where the production processes can be readily controlled and where large amounts of capital are required. It is in large-scale manufacturing industries that these conditions are best satisfied. Long-term relationships are relatively less important, products are usually guaranteed, and capital needs are high.

Table 8.2 illustrates our theory. In manufacturing, where fluidity is important, the number of businesses that are proprietorships or partnerships is small relative to other industries. Corporations are the predominant organizational form by a very large margin. In contrast, in services where dedication is important, proprietorships and partnerships are much more prevalent. The number of businesses that are proprietorships is much larger relatively than in other industries and partnerships are also significant.

The history of the investment banking industry provides a good illustration of the relationship between organizational form and firm capabilities. In the eighteenth and nineteenth centuries the industry was dominated by family-based firms, such as Rothschilds and Baring Brothers. During this era, the prime considerations were the establishment of long-term relationships and the

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<th>TABLE 8.2. Number of Returns and Business Receipts by Organizational Form and by Industry for the United States in 1988</th>
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<tr>
<td>Agriculture, forest, and fishing</td>
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<td>Mining</td>
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<td>Transportation and utilities</td>
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<td>Wholesale and retail trade</td>
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<td>Finance, insur., and real estate</td>
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<td>Services</td>
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Notes: Proprietorships only include nonfarm proprietorships. Corporations include both privately held firms and publicly traded corporations.
maintenance of an impeccable reputation. As the needs of the firms expanded, they were unable to fill all the positions with family members and the firms became partnerships. They were still able to maintain the advantages associated with dedication, namely long-term relationships and incentives against opportunistic behavior, but they gained some fluidity of resources.

When the investment banks were organized as partnerships, each partner had his or her own team, which, to a large extent, operated as an autonomous unit. From a human resources perspective, this arrangement worked well. Unfortunately, the access of partnerships to financial capital was limited. They could only borrow a limited amount using debt because of the high risk of bankruptcy. Their access to equity capital was restricted by the wealth of the partners. Limited partners were a possibility but there was little scope for mutual monitoring, and without this or hierarchical monitoring their capital was at risk. As a result of these factors, the overall size of the partnership was limited.

In 1971 Merrill Lynch was the first investment bank to go public and become a corporation. In the 1980s, nearly all the other investment banks followed suit. By becoming corporations they gained access to equity capital, and the size of their assets grew substantially. On the other hand, the supervision required by the suppliers of equity capital meant that from a human resources point of view very different types of organization and compensation schemes were necessary. In exchange for the fluidity of resources associated with a corporate form, the banks gave up the advantages of dedicated resources. In particular, the people who were previously partners now became employees and were no longer as closely tied to the firm. Motivating these people to act in the interests of the firm has been a significant problem. Whereas partners have incentives to avoid unnecessary costs and unwarranted risks, employees are essentially using the shareholders' money and controls on their actions must be more direct. If employees are given the possibility of earning large amounts when investments are successful, they may be too willing to take risks. If they are successful, they make a fortune; if they are unsuccessful, they do not lose money and, at worst, may have to change jobs. In a partnership their own money would be at risk.

The difficulties of switching from a partnership to a corporate form are well illustrated by some of the problems Salomon Brothers, Inc. has had in recent years (Management Brief, The Economist, September 5, 1992). Under their old system, partners' earnings largely remained in the firm and the amount of cash they received in the short run was relatively small. When it switched to being a corporation, there was no longer the same security of tenure: as a result, deferred payments became problematic because employees could be fired. There was therefore a switch to shorter-term incentive schemes, which involved higher costs system with they stay partners substantial Economis ship profi thrived; Morgan & tax earni Oth er sign exam service p unique, to tradit propriety quality, contrast Crawford easier than as McDo rations adveris Gra of these largest Cargill relation grain at The de
higher cash payments. For example, Salomon introduced a "phantom share" system where employees received a bonus related to the share price, provided they stayed with the firm for five years. This was a much shorter period than partners had previously been expected to wait. Cash bonuses also increased substantially. In 1990, for example, one trader earned a $2.3 million bonus. The Economist suggested that the payment system used to supplant the old partnership's profit sharing system "proved disastrous." In contrast, Goldman Sachs has thrived; in the period from 1986-1991, it has outperformed its major rivals, Morgan Stanley & Company Inc., Salomon and Merrill Lynch in terms of pretax earnings (The Wall Street Journal, September 22, 1991).

Other industries—in particular the restaurant industry—offer interesting examples of the significance of organizational form for capabilities. The service provided at quality restaurants is difficult to guarantee. Each meal is unique, and specifying a standard procedure is almost impossible; a dedication to traditions and standards for quality is, however, a must. In this sector, proprietorships are almost universal. Owners know that if they fail to deliver quality, the restaurant will go bankrupt and they will lose their investment. In contrast, in the fast-food end of the market, the product is much more standardized. The menu remains largely unchanged and ensuring quality is much easier than at the top end of the market. In this sector, large corporations such as McDonalds and Burger King dominate. The fluidity of resources that corporations have means that they can invest heavily and bring a wide range of advertising and marketing skills to bear.

Grain trading has traditionally been dominated by five major companies. All of these are privately owned. Cargill, the largest grain trading company and the largest proprietorship in the United States, is entirely owned and run by the Cargill and Macmillan families. To a surprising extent, the grain trade is relationship-based. The transaction costs of measuring the quality of all the grain are high, and trust between farmer and purchaser plays an important role. The dedicated nature of a family firm such as Cargill fosters this trust.

Concluding Remarks

In sum, we argue that a critical reason in firms' selection of one organizational form over another is the capabilities of each to provide goods and services to the firms' external clients. Each organizational form strikes a different balance between access to human and financial resources, and their continuing dedication to the firm. A firm that finds itself in, or looking to enter a product or service market where there is greater demand for fluid or dedicated capabilities will need to design or redesign its organizational form accordingly.
We do not think, however, that capabilities is the only determinant of the choice of organizational form. Another factor that has received much attention in the literature is taxes. Scholes and Wolfson (1992) have provided an extensive analysis of the incentives provided by the tax system (see, in particular, chap. 4, Mackie-Mason and Gordon 1991). The corporate income tax distorts the incentives to choose a particular organizational form by taxing corporations more than other organizational forms. Nor is organizational form the only explanation for the troubles that befell Salomon Brothers and other Wall Street firms that became corporations during the 1980s.

Our analysis of firm capabilities and organizational form, however, has implications for a comparison of institutional structures in different countries. A chief criticism levelled against U.S. firms in recent years has been that their time horizon is much shorter than in firms in other countries, such as Japan. Our analysis suggests that this difference might be explained by the fact that large Japanese corporations appear to mix the corporate and partnership models. R. Dore (1992) has argued that the equity suppliers to Japanese corporations operate more like partners or stakeholders than stockholders:

The main distinctive features of the Japanese situation are as follows: (1) A heavy, though in the last decade rapidly diminishing, reliance on bank loans rather than equity capital; (2) One of the banks is generally considered a firm's lead bank. It may provide only marginally more loan capital than other banks, but it will own more of the firm's equity, it will put forth more effort into monitoring the company's performance, and it will be the prime mover in any brink-bankruptcy reconstructions; (3) A large part of the equity is in the hands of friendly, corporate stockholders: the suppliers, banks, insurers, trading companies, dealers it does business with. . . . For most firms, the percentage of floating stock holdings is relatively small. (P. 9)

Paralleling the financial aspect of the firm, the large Japanese firm views its top managers as key "stakeholders," who operate almost like general partners. These managers have been carefully selected, enjoy long-term employment in their firms, have developed a great deal of firm-specific human capital, and see reward and sacrifice in the firm's fate. Given that the organizational form of the Japanese corporation is a mix or hybrid of the partnership and corporate form, it is not surprising that Japanese corporations appear to be able to have some dedicated capabilities while still having some fluid capabilities.

Japanese firms suggest the wealth of possible choices of organizational form that are available to organizations. Complex attachments of forms may occur through pooling arrangements like franchising, where a parent corporation is linked with a proprietorship. The corporation provides the fluid re-
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sources and capabilities; the proprietorship provides the dedicated link to the client.

Such pooling arrangements are the focus of a growing literature that has caught the attention of business practitioners and students of organizations alike. In practice, there is an almost infinite number of configurations. Existing forms in organizations are constantly changing in an attempt to have a form that has more of the advantages of fluidity, as well as dedication. These changes reflect the very significant role for organizational form in the design and re-

development of firms.

Notes

We thank our discussants David Pierson of Towers and Perin, Ned Bowman, Bruce Kogut, and Jeffrey Trester for helpful comments and suggestions. Franklin Allen is grateful for financial support from the NSF.

1. The term organizational form is used in a number of ways. One common use of it is for distinguishing among various organizational structures (Daft, 1986; Williamson, 1985), such as the large functional or unitary form (U-form) versus the multi-
divisional form (M-form). We use the term in a more fundamental way to refer to the basic choice between proprietorships, partnerships and corporations. Our use of the term corresponds to its legal meaning.

2. For further development of how human resources links to organizational capa-
bilities, see Sherer (1993).

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MacKie-Mason, Jeffrey K., and R. H. Gordon. 1991. Taxes and the choice of organiza-

