ACCF

Amsterdam Center for Corporate finance

# *Topics in Corporate Finance*

## *Understanding (Un)incorporated Business Forms*

Joseph A. McCahery and
Erik P.M. Vermeulen

*in cooperation with*

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# Preface

Part of the ongoing agenda of the Amsterdam Center for Corporate Finance (ACCF) is to analyze the ownership structure of corporations. The corporate structure, i.e. the legal form of the corporation, is an important manifestation of this. Several types of corporate structures can be identified: from (not-incorporated) partnership-type to fully incorporated forms. An important policy issue is whether business forms could be introduced that are more flexible, not incorporated, yet rooted in partnership and corporate law.

Flexibility in business forms could offer distinct benefits if it improves the competitiveness of firms. This has become more important in today's dynamic environment. In particular, the increasing emphasis on innovation and entrepreneurship could ask for more tailored business forms.

The authors, Professor Joseph McCahery (University of Amsterdam, and incoming co-director of the ACCF) and Professor Erik Vermeulen (Tilburg University and Legal Counsel, Philips International BV) have been at the forefront of research on corporate forms. The authors strongly advocate the need for new and more efficient structures, and argue that such forms will create "new opportunities for both entrepreneurs and investors".

The Amsterdam Center for Corporate Finance gladly dedicates this issue of its Topics in Corporate Finance series to such an important topic. I hope you enjoy reading it.

A.W.A. Boot
December 2005

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## Summary

In recent years, unincorporated business forms, such as partnerships and hybrid legal entities that combine the best of partnership and corporate law, have attracted a great deal of attention from policymakers and entrepreneurs. Indeed, the increase in interest is both wide and deep. The new focus on partnership law reform is not accidental, however. During the last two decades, the expansion of activity in this area in Europe and the United States (US) has been substantial. In the US, the rapid increase in partnership-type business forms has grown much faster than anticipated. Several factors contribute to the growth of new and more efficient partnership law structures. First, states have responded to the needs of a wide variety of firms for a more flexible set of forms, which has reduced reliance on or eliminated inefficient older forms. Second, the liberalization of partnership law has been accompanied by the virtual elimination of the distinctions between partnerships and corporations accompanied by a move toward the recognition of partnerships as entities. Third, the increase in the choice among business forms has resulted in the erosion of traditional restrictions of the internal structure of legal business forms.

The emergence of new limited liability vehicles in Europe has been influenced by both domestic and international factors. Undoubtedly, the US reforms have stimulated policymakers' expectations that new business forms will create significant investment opportunities, increased employment and higher growth rates. At the same time, legal innovation in the European Union has been encouraged by changes in European Court of Justice case law, which has triggered jurisdictional competition in European business law and hence the introduction of various new entities designed to meet the needs of small and medium sized firms (SMEs) and professionals. Like the US and Europe, Japan has recently embarked on the reform of its company law framework. This has resulted in the development of two new legal business forms, the Limited Liability Partnership (LLP) and the Limited Liability Company (LLC), as well as the modification of traditional corporate entities. This trend can be seen as a response to the demand for the reduction of regulation and improved legal vehicles that are better tailored to meet the needs of different types of firms. It would appear that the developments in Japan are not the result of a competitive lawmaking process directly, but have been shaped by a mixture of learning and professional advice arising from the company law review process, as well as the indirect influence of overseas legal forms. This process may eventually yield interesting partnership type structures that supply efficient and flexible legal rules for most entrepreneurs, SMEs, and professionals.

In this study, which builds on our earlier work, we argue that the design of new business vehicles is more likely to meet the needs of professional firms, SMEs, and entrepreneurs if the legislative process is shaped by market forces and evolutionary pressures that push in the direction of efficiency-enhancing outcomes. We also explain that separate reform projects for closely held firms would be more efficient in providing these firms with distinct sets of rules and norms. A diverse set of corporate governance frameworks

and legal rules will allow firms to develop organizational structures that are suited to their particular preferences. It is argued, moreover, that various sets of legal arrangements could have substantial contracting benefits for the firm's participants by enabling them to define their expectations *ex ante* and, hence, assist judges in solving governance problems and other related conflicts *ex post*. We develop a full account of how separate unincorporated business forms affect the market environment and provide an opportunity for regulatory arbitrage. Drawing on this learning, we argue that creation of a coherent and simplified set of "delinked", stand-alone business forms may have clear economic benefits for business parties.

This study proceeds as follows. The first chapter broadly describes the open and close corporation and the legal rules that support and structure these forms. It will be shown that non-listed corporations are largely closely held and hence a specially tailored set of measures is needed to prevent opportunism and encourage value-maximizing outcomes. We turn to discuss in chapter two the legal regime for closely-held firms and examine the evolution of unincorporated business forms in Europe, the US and Japan. The final chapter shows how a set of new and more efficient structures could improve the governance of closely held companies, give investors and stakeholders more legal certainty and thereby create new opportunities for both entrepreneurs and investors.

# Understanding (Un)incorporated Business Forms

## 1 "Publicly Held versus Closely Held" and the Agenda for Reform

### 1.1 Introduction

This chapter will explain the two distinct types of corporations, namely the open and closed corporation, and the corresponding set of legal reforms targeted to address governance problems.

Corporation law reform is a key item on the policy agenda of governments worldwide. For the publicly held corporation, reform efforts have accelerated in many jurisdictions due to the perceived need to modernize corporation law provisions. Earlier reform proposals, which received insufficient political support, have been revised and updated, particularly in light of recent governance scandals, to respond to a new set of demands. Proposals have arisen to alter, among other things, the role of non-executive directors, executive pay, disclosure, the internal and external audit process, and sanctions on managers' misconduct. Measures have been proposed with the aim of creating new standards of integrity for auditors, analysts and rating agencies. Policymakers and lawmakers are prompted to design measures to protect a corporation's shareholders from fraud, poor board performance and auditor failure. These most notably include the certification of accounts by Chief Executive Officers and Chief Financial Officers, the imposition of internal controls, prohibition of corporate loans to managers and the requiring of firms to establish an independent audit committee. The objective of these corporate governance measures is to create value to the primary stakeholders of the publicly held corporation, *i.e.*, the shareholders, as well as creditors. That is not to say that other stakeholders are neglected. Arguably no corporation ever survived that ignored the interests of employees, customers and suppliers. The public debate, however, focuses generally on the internal elements of the corporate governance framework that mediate in the relationship between self-interested management and weak, dispersed shareholders. This is hardly surprising since provocative comparative studies show that the greater effectiveness of the legal rules affording greater protection of minority shareholders in common law countries compared to the rules originating in their civil law counterparts, explains the out-performance of the financial systems and equity markets in Anglo-American countries (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1997, 1998 and 1999).

At the same time, policymakers are devising and adopting "comply-or-explain" based codes of corporate governance, which cover the protection of shareholders in publicly held corporations, to supplement traditional corporation law mechanisms. Not only have these codes led to greater flexibility, but they have also enhanced the role of institutional investors who are taking steps to enforce them at the firm level – Table 1 gives an overview of corporate governance codes in Europe until 2003. To be sure, the voluntary codes mainly address the concerns of investors in publicly-listed corporations. To the extent that policymakers have few-revenue-based incentives to research the specific characteristics of closely held firms, they tend to recommend the application of the corporate governance structures tailored to the needs of publicly held corporations. It is certainly reasonable to infer that rules and principles that ensure: 1) the basis for an effective corporate governance framework; 2) define the rights of shareholders and the responsibilities of management; and 3) set out guidelines for enhanced disclosure and transparency, could also improve the governance of closely held corporations. In fact, many of the “best practice” rules and principles are imposed on non-listed, closely held corporations by government,[1] investors, insurance companies, lenders and others. This leads, however, to the question of whether such a “one-size-fits-all” approach to corporate governance regulation is justified in economic and social terms. Indeed, closely held corporations do not seem to benefit from this spillover effect. For instance, the compliance costs are exorbitantly high. This is especially true of corporate governance provisions that are still being evaded by publicly held corporations due to their cumbersome, complex and time-consuming nature. Moreover, the increased information costs and uncertainty about the application of the “comply-or-explain” terms by courts may have a detrimental effect on the performance of closely held corporations. It is therefore suggested that the typical organizational structure of these corporations demands an approach different from publicly held firms. This is implicitly acknowledged with financial reporting for non-listed firms.

The above discussion challenges the applicability of the publicly held corporate governance framework to non-listed corporations. It suggests that problems that are related to publicly held firms are not necessarily present in their closely held counterparts. It follows the idea of corporate governance mechanisms evolving along the lines of either publicly held or closely held firms. In this respect, the “closely-held-versus-public” dichotomy is a useful classification system to explain the different kinds of incentive and governance structures in play and, more importantly, it helps policymakers to rethink corporate governance mechanisms and law reforms. It is not surprising, therefore, that the dichotomy is reflected in the legal systems of most jurisdictions around the world.

1 In this paper, the terms “closely held corporation” and “non-listed corporation” are used interchangeably. In this respect, a closely held company is a company whose shares are not generally traded in the securities market.

**Table 1: Comparison of Corporate Governance Codes**
Source: OECD Steering Group on Corporate Governance (2003), Survey of Corporate Governance Developments in OECD Countries. (Corporate governance developments after 2003 are not included in Table 1.)

| *Nation* | *Code* | *Main Objectives* | *Instruments* |
|---|---|---|---|
| *Belgium* | Recommendations of the Federation of Belgian Companies (January 1998) | Improve companies' performance, competitiveness and/or access to capital | Balance of authority within the board, which should comprise a number of nonexecutive directors; independence of committees. |
| | Cardon Report (December 1998) | Improve companies' performance, competitiveness and/or access to capital | Comply or explain principle required by BSX listing rules; balance of authority within the board, which should comprise a number of non-executive and independent directors; transparent compensation tied to corporate performance. |
| *France* | Pour un meilleur gouvernement des entreprises cotées (Bouton rapport), Septembre 2002 | Revision of the Viénot reports after recent company events. | Viénot reports as a starting point; board supervision of management; competent and diversified board with to 1/2 independent directors; independence of external auditors; audit and compensation committees entirely of non-executive directors and with 2/3 independent directors; concern for balance-sheet volatility from the adoption of IAS accounting standards. |
| | Hellebuyck Commission Recommendations (June 1998; Updated October 2001) | Improve accountability to shareholders and/or maximize shareholder value | Improve shareholders' participation, information and voting at AGM; establish board committees with – majority independent directors; transparent compensation tied to corporate performance. |
| | Viénot I and II Reports (July 1995 and July 1999) | Improve quality of board (supervisory) Governance | Pre-eminent role of the board and collegial nature of its decisions; establish board committees; at least independent directors; audit committees made for of independent directors. |
| *Germany* | Berlin Initiative Code (GCCG) (June 2000) | Improve quality of board (supervisory) governance | Voluntary. Balance of power within and between management and supervisory board; compensation tied to corporate performance and seniority; establish supervisory board committees; facilitate shareholders' voting. |
| | German Panel Rules (January 2000) | Improve accountability to shareholders and/or maximize shareholder value; improve board (supervisory) governance | Voluntary. Provisions of German company and group law concerning shareholder protection, disclosure and transparency, boards' composition, responsibilities and remuneration. |
| | Cromme Commission Code ( February 2002) Now the German Kodex updated May 2003 | To promote the trust of international and national investors in the management and supervision of listed German stock corporations. | Comply or explain principle in law; improved disclosure to shareholders and voting possibilities; establish supervisory board committees; transparent compensation tied to corporate performance and seniority; disclosure of directors' conflicts of interest. |

**Table 1: Comparison of Corporate Governance Codes (Continued)**

| *Nation* | *Code* | *Main Objectives* | *Instruments* |
|---|---|---|---|
| *Italy* | Corporate governance code, Borsa Italiana, revised, July 2002 (Preda code) | Improve company performance, competitiveness and/or access to capital; improve quality of governance-related information available to equity markets. | Voluntary comply or explain. Unspecified but sizable number of non-executive and independent directors; neutrality on separating CEO and Chair; executive committee full reporting duty to the board; establish remuneration committees with majority of non-executive directors; compensation tied to corporate performance; establish internal control committees, entirely made up by nonexecutive directors, a majority of whom independent; substantial and procedural fairness in transactions with related parties. |
| *Netherlands* | Peters Report (June 1997) | Improve quality of board (supervisory) governance | Voluntary. Supervisory board: report conflicts of interest to chairman, limited number of directorships to be held by the same person, remuneration not tied to the company's results, committees neither recommended nor discouraged; deviations from one-share-one-vote principle admitted (notably in takeover bids); improve shareholders' participation and information. |
| | SCGOP Handbook and Guidelines (August 2001) | Improve accountability to shareholders and/or maximize shareholder value | Comply or explain principle recommended; improve (institutional) shareholders' participation, information and voting; restrictions to issuance of multiple-voting shares and to anti-takeover defenses; supervisory directors' remuneration not tied to the company's results. |
| | Tabaksblat Commission Recommendations, July 2003 | Improve implementation of the Peters Report. Modernize practices | Comply or explain to be legal requirement. Covers single and two tier boards. Define responsibilities of the management board to include risk management and control. Protect rights of whistleblowers. Limit on directorships held. Remuneration policy to be approved by shareholders and full individual disclosure. Control of conflict of interest. Supervisory board to have retirement nota and committees including audit and remuneration. Independence from management and sectional interest. Independence defined. Majority independent directors and separation of chairman/CEO for single board companies. Change in identity of company to be approved by shareholders. Full powers of depository receipt holders. Disclosure by institutional investors and a fiduciary duty for them. |

## 1.2 Separation of Ownership and Control

Corporation law serves to facilitate the separation of ownership and control. It gives the general meeting of "widely dispersed" shareholders as a "homogeneous and monolithic group" an *ex ante* incentive to make investments of financial capital, and delegates the residual control rights to management. In a publicly held corporation the shareholders are usually too small and numerous to exercise the residual rights of control. It would be too costly if all of them were involved in decision management. Moreover, the shareholders, who are only interested in the share price, lack the expertise and competency to take part in the decision-making process. Although corporation law typically limits the shareholders' ability to intervene in management's decision-making power, it would be erroneous to conclude that shareholders are deprived of every control right within the firm. In order to mitigate shareholder hold-up by management, shareholders are given, among other things, the right to elect and remove managers and the right to information. In addition, shareholders have the legal power to veto substantial asset purchases or sales initiated by the managers, such as mergers and acquisitions. Finally, corporation law and the extended corporate governance regulations set the internal rules for each of the participating groups within the firm. How do these regulations work? How can decisions be made? How are these groups represented?

How can they react to unforeseen problems that are looming over the firm due to bounded rationality and asymmetric information? We argue that any set of recommendations should take account of the effective governance needs of the corporation but also anticipate future conflicts.

By emphasizing the importance of dispersed ownership and the separation of ownership and control, the current corporate governance frameworks, which are based on the premise that the main corporate governance problem is the prevention of managerial opportunism, fail to understand the typical characteristics of closely held firms. As the identity of the individual shareholders comes to the foreground, the shareholders cannot be perceived as a "homogeneous and monolithic group". The focus shifts from the relationship between management and shareholders to the relationship among several groups of shareholders. In this view, an effective legal governance framework must offer mechanisms that serve to protect shareholders from the misconduct by fellow shareholders. The focus on managerial opportunism becomes again important when closely held firms have many characteristics of their publicly held counterparts.

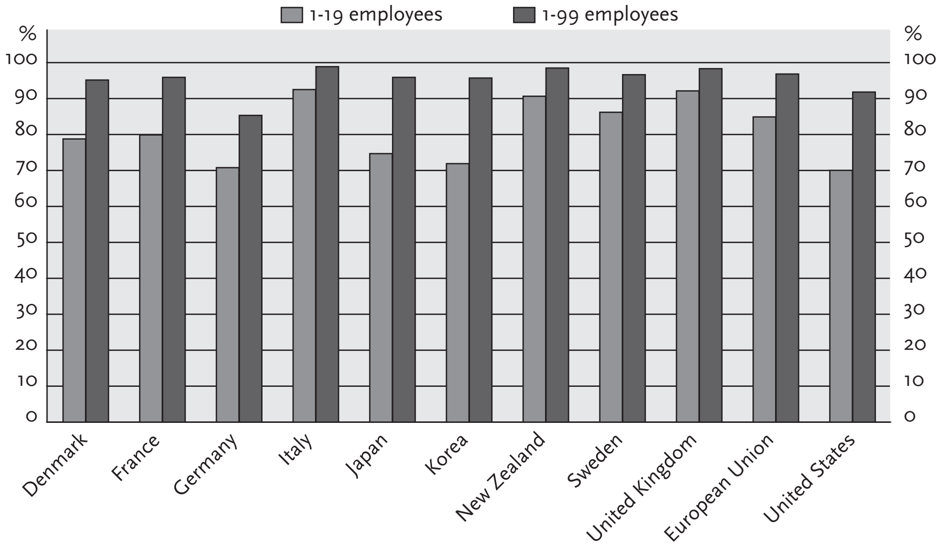
A comparison of closely held firms shows that they can be divided into two different types. At the one end of the continuum, there are so called "open", non-listed firms, such as corporations with the potential to go public in the short-term and unlisted mass-privatized corporations with a relatively high number of shareholders. On the other end of the continuum, there are the contractual arrangements in which the firm-owners retain substantial autonomy and the small partnerships in which the owners are active managers themselves. In between there are larger firms that have neither listed shares nor the intention to go public in the short-term. Along the continuum, there are family-owned firms, group-owned firms, private-investor-owned firms and joint ventures. These types of firms could be characterized by a three-way conflict between majority shareholders, managers and minority shareholders. The contrast between the interests of shareholders in publicly held corporations and this class of closely held firms is that shareholders in the former group usually: 1) hold few shares and are numerous; 2) are only interested in the corporation's share price; 3) lack the expertise and competency to take part in decision-making process; and 4) hence, must delegate, as a homogeneous and monolithic group, their control rights.

### 1.3 Distinct Sets of Rules and Standards for Closely Held Firms

Since most corporations across the world are closely held – even large publicly held corporations (see Figure 1), it might be argued that non-listed and listed closely held firms share many of the same corporate governance problems, and, hence, similar legal and market techniques could apply to prevent opportunism. However, multi-ownership in publicly held corporations is considered more advantageous for constraining large shareholders due to the important role that reputational agents, like accountants, rating agencies, and stock exchange watchdogs, play in both reducing information asymmetries and detecting fraud. In contrast, the shareholders in closely held companies have fewer market mechanisms to restrict opportunism. For example, one of the primary dangers that minority shareholders face in a closely held corporation is that he or she will end up as the victim of what is often referred to as a squeeze-out. As there is no liquid and deep market for their shares, the controlling shareholder may use his or her control rights to deprive the minority of: 1) any managerial control over the firm, which is important in for instance joint ventures and private equity deals; and 2) any significant distribution of the business earnings.[2]

2 Since there is no ready market for a closely held corporation's shares, the basic problem of corporate governance in non-listed firms is to protect minority shareholders from expropriation by controlling shareholders. It is imperative that the minority shareholders' interests be taken into account in business decisions. This can be accomplished by, for instance, the formalization of the board's decision-making process and the inception of a family council. In non-listed companies, especially when personal relationships in the family are involved, it is of utmost importance that the directors are aware of potential conflict of interest issues. Decision-making procedures that reveal information to shareholders and increase the involvement of minority shareholders prevent internal disputes. A family council, which protects and combines family and business affairs, is yet another mechanism to anticipate internal strife and disruption of the company's business operations before it occurs.

**Figure 1: Share of SMEs in manufacturing firms, late 1990s**
Source: OECD Small and Medium Enterprise Outlook, 2000 Edition.




It follows from the above-discussion that closely-held firms require a business organization law framework that is both flexible and adaptive in order to satisfy the varying demands of these businesses. It is therefore suggested that separate reform projects for closely held firms would be more efficient in providing them with distinct sets of rules and norms. In this respect, alternative corporate governance frameworks and legal rules might help firms to tailor the organization of their business to their particular needs. A distinct set of rules is better positioned to define the firm participants' expectations *ex ante* and, hence, assist judiciaries in solving governance problems and other conflicts *ex post*. Another advantage is that it is easier for policymakers to a create coherent and clear "delinked", stand-alone business forms, which are consequently better able to attract firms to their network. Indeed, as more firms adopt the corporate governance mechanisms for non-listed companies, networks of legal actors specializing in this framework (e.g., legal advisors and researchers) will develop, thereby offering legal services of a higher quality and a lower cost. Furthermore, firms may choose to adopt the framework to attract and accommodate (foreign) investors who expect firms to use it.

To the extent that many jurisdictions depend for their innovations and employment growth on the development of closely held firms, it is crucial to adopt a legal framework that encourages start-ups and private equity finance. Moreover, non-listed firms, especially the high-tech and fast-growing ones, are now widely regarded as the backbone of a robust economy. As a consequence, policymakers and lawmakers recognize that neglecting the governance needs of these firms will eventually stunt productivity growth and job creation. Not only has the rapid pace of technological change and the removal of barriers to international trade over the past decade created new strategic and organizational opportunities for firms, but it has also made them more vulnerable to risks. Hence, it is submitted that in order to help these companies fully exploit the new opportunities and adjust more easily to immediate uncertainty, policymakers at both a national and international level should endeavour to devise the most efficient institutions as part of their long-term strategy to foster investment, innovation and entrepreneurship. However, the legal reforms, as discussed above, are for the most part inappropriate for closely held firms, and therefore a shift in the focus from publicly held corporations to closely held firms is needed particularly because the preponderance of firms are not listed and ownership and control are typically not completely severed.

Indeed, as these firms continue to rely on family-financing and private equity sources for expansion and growth, it is necessary to understand more about the specific organizational and governance challenges and opportunities that surround these firms. Of course, the legal framework is only one of the many determinants of investment and expansion decisions. There is little doubt that the main considerations affecting these decisions are operational and macro-economic. Nevertheless, in the age of globalization, companies are likely to be increasingly sensitive to organizational and governance issues. A legal governance framework must allow firms to ideally match their legal status with their organizational needs, giving them the opportunity to grow and develop in the context of a highly competitive business environment.

A governance framework that is considerably out of step with the social and economic needs of most closely held firms arguably leads to inefficiency. That is, of course, not to say that policymakers should completely change course and redirect their focus solely to corporate governance issues of non-listed companies. Corporate governance and other legal reforms for publicly held firms tend to have some positive spill-over effects on non-listed firms: 1) these reforms improve the investment climate in regions; and 2) they help to better facilitate the conversion from non-listed to listed firms (see Table 2).

**Table 2: The relation between corporate governance projects**

| *Type of firm* | *Corporate Governance Problem* | *Importance of research* |
|---|---|---|
| *Non-listed firms* | Three-way conflict between majority shareholders, managers and minority shareholders. | The majority of firms are non-listed family owned enterprises (FOEs); corporate governance framework must be in line with social and economic needs. |
| *Listed firms* | Separation of ownership and control: agency problem<br>Controlling shareholders opportunism | Encouraging the separation of ownership and control<br>Improving capital markets<br>Creating incentives for public listing |

# 2 The Legal Regime for Closely Held Firms

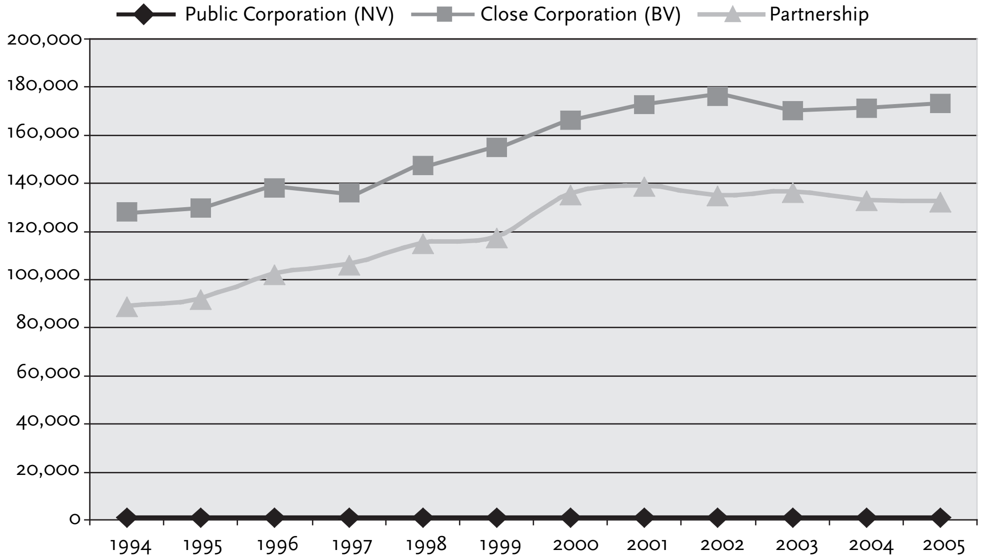
## 2.1 Introduction

Companies are commonly characterized as a set of relational contracts. It is assumed that since future contingencies are uncertain and the parties' activities are practically impossible to specify or observe *ex ante*, these relational contracts are inherently incomplete. In order to solve the problems associated with contractual incompleteness, firm participants can select among different governance structures that rely more or less on "softer" mechanisms. Obviously, integrating the ownership of the crucial assets can protect investments from post-contractual opportunism. In this case, ownership and power are allocated to the party that has the largest firm specific investment and is most crucial to the generation of surplus. The owner then has control and primary monitoring authority. Norms and implicit contracts help to ensure that both the owner of the firm and other participants inside the firm act diligently and honestly.

In this chapter, however, we focus on multi-ownership structures that prove to be very robust when relationship-specific investments are sufficiently complementary, parties are indispensable to each other, they both depend on unique resources, and sharing ownership rights is necessary due to time and wealth constraints, and regulations. For instance, joint ventures often result in a synergy that can be very productive, especially when financially constrained parties seek to share risks. Typically, multi-ownership structures are organized in an egalitarian rather than a hierarchical fashion. Each party usually has equal control rights over the physical assets, and share equally in profits and losses. Ostensibly, multi-ownership structures work best when they involve participants of similar talents and propensities and who make similar investments. However, parties of different productivity and capital levels use this very popular structure. The asymmetry between the owners of the firm gives participants an incentive to engage in opportunistic behaviour. To be sure, the participants and their legal advisors could attempt to deal with the high potential of opportunism contractually, but again these mechanisms are often very costly solutions due to technological limitations, private information and strategic behaviour. That is not to say that contractual mechanisms are not used to deal with the possibility of opportunism and self-dealing transactions. However, the incomplete contracts paradigm asserts that the participants may not be able to contract their way into organizational and governance structures that deal with every contingency *ex ante*.

Accordingly, the business participants usually prefer to use a legal business form that defines and sets forth the ownership structure, provides important contractual provisions in advance, supports the enforcement of implicit contracts and internalized norms and gives the business relationship legal entity status. That said, the regulation of legal business forms defines the organizational and governance framework for non-listed firms. The question then is: which legal business form to focus on when analyzing the persistent legal features that serve to protect participants from the misconduct by fellow participants? Even though the number and variety of firms using the public corporation varies greatly among the jurisdictions,[3] most publicly held firms are organized as joint stock companies or corporations. The close corporation is the most prevalent business form around the world. This type of corporate business form accounts for more than 55% of registered businesses and 90% of output in OECD countries. Figure 2 contains an example of the predominant use of the close corporation as legal organizational form in the Netherlands. Since subsidiaries are not taken into account in this figure, the number of Dutch close corporations will be higher in contrast to other business forms.

**Figure 2: The popularity of the Dutch close corporation form, the *Besloten Vennootschap met beperkte aansprakelijkheid.***
Source: Centraal Bureau voor de Statistiek (CBS).




## 2.2 The Evolution of Closely Held Business Forms

This section canvasses the factors that have influenced the evolution of closely held business forms in Europe and the United States and the conditions leading to rapid and substantial change in this area. As we have argued above, the publicly held corporation alone is not adequate to the needs of all entrepreneurs. Consequently, lawmakers have struggled to create a business form that is sufficiently distinct, and reduces the expenses of non-listed firms. However, these efforts resulted in nothing more than organizational forms that continue to mirror substantially the existing corporate form. Although the development has been quite different depending on the legal system, the close corpora-

3 The numbers of publicly held corporations – compared to closely held corporations – are relatively small in the United Kingdom and Germany. France and Italy, in contrast, have many SMEs employing the form of a publicly held corporation. In Japan, the general corporation form (*Kabushiki Kaish*a) is the dominant business form. The use of a *Kabushiki Kaish*a is a sign of prominence and stability and consequently many smaller businesses adopted this vehicle even though the *Yugen Kaisha* – the closely held corporation – is considered the more efficient form.

tion has been adopted in almost all developed countries of the world.

In the United Kingdom, for example, the close corporation has a single legislative base. It was initially developed in practice and later recognized by the legislature, which furnished it with certain distinct features. Most countries that once belonged to the British Empire included the close corporation into their own company laws, as they were already familiar with basic legal principles of the donor jurisdiction. The second strand of development is the enactment of a separate statute for the close corporation. Germany is renowned for its close corporation (*Gesellschaft mit Beschränkter Haftung* or *GmbH*), which was the precursor of separate close corporation legislations throughout the European continent, Asian, including Japan, Latin-American jurisdictions, and former Socialist countries. The United States offers only a single corporate form which can be contractually tailored to the needs and wishes of closely held firms.

Regardless of whether they are governed by a separate statute (the "free-standing approach") or viewed as factual variations on or sub-type of the general corporation (the "integrated approach"), the close corporation has developed in the image of the corporation with its capital-oriented structure. Since this governance structure is designed to attract substantial amounts of capital into the firm from passive investors and, consequently, to regulate the rich and intricate principal – agency problem, this structure is poorly designed to confer positive externalities to non-listed firms, in which ownership and control are typically not completely severed. Despite its cumbersome and burdensome structure, the close corporation has nevertheless become the preferred vehicle for closely held firms. This is largely due to the positive externalities that arise as a consequence of firms having selected the closely held corporation for tax and liability reasons. Moreover, the widespread use of this form effectively crowds out the introduction of alternative vehicles.

However, in order to better satisfy the contrasting requirements of the specialized and idiosyncratic relationships in non-listed firms, legislative and judicial adjustments have been made in a piecemeal fashion across jurisdictions through the years. Two sets of problems have arisen repeatedly due to the publicly held character of the close corporation form. The first revolved around the enforceability of contractual attempts by participants to modify and sidestep rigid rules tailored to the needs of publicly held companies. Today, most jurisdictions either provide more flexible close corporation law rules, or allow non-listed firms to contract around the rules provided by statute. The second set of problems falls under the caption of "protection of minority shareholders". Case law often assumes that private companies and partnerships are functionally equivalent business forms with the same organizational needs. For instance, in the United States and Germany, the judiciary has recognized that shareholders in a close corporation setting may owe each other a strict fiduciary duty of good faith and loyalty.[4] In the Netherlands, the Dutch Supreme Court articulated strict restrictions on interest transfer for sharehold-

4 See *Donahue v Rodd Electrotype Co.*, 328 N.E.2d 505 (Mass. 1975) and, to a lesser extent, *Wilkes v Springside Nursing Home, Inc.*, 353 N.E.2d 657, 663 (Mass. 1976). In Germany, the German Supreme Court imposed a broad fiduciary duty on controlling shareholders of the German close corporation – *Gesellschaft mit beschränkter Haftung* (*GmbH*) – in the ITT case (BGH 5 June 1975, BGHZ 65, 15 (ITT).

ers of close corporations, based on enhanced good faith and fiduciary duties, where the articles of incorporation did not explicitly address these matters.[5] Finally, in *Ebrahami v Westbourne Galleries,*[6] the House of Lords decided that circumstances in which a UK close corporation is in essence a quasi-partnership (formed and continued by individuals who were essentially partners but who had chosen the legal mechanism of a corporate structure for its obvious advantages) justify the application of partnership just and equitable winding-up principles.[7] In short, the application of automatic dissolution and buy-out rights, strict precepts of fiduciary duty and good faith to protect shareholders, the authorization of strict share transfer restrictions, and contractual flexibility to modify and sidestep rigid rules characterize the close corporation form as a "quasi-partnership", "incorporated partnership", or "partnership corporation".[8]

Notwithstanding the robustness of the partnership analogy, lawmakers acknowledge that the corporate form alone may not be equal to the challenge of serving all types of closely held firms despite its obvious benefits. Converting the close corporation into an incorporated partnership by codifying numerous judicial opinions would better serve the interests of the vast majority of small firms. However, to some extent this could act as a barrier to growth for firms wishing to expand and to attract outside capital.

Thus, because it is not clear when and to what extent the partnership principles should be applied to close corporations, the "partnership law" analogy may be inappropriate. For instance, the judicial discretion to meddle in the internal affairs of close corporations might entail deficiencies and inconsistencies as it could limit the law's certainty and its value for larger non-listed firms. It is well known that legal rules for firms with capital symmetry should differ from the rules for those without. For example, equal rights in management, automatic buyout rights and broad fiduciary duties that govern "partnership corporations" are not suitable for start-up corporations financed by venture capital. The deregulatory approach tends to increase the transaction cost associated with statutory ambiguity, including legal research, litigation and judicial system costs. Moreover, it appears that once partnership-type doctrines are accepted in the close corporation law, these doctrines are difficult to opt out of due to the judiciary tendency to rely on established precedents rather than the facts of the case. Finally, because these doctrines are vague and open-ended, they could arguably create confusion, thereby preventing the participation of (international) investors in the governance of these firms.

## 2.3 Developments in Partnership and Corporate Law (12th century – 20th century)

The discussion on the evolution of the close corporation reveals the theoretical and

5 See Hoge Raad, 31 December 1993, (1994) NJ, 436.
6 [1973] AC 360 (HL).
7 See Acton (2001), arguing that the decision in *Re Guidezone Ltd.*, [2000] 2 B.C.L.C. 321, Ch D., (which held that the just and equitable winding-up jurisdiction was no wider than the jurisdiction under section 459 of the Companies Act 1985), is wrong.
8 In other jurisdictions, these strategies have not been developed to same extent as in the United States. However, the fact that the majority of close corporations usually have less than four shareholders tends to support the partnership metaphor.

practical limitations of creating new forms that are sufficiently adaptive and flexible to meet the complex needs of a wide range of closely held firms. This section begins with an account of the evolution of partnership-type business forms, starting with the reception of the Roman partnership form in the Middle Ages and then tracing the evolution of these forms in Europe, the US and Japan up to the first few years of the 21st century.

In general, the emergence of new partnership-type business forms presents clear benefits for a wide range of business and professional firms. Economic studies tend to confirm that the modernized and new business forms have advantages over traditional partnership and close corporation forms. For instance, the US LLC and LLP, which combine a menu of limited liability, flexibility-respecting governance terms and a choice of tax treatments, allow firms to select legal forms that are compatible with their organizational features. It is often claimed that the development of a menu of "off-the-rack" business forms will eventually provide an efficient, low-cost solution to the governance problems of closely held firms.

A closer investigation of the recent developments of closely held business forms within the European Union and the United States will reveal that competitive pressures have driven the rapid evolution of "new partnership law". It turns out that these pressures, if unchallenged, yield a dynamic law that is responsive to the varied needs of modern firms. In sharp contrast to the US evolution story, however, stands the recent expansion of business forms within the European Union, which has arguably been disadvantaged by a legal framework that includes mandatory rules derived from public corporation law greatly influenced by European directives. Apparently, there are a number of interest group barriers that prevent European member states from adopting more cost-effective legal business structures for closely held firms. Thus, the combination of pressure group influence activities and market barriers serves to constrain freedom of choice for entrepreneurs. As we have seen, the legal regimes used by European closely held firms cannot be expected to result in efficient contracting ends.

### *2.3.1 The Genesis and Development of Partnership-type Business Forms*

When trade started to revive in the Middle Ages, after a long economic slowdown, mediaeval merchants began looking for a business organization form that meshed with contemporary social and economic conditions. In the light of the reception of Roman law, which surpassed the rudimentary local laws as a legal system, the Roman *societas* helped to fill the gap (Zimmermann, 1996). The mercantile courts and guilds that took cognizance of the Roman form viewed it as a convenient and particularly flexible basis for business associations in which partners own and control the business together, thereby sharing profits and losses. It did not take long for the *societas* to become part of the generally accepted Law Merchant, where it evolved into a legal organizational form with entity-based features necessary to facilitate commercial relationships with third parties, such as the doctrine of the mutual agency of partners.[9]

9 Limited liability issues did not matter much in a world without products liability, punitive damages, class actions and other twentieth century legal innovations.

As trade communities grew and trade among different regions expanded, the mercantile class required a business form that could bring together scarce capital and adventurous entrepreneurs willing to undertake difficult and perilous overseas voyages. The mediaeval general partnership, which was ideally suited to small, often family-owned, commercial firms, did not satisfy the requirements. In response to the influence of powerful interest groups such as the nobles and the clergy, the Mercantile system began to acknowledge another type of partnership: the *commenda*. The *commenda*, which evolved from a loan contract into a partnership-type business form, was intended to mobilize risk capital for short-term overseas commercial ventures (Berman, 1983). This limited partnership-type business form offered investors limited liability and anonymity, and thus made it possible for the special interest groups to pour money into lucrative ventures without risking being condemned for usury or violating inhibitions against engaging in trade. The investors only risked losing their initial investment.[10] The universality and uniformity of partnership law, which ensued from the rapid expansion of the Law Merchant throughout the Western European regions, gave an important impetus to commerce in the Middle Ages.

In the 18th century, the codification measures, largely intended to sever all ties with the past, prevailed in Continental Europe. In the spirit of revolution rather than evolution, judge-made law was viewed as suspicious and a means of upholding the old regime. As a result, the lawmaking authority shifted from judges to scholars appointed as members of drafting commissions. Even though judges retained their lawmaking influence in the United Kingdom and the United States, the considerable use of partnerships and the development of the common law of partnership also resulted in demands for codification in common law jurisdictions at the end of the 19th century.[11] Because the new lawmaking elite used different sources of inspiration, the codes, often differed significantly in features dealing with similar issues across jurisdictions, reflecting the ideas of the lawmakers.

Although the principles of partnership law have been embedded in various ways in different national codifications, most jurisdictions base their partnership laws on the same fundamental principles and ideas. The traditional general partnership forms are designed to cater for the needs and circumstances of small firms with only a few owners, all of whom are involved in the operation of the business. Typically, partnerships are the basic form of business association in which more than one person is involved. They have their origin in express or implied consensual agreements to engage in an economic activity for profit.[12] The partners are personally liable for the firm's debts and, as a default, participate directly in management and control, and may veto the admission of new owners. The relationship is based on the highest level of trust and fraternity. Because human capital (*e.g.*, the knowledge and abilities of the owners) is often the most valuable

10 They had no claim against the merchant-adventurer for losses that were not his fault.

11 Unlike in continental Europe, the codifications in the United Kingdom and the United States were largely declaratory of the existing law. Cf. s 46 of the Partnership Act 1890: "The rules of Equity and Common Law applicable to partnership shall continue in force except so far as they are inconsistent with the express provisions of this Act."

12 In Germany, the civil partnership may exercise any activity for a non-profit purpose. See §705 German Civil Code *(Bürgerliches Gesetzbuch (BGB))*.

contribution to a partnership, the law traditionally provides for dissolution upon dissociation of a partner.

Generally, partners have personal liability as a consequence of the obligations incurred by the partnership. As long as the business is in a low-risk area, this need not be problematic. When one or more partners (*e.g.*, family members) prefer to be passive, contributing only financial or physical capital, the limited partnership form offers a more appropriate vehicle across jurisdictions. The liability protection of the limited partners reduces the need to monitor the controlling partners, at a price. Limited partners have only very restricted rights to participate in management. If they exceed these restricted rights, they become personally liable for the firm's debts.[13] The limited partnership has another flaw in its design: the mandatory obligation to have one or more general partners that are, by definition, unlimitedly liable for the debts and obligations of the firm.[14]

When the corporate form was only available to certain types of businesses because of the formal concession of a sovereign person or government, partnerships were the prevailing form of organization. With the growth of commercial and industrial activity in the 19th century, the pressure from politically influential industrialists to abandon the specific governmental approval of a corporate charter and to introduce fully fledged limited liability for corporations grew steadily in most industrialized countries.[15] In the United States, the charter approval, which invited intensive lobbying, became increasingly standardized. By 1890, all states had adopted statutes providing for incorporation with limited liability by simple registration.[16] The introduction of a relatively simple incorporation procedure in France in 1867 entailed the rapid proliferation of general incorporation statutes throughout continental Europe, which already embraced the corporate limited liability doctrine since the enactment of the *Napoleonic Code de Commerce* in 1807.[17]

The principle of limited liability was acclaimed as an industrial breakthrough by some, but it was stridently vilified by others. The proponents usually pointed to the wealth-increasing role limited liability corporations played in the economy. The defenders of unlimited liability argued that limited liability would only entail wealth transfers from

13 For instance, if a limited partner takes part in the management of a limited partnership in the United Kingdom, he will be liable for all debts and obligations of the firm incurred while he takes part in the management as if he was a general partner. See s6(1) of the Limited Partnerships Act 1907. Under German case law and doctrine, registered limited partners (see §176 German Commercial Code *(Handelsgesetzbuch (HGB))* of a German limited partnership are to a great extent protected if they are involved in management. They will be liable if they misuse their limited liability protection. Under the Uniform Limited Partnership Act (1976) with 1985 Amendments, the limited partners of an US partnership are also protected by the extensive safe harbour provisions of §303(b). Nevertheless, the rule inhibits several limited partner actions.

14 See §161 German Commercial Code *(Handelsgesetzbuch (HGB))*; s4 Limited Partnerships Act 1907; §101(7) Uniform Limited Partnership Act (1976) with 1985 Amendments.

15 In order to circumvent the partnership liability regime as well as the almost insuperable incorporation requirements, British (and to a lesser extent, American) fast-growing commercial businesses and their legal advisers resorted to other unincorporated business forms. The most notable alternative was the Joint Stock Company, which could be classified as a hybrid between the partnership and the corporation. In order to obtain limited liability for its members, a variety of devices were employed, such as contractual clauses and insertion of the term "limited" after the firm's name (Blumberg, 1986).

16 In the United Kingdom, the Joint Stock Companies, Registration, Incorporation and Regulation Act permitted general incorporation without preceding legislative action by the government in 1844. After the enactment of the 1962 Companies Act, the uncertainty about the limited liability protection for publicly traded companies with merely passive investors disappeared almost completely.

17 For instance, the *Aktienrechtsnovelle* liberalized the German publicly held corporation (Aktiengesellschaft) in 1870.

creditors to shareholders, which could eventually lead to corporate inactivity (Halpern, Trebilcock, and Turnbull, 1980). They alluded to the involvement of corporations in criminal activities, such as pollution and swindling. Even though legislatures sometimes responded to these suspicions and fears by tightening the rules to protect the creditors, it seems that the ultimate triumph of limited liability came with the general acceptance of the use of limited liability corporations by closely held firms. Not only were business organizations with only a few members and without publicly traded shares permitted to incorporate, but incorporation also became possible in practice, since (to some extent) these organizations were allowed to avoid the costly and cumbersome protective rules applicable to public corporations.

Two legal methods of achieving the same goal – making limited liability vehicles accessible to closely held firms – can be distinguished. First, a new limited liability corporation that focuses on closely held firms could be designed. For instance, Germany is renowned for the enactment of its close corporation, the *Gesellschaft mit beschränkter Haftung (GmbH)*, which became effective on 19 May 1892. Although the *GmbH* was meant to serve the needs of small and medium-sized enterprises (SMEs) composed of a few owners who were acquainted with one another and provided most of the firm's capital themselves, it was modelled on the public corporation and its capital-oriented structure.[18] The German *GmbH* was the precursor of separate close corporation statutes throughout the European continent.[19] Around the same time, the lawmakers in England endeavoured to introduce legislation based on the limited partnership form that already played an important role in the continental European economy. This new act was supposed to be the counterpart of the Companies Act (1862), which purportedly only granted limited liability to enable passive shareholders to invest in businesses without shouldering the burden of personal liability. A decision of the House of Lords in *Solomon v Solomon & Co. Ltd.*[20] overturned this assumption by clarifying that the Companies Act also covered closely held firms in which no particular business risk was involved, and which required no outside capital.[21] The English legislature recognized the close corporation's special needs by exempting them from certain requirements of publicity in the Companies Act of 1900 and 1907. In Japan a similar business form (*Yugen Kaisha*) emerged in 1940 for the benefit of SMEs.[22]

We know from the standard analyses of the corporation that corporate forms were initially geared to publicly held firms, most jurisdictions either provide for a more flexible close corporation statute or allow firms to differ from the general corporation statute so as to confer limited liability protection to closely held businesses. Commentators who

18 Another group of proponents of a separate business form argued in favour of the promulgation of a limited liability partnership type of *GmbH*. Lutter (1998) states: "[o]ne group of proponents, led by Oechelhauser, favoured a strongly individualistic, i.e., a personalized form of enterprise organization modelled on the partnership (*offene Handelsgesellschaft*). This model could be characterized as a limited partnership and having no general partner".

19 It might be argued that the spread of the close corporation form in Europe is an example of a successful legal transplant. Yet, despite similarities there are differences in the legal approaches regarding close corporations across jurisdictions, which can partly be explained by different legal doctrines.

20 [1897] AC 22, H.L.

21 For a critical assessment of this decision, see Kahn-Freund (1944).

22 The general corporation form (*Kabushiki Kaisha*) is the dominant business form. The use of a *Kabushiki Kaisha* is a sign of prominence and stability and consequently many small businesses adopted this vehicle even though the *Yugen Kaisha* is considered the more efficient form.

point to the success story of these close corporations in both Europe and the United States view them as the only necessary link between partnerships on the one hand and publicly held corporations on the other. In their opinion, close corporations can be tailored easily to the needs and wishes of a wide variety of firms. However, the participants of a closely held firm that opt for the corporate form must pay a considerable price for obtaining liability protection. Even in jurisdictions where the actual costs of forming a corporation are considered as rather trivial,[23] the compliance with various technical and rigid statutory rules often places costly burdens on small and medium-sized firms. Consider, for instance, the lack of flexibility due to the formal rules which establish the separation of ownership and control or the public disclosure of a firm's annual accounts. An adverse corporate tax treatment just amounts to high regulatory costs of limited liability. Clearly, legally unsophisticated SMEs suffer the most from sub-optimal regulations.

From a relatively early date, in response to the special wishes of larger firms that had little appetite for incurring the extra costs of the incorporation process, innovative lawmakers started modifying and mixing legal structures so as to obtain the most cost-effective limited liability vehicle. Practitioners viewed the traditional limited partnership form as a product that could be traded in the market, as it could offer their clients a flexible limited liability tax shelter. They solved the problem of the general partner's unlimited liability by creating a hybrid business form between the limited partnership and a corporation, which played the role of general partner. The restrictions on the limited partners' rights to participate in management have occasionally turned out to be advantageous both to the founders, who want to retain control of the business in conjunction with limited liability protection, and to passive investors who covet the pass-through taxation and other favourable tax attributes. Despite the concerns about legal permissibility and the perverse influence of tax law on the limited partnership, this hybrid vehicle has been a success story in many jurisdictions. The German *"GmbH & Co KG"*, devised to combine the benefits of partnership taxation with the possibility of evading onerous corporate rules (such as the German co-determination act and other cumbersome statutory audit and disclosure rules) is a good example.[24] In other industrialized jurisdictions too, this limited liability vehicle gained popularity due to its hoped-for tax advantages and flexibility. It has been most attractive not only to firms with small and dispersed passive investors, but also to closely held firms engaged in businesses of which the assets present valuation problems, or in which managers must make firm-specific human capital investments. In the fields of ship and film production or exploration, real estate developing and operation, venture capital funding, and family businesses, this hybrid business form is especially popular.

Despite the popularity of the limited partnership with a corporate partner, it is not always possible for closely held firms to use this form. Besides the fact that this hybrid

23 For instance, the United Kingdom and Ireland do not impose minimum capital requirements on close corporations.

24 Both the judiciary (already in 1912) and the legislature have acknowledged the German *GmbH & Co KG*. After the adoption of the *Kapitalgesellschaften- und Co-Richtlinie-Gesetzes (KapCoRiLiG)* the corporate statutory audit and disclosure rules also apply to limited partnerships with a corporation as the sole general partner.

form is not recognized or is prohibited from engaging in specific kinds of activities in some countries, the limited partnership and its statutory "control rule" may not be optimal for firms in which the owners are unwilling to give up their control power. In addition, since this vehicle comprises two business entities that must be organized and administered separately, it is not a form that practitioners can always sell easily to their clients, who have to go through the extra expense and effort of setting up an intermediary corporation. Regardless, limited partnerships with a corporation as the sole general partner are suboptimal responses to the search for cheaply accessible limited liability vehicles.

Nevertheless, experimentation and subsequent innovations have given new momentum towards the reworking of traditional partnerships and the design of new business forms in order to offer a menu that is essential to meet the complex needs of firms in the modern business climate.[25] It has been clear for some time that the close corporation is unlikely to maximize the interests of closely held firms at all levels. In this chapter, the emergence of revised and new partnership-type business forms is the subject of discussion. Developments in close corporations will only be discussed in so far as they illustrate the evolution of these partnership-type forms.[26] Certainly, some will argue that due to the legal entity features such as limited liability, many new business forms reflect the corporate approach more than the partnership approach.[27] Nevertheless, we treat these forms as a part of new partnership law. In most statutes, the internal relationship between the business participants is heavily based on partnership law with its extreme flexibility and contractual freedom, and is usually influenced by the principle of *intuitu personae*. These new business forms are different from close corporations in which the notion of government regulation rather than private ordering still dominates.

25 The design of new business forms is not new. Firms that were engaged in certain business activities from which corporations were legally excluded have always attempted to organize with limited liability protection. For instance, in England and the United States the business trust was developed by persons who wanted to combine their capital for the purpose of engaging in certain business activities from which corporations were barred by prohibitory statutes. This form gained its greatest popularity in Massachusetts during the latter part of the 19th century. The limited partnership association is considered to be the LLC's predecessor in the United States. Its emergence has been ascribed to the need of a simpler alternative to the corporation.

26 Although the line is blurry and many business forms do not fit exactly in one of the two moulds, this paper distinguishes between partnerships and corporations. This distinction appears to be deeply ingrained in the legal thought of most industrialized countries. Even in jurisdictions which show some overlap in the legal regulation of partnerships and corporations, commentators use the distinction to help explain the different legal treatment. For instance, even though close corporations have been creeping toward partnership law, their statutes maintain a considerable amount of regulation ensuing from the more institutional approach.

27 Yet even though it is suggested that the US LLC originated from the German, and South and Central American closely held corporate form (the *Gesellschaft mit beschränkter Haftung (GmbH)* and *limitada*), the US LLC is a noncorporate – or unincorporated – business form. Initially, it derived its essential business characteristics from partnerships, and has the "corporate features" of limited liability and, under some statutes, an option for centralized management.

## 2.4 The United States: From General Partnerships to Hybrids (20th and 21st century)

### 2.4.1 Partnership Law Reform

The trend away from corporation law as a business form for closely held firms is most obvious in the United States, where the relatively simple landscape of partnership law has changed dramatically over the last decade. Until recently, the Uniform Partnership Act (UPA) was the main statutory basis of partnership law. In 1914, The National Conference of Commissioners on Uniform State Laws (NCCUSL),[28] spurred by the promulgation of the English Partnership Act in 1890, adopted the UPA. The Act codified much of the common law that had previously governed the general partnership, with some modifications. Every state but Louisiana enacted the UPA, usually with only few variations from its official form and with few modifications over time.[29] Consequently, the law of general partnerships in the United States was both remarkably uniform and essentially static.[30]

The Revised Uniform Partnership Act (RUPA), which was initially promulgated in 1992 and subsequently revised in 1993, 1994, 1996 and 1997, made many profound improvements to the law of general partnerships. The Revised Act constitutes a series of default rules that govern the relations among partners in situations they have not addressed in their partnership agreement. RUPA also provides that a general partnership is an entity distinct from its partners, a partnership creditor should seek exhaustion of partnership assets before seeking a recovery from a partner's personal assets, and distinguishes between buy-outs without dissolution and wind-ups.[31]

The reform process has also affected US limited partnership law. Although most states have adopted the Revised Uniform Limited Partnership Act (1976) with 1985 Amendments (RULPA), many states have made substantial amendments to the official act, thereby forfeiting the benefits of uniformity.[32] The most critical source of uniformity to limited partnerships, i.e., the implicit and explicit link in limited partnership statutes to general partnerships,[33] disappeared with the states' enactment of non-uniform general partnership statutes. As a consequence, for this and other reasons, some policymakers have recommended de-linking limited partnerships from general partnership law. This has resulted in the appointment of a drafting committee by NCCUSL to prepare a "stand-alone" Uniform Partnership Act (Re-RULPA); the committee finished its work in August 2001.[34]

28 NCUSSL could be described as a non-profit private organization that has close ties to both the states and the American Bar Association.

29 NCUSSL and the American Law Institute (ALI) promulgate uniform and model acts for consideration by the states. Legislatures are urged to adopt uniform acts exactly as written, to "promote uniformity in the law among the states." Model acts are designed to serve as guideline legislation, which states can borrow from or adapt to suit their individual needs and conditions. See the official website of NCCUSL at www.nccusl.org.

30 Variations to the UPA as adopted by each state are explained in the statutory notes following each section in ULA (1995) and additional supplement 2001.

31 See RUPA (1997) §§ 201, 307(d), and Articles 6, 7, and 8 respectively.

32 The fact that, unlike general partnership laws, limited partnership statutes have been amended periodically shows the influence of special interest groups on the lawmaking process. As pointed out above, form entrepreneurs viewed the limited partnership as a means to attract clients.

33 See RULPA (1976) with the 1985 Amendments §§101(7), 403, and 1105.

34 The prefatory note to the Uniform Limited Partnership Act (2001) (Re-RULPA) states that "[t]he new Limited Partnership Act is a "stand alone" act, "de-linked" from both the original general partnership act ("UPA") and the Revised Uniform Partnership Act ("RUPA"). To be able to stand alone, the Limited Partnership incorporates many provisions from RUPA and some from the Uniform Limited Liability Company Act ("ULLCA"). As a result, the new Act is far longer and more complex than its immediate predecessor, the Revised Uniform Limited Partnership Act ("RULPA")."

### 2.4.2 Introduction of the Limited Liability Partnership (LLP)

Both the RUPA and Re-RULPA contain provisions to extend limited liability to the general partners, thereby permitting the formation of a limited liability partnership (LLP) and a limited liability limited partnership (LLLP) respectively.[35] The uniform acts did not precede state legislation on this point; they merely reflected the developments in state legislation. Unlike the reform of traditional general partnership and limited partnership law, the proliferation of these new partnership variations took place without the impetus of a uniform act. For instance, the LLP emerged in Texas in 1991 to provide "peace of mind" insurance for innocent partners. Thereafter, the LLP spread rapidly from two states in 1992 to all 50 states and the District of Columbia by 2001. In the original Texan conception of the LLP, general partners in professional firms were allowed to avoid joint and several malpractice liabilities. As the LLP evolved, most states expanded the scope of this business form by allowing non-professional firms to use the statute,[36] and in some jurisdictions state lawmakers extended the concept to include limited partnerships (LLLPs). In addition, most states expanded the original shield of limited liability protection beyond malpractice or other torts of their fellow partners to include all liabilities of the firm, whether based on tort, contract or other basis.

### 2.4.3 Introduction of the Limited Liability Company (LLC)

The introduction of the LLC bundled together limited liability, a flexible governance structure and preferential tax treatment and also requires less ongoing paperwork than corporations. Also, it provides an almost total shield against personal liability without cumbersome formation and capital maintenance rules.[37]

The advent of the LLC evinces a similar developmental to the LLP. Because the Uniform Limited Liability Company Act (1995) (ULLCA) has only been promulgated after most states had developed their own statutes, ULLCA has not played a crucial role in the evolution of the LLC in most states. Nevertheless, ULLCA has been drafted in response to concerns that diversity in LLC statutes might cause serious problems, especially for interstate LLCs.[38] NCCUSL apparently believes that individual states will ultimately repeal the existing statutes in favour of the uniform act. It is of course doubtful whether ULLCA will be a success story, for state legislatures are understandably reluctant to overhaul their relatively new statutes.[39]

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35 See RUPA (1997) §306 stating that except as provided in subsections (b) and (c) – the LLP provisions – all partners in a partnership are liable jointly and severally. Re-RULPA permits LLLP election, a limited partnership that offers limited liability protection to its general partners. However, the LLLP is not the default limited partnership.

36 For instance, the intention of the original Texas LLP was to protect law and accounting firms against a limited list of torts. Although an earlier bill limited the LLP form to "professional" partnerships, the Texas legislature responded to the criticism it received and extended the liability protection to all possible partnerships. To date, only a few states are restrictive in allowing only professional partnerships to be LLPs. One should take note of the fact that even though LLP statutes authorize professional firms to organize as LLPs, ethical rules and opinions promulgated by professional organizations may prohibit professionals from adopting such business forms.

37 Most LLC statutes provide extreme flexibility with respect to the internal organization; there are only few mandatory provisions. The operating agreement overrides the articles of organization in the case of a conflict.

38 Before the promulgation of ULLCA, a committee of the American Bar Association proposed a Prototype Limited Liability Company Act in 1992 (PLLCA). Although this "model act" is open to variations by state legislatures, its concepts have been incorporated in many state statutes.

39 In 2000, only seven jurisdictions, which do not play a major role in the development of business organization laws, adopted ULLCA: Alabama, Hawaii, Montana, South Carolina, South Dakota, Vermont and West Virginia.

In 1977, the first modern LLC statute was promulgated in Wyoming at the behest of lawyers and accountants acting as a lobby group for an oil company wishing to combine limited liability and pass-through tax treatment.[40] Before the Internal Revenue Service (IRS) generally secured the favourable partnership taxation for this new business form, Florida was the only other state that enacted LLC legislation, which it did in 1982 so as to attract foreign investors, particularly from South and Central America. However, the uncertainties with respect to the tax treatment of the new business form severely hampered the rush to conduct business under this new statute, and consequently did not lead to the expected upsurge of economic activity in Florida.[41]

As late as 1988, the IRS clarified the tax treatment of the LLC by issuing a ruling stating that the eligibility for partnership tax treatment is conditional upon the business form's corporate features.[42] If the LLC lacked two of the four corporate characteristics considered by the IRS to be crucial (continuity of life, centralization of management, limited liability and free transferability of interests), then the Treasury regulations would treat the LLC as a partnership for tax purposes.[43] After this ruling, other states jumped on the LLC bandwagon, slowly and hesitantly at first. After 1990, LLC legislation swept rapidly through the United States, largely because of competitive pressures and domestic interest groups, especially legal practitioners who expected additional clients and work from the LLC. LLC provisions have been adopted in all 51 US jurisdictions.

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40 In 1975, lawyers and accountants advising Hamilton Brothers Oil Company devised the "limited liability company", resembling the Panamanian *limitadas*. After a failed legislative effort in Alaska, they lobbied successfully for enactment of the LLC statute in Wyoming. In 1980 only, the IRS issued a favourable private letter ruling to Hamilton Brothers Oil Company regarding its Wyoming LLC structure (Hamilton, 2001).

41 One year after the enactment, only two LLCs had been formed in Florida.

42 Revenue Ruling 88-76, 1988-2 C.B. 360.

43 The test for determining entity classification was set out in section 301.7701-2 of the Treasury regulations, known as the "Kintner regulations". These regulations had a profound influence on the development of the early LLC statutes. A so-called "bulletproof" statute was designed so that the entity would be treated as a partnership for federal income tax purposes.

**Table 3: Comparison of "new" business structures (United States)**

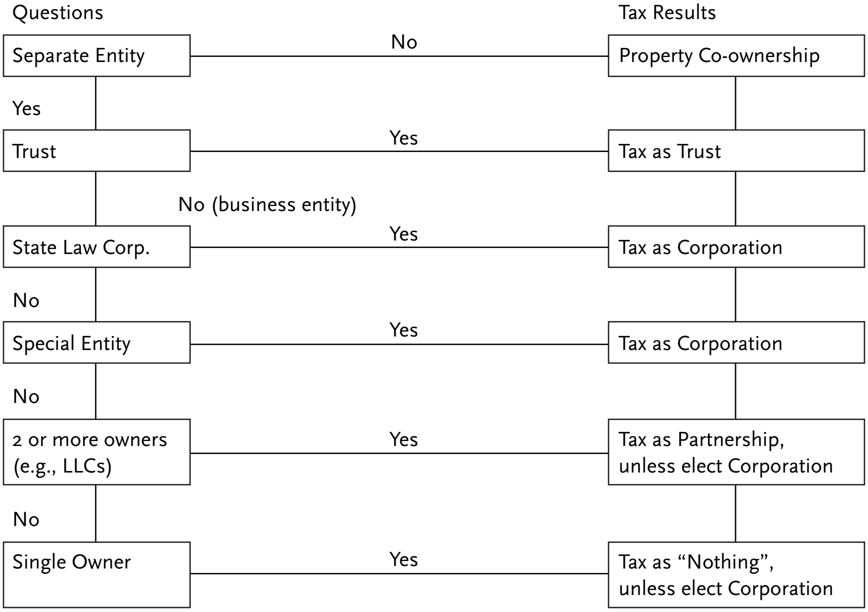
| *Characteristic* | *Partnership (RUPA (incl. LLP)* | *LLC* | *LP (Re-RULPA)* |
|---|---|---|---|
| *Legal Personality* | Entity | Entity | Entity |
| *Management* | Decentralized. Every partner may take part in management | Decentralized (default) / centralized (opt-in) | Centralized |
| *Formation* | Informal (two or more partners) | Public filing with the Secretary of State (one or more members) | Public filing with the Secretary of State (two or more partners) |
| *Fiduciary Duties* | Duties of loyalty and care. Obligation of good faith and fair dealing | Information right<br><br>Good faith and fair dealing | RUPA general partner duties imported Limited partners: no fiduciary duties each limited partner is obliged to "discharge duties ... and exercise rights consistently with the obligation of good faith and fair dealing" |
| *Financial Rights* | Equal sharing | If no agreement, sharing in proportion to the partner's contribution to capital | Sharing in proportion to the partner's contributions to capital |
| *Transferable Interests* | Generally, no | Yes, restrictions are imposed by state laws, securities laws and LLC operating agreement | Yes, restrictions are imposed by state laws, securities laws and LP agreement |
| *Continuity of Life* | Continuation on buy-out of dissociated partner's interest | Withdrawal does not dissolve the LLC | Withdrawal does not dissolve the LP, unless there is no general or limited partner left |
| *Limited Liability* | Joint and several (limited by filing statement) | Limited | General partners: LLLP status provides a full liability shield to all general partners; if not an LLLP, general partners are liable just as under RUPA.<br><br>Limited partners: none, regardless of whether the limited partnership is an LLLP "even if the limited partner participates in the management and control of the limited partnership". |
| *Taxation* | Pass-through ("check-the-box") | Pass-through ("check-the-box") | Pass-through ("check-the-box") |

## 2.5 The Limited Liability Company: The Entity of Choice for US Business

The LLC is a separate legal entity that attempts to take proper account of the concerns of economic actors in an increasingly competitive and litigious business environment. The most important feature is that it offers limited liability protection. By doing so, the LLC allows easy access to the limited liability feature and hence puts a legal shield between individuals and creditors, thereby encouraging entrepreneurship and start-ups. The LLC keeps the price of limited liability down by providing for flexible tax rules and the tax planner with the chance to opt for the most optimal taxation. Due to the over-regulatory nature of the marketplace, clear and flexible business forms that shun formation and operation formalities, like the LLC, were heralded in the United States.

### 2.5.1 *Tax Status*

**Figure 3: US Tax Classification under "check-the-box"**
Source: J. William Callison, Partnership Law and Practice, West Group 2001.




The emergence of the LLC in all states forced the tax authorities to explain in more detail the distinction between partnership and corporate tax treatment, which eventually led to a new federal "check-the-box" tax rule. Under the Internal Revenue Service's "check-the-box" regulations, which became effective on 1 January 1997, unincorporated associations are taxed as partnerships unless they affirmatively elect to be taxed as corporations.

The partnership taxation – pass-through tax treatment – is based on the assumption that a partnership is a mere aggregate of individual partners who re-distribute profits among themselves.[44] Consequently, LLC income is treated as if it were personal income

44 It is worth pointing out that an LLC that is treated as a partnership for tax purposes is neither a general or limited partnership nor are the member considered as general or limited partners. There are a variety of rules in the Code and Regulations that refer to limited partners, limited interests in entities, etc.

realized by the members, and is taxed to the members as individuals.[45] In contrast, corporate income is taxed first to the corporation and later, if it is distributed as dividend, to the shareholders individually.

### *2.5.2 Entity Status and Asset Partitioning*

Entity status is bestowed on the LLC by statutory law. An LLC in its own name acquires rights and obligations, acquires property and other legal rights in immovables, and can sue and be sued. From a law and economics perspective, legal entity status is a necessary shorthand device to define the property rights over which participants within a firm can contract. In the absence of entity status, it would be practicably impossible to shield the assets of the LLC from creditors of the firm's owners. First, the transaction costs of drafting and inserting provisions in all contracts between the participants inside the firm and the firm creditors on the one hand and their personal creditors on the other will be prohibitively high. Second, the firm participants, including the business creditors, would face a moral hazard problem, *viz.* it is virtually impossible to assure the business creditors of the existence of the necessary agreements with the personal creditors.

The separation between the firm's assets and the personal assets of the participants inside the firm – "affirmative asset partitioning" – is viewed as the "core defining characteristic of a legal entity" (Hansmann and Kraakman, 2000). Surprisingly, the opposite form of asset partitioning (limited liability or, as referred to by some lawyer economists, "defensive asset partitioning") is not essential for the creation of a legal entity. That is not to say that there are no other transaction cost advantages or other advantages attached to legal entity status. The entity status strengthens the firm's bargaining power vis-à-vis outsiders. Creditors and other outsiders can deal with the firm as a unit rather than with the individual members.[46]

Nevertheless, the type of asset partitioning conferred on traditional commercial partnerships differs from the stronger type found in the corporate liquidation process. Both types of affirmative asset partitioning assign to the firm's creditors a prior claim on the firm's assets. But in contrast to corporations, the personal creditors of an insolvent partner can initiate the dissolution and liquidation of the partnership's assets to satisfy their claims. It might be argued that the available statutory forms for the organization of business firms should reflect different degrees of entity status. For instance, the menu of business forms could be limited and adapted to prevailing forms of asset partitioning, varying from no partitioning to super-strong asset partitioning. This could, for instance, explain the distinction between civil and commercial partnerships in civil law jurisdictions.

45 IRC § 701 provides that an LLC which are classified as partnership pays no tax on its income, but each member pays tax on the distributive share of the LLC's tax items, see IRC §§ 701 and 702.

46 For these and other reasons, in the early stages of the development of partnership law, lawmakers in civil law jurisdictions have bestowed a weak form of entity status on commercial partnerships and, to some extent, on civil partnerships. In contrast, Anglo-American lawmakers applied common law's aggregate theory to most of the problems arising out of partnership transactions. However, it did not take the entity view long to become embedded in practice. The entity approach mingled increasingly with the aggregate approach. The Revised Uniform Partnership Act (1997) explicitly recognizes a partnership as a legal entity.

### 2.5.3 Capital Structure and Contributions

The capital structure of the LLC is based on similar principles as the public corporation. It determines the members' voting rights, profit and loss sharing, and received distributions.[47] As with the corporation, the statute enunciates the rights of members are allocated in respect of their financial interests. To be sure, members could adopt per capita sharing in some LLCs, where they supply a personal guarantee, make unsecured loans, or undertake a management role in the firm. As a consequence, members can expect to receive additional votes or other rights in exchange for such additional contributions.

As for the consideration for the payment of shares, most LLC statutes provide that contributions may be made to the firm in many different forms, such as "tangible or intangible property or other benefits to the firm, including money, promissory notes, services performed[48], or other agreements to contribute cash or property, or contracts for services to be performed".[49] The relationship – matters such as contribution, distributions, admission and withdrawal, management, and so forth – between the members of an LLC is under US law governed by the informal "operating agreement", which may even be oral. To be sure, states differ in their requirements regarding whether both an oral and written agreement are necessary in respect of the contribution obligations. The LLC does not require minimum contributions in exchange for a membership interest.[50] As a default rule, the Uniform Liability Liability Act provides that a member's inability is not excusable to make payments or deliver property or services.[51]

Most states mandate that the members to maintain a central record of each contribution to ensure the rights of members are respected. Therefore, a member could make a claim regarding a past contribution that has not been registered and seek to update the central record. Thus, if an LLC has more than one class of units, it may be necessary to create two sets of books, one that records the economic relationships among the members ("inside basis") and another for tax purposes ("outside basis").

### 2.5.4 Distributions

In general, LLC statutes do not demand that members receive any distribution before they exit the firm. In some cases, the distributions from an LLC will be tax free.[52] Consistent with what we have seen in the previous section, the LLC statutes that include

47 An operating agreement may establish the manner in which LLC members allocate amongst themselves the profit and losses of the LLC. In the absence of an express agreement, most LLC statutes provide a default rule which states that the profits and losses of the LLC are shared in proportion to the value of the members' contributions.

48 The treatment of a member's contribution of services to an LLC in exchange for an interest may vary depending on whether a member receives an interest in capital and profits of the LLC or an interest in the future profits of the LLC, see *Mark IV Pictures, Inc. v. Comm.* 969 F2d 669, 673 (CA8 1992).

49 ULLCA §401. It is worth pointing out that the initial basis of a member's interest in an LLC will depend on the method by which the interest was obtained. The initial basis of a member's interest is employed to reflect the gains and losses that are passed on to the member from the LLC and to calculate the amount of gain or loss that a member must recognize on the sale of the interest, see IRC § 1001 (a).

50 Whilst contributions of cash or property to an LLC are considered tax-neutral, investors must also recognize that if the LLC is an "investment company", a member may thereby recognize gains but not losses on a transfer of property to the LLC IRC §§ 721(a)-(b).

51 ULLCA §402.

52 Generally, most pro rata distributions of the LLC's net profits will be tax free. Clearly, IRC § 731(a) provides that an LLC member recognizes gain on a distribution of an LLC only where the extent of the money distributed exceeds the adjusted basis of the member's interest in the LLC.

a distribution clause rely on the members' contributions rather than per capita as for the sharing of profits, losses or retained earnings. If a member receives distributions, it is likely to be in the form of cash. In circumstances where a member would demand a non-cash distribution, some states simply deny this right.[53]

Should a member receive excessive distributions, a creditor may have a remedy - in some states- in case the firm would not recognize his claim. There is some variation across the states regarding what constitutes an excessive or wrongful distribution. The statutes attempt to proxy excessive or wrongful distribution by reference to those transactions that tend to induce an LLC's insolvency. Managers and member are liable to creditors in circumstances they return contributions while making the LLC insolvent and leaving creditors unpaid. Naturally, a valuation is required to determine if the distribution entails a return of contributions in a firm that is unable to discharge its debt and other obligations.

Arguably liability for wrongful distributions is similar to fraudulent conveyance law. Law reform experts argue that partnership and corporate law are not the optimal mechanisms for regulating creditors' claims against members in the case of excessive distributions and posit the general tort remedy is better tailored to achieving the policy objectives in this area. In fact, a number of scholars have recommended on efficiency grounds abandoning veil-piercing in favour of a fraudulent conveyance remedy.[54] On this view, increasing the liability of members will discourage the transfer of members' interest to their most valued use.

### *2.5.5 Members' Interests*

Members' interests consist of: 1) financial rights to share in the profit and losses and receive distributions; and 2) governance rights to participate in management and control.[55] Generally these rights are defined by the statute and relevant case law. It is commonly agreed that, in the absence of contrary agreement, members may only transfer their financial rights.[56] The governance rights may only transfer by consent of the non-transferring members. To be sure, there is some conflict over the precise interpretation of financial rights. For instance, some question whether financial rights include indemnifications, repayment of loans and salaries. Of course, this defect can be addressed by the promulgation of precise legal measures that clearly specify the transferable financial rights.

With respect to assignments, some jurisdictions mandate that assignors can be released from liability when all members have given their consent to the transfer. In some states, the assignee will not automatically obtain governance rights in the LLC even when the financial rights have been transferred. The restrictions on the transferability of a member's interest obviously preclude the development of a liquid market in members'

53 ULLCA §405(b)
54 UCLA 303 emphasizes that failure to meet legal formalities is not a basis for veil piercing.
55 As discussed earlier, these rights are characteristic of closely held firms.
56 The general rule is that with the sale or exchange of a member's interest in an LLC, the member's interest is treated as a capital asset and the gain or loss on the sale or transfer is a capital gain or loss, see IRC § 1221.

interests. To be sure, a number of states have introduced publicly traded units – which are nothing more than depository receipts for the owners' property interests. However, the efficiency of selling units is called into question because underwriters are unwilling to offer units on a wide scale. Further, the introduction of units could trigger obligations for securities law purposes that will in turn entail additional costs for members.

Legislators have determined that the interests of members that pass to heirs are strictly limited to financial, but not to other rights. In effect, they are entitled to the same rights as an assignee. To be sure an exception is allowed for a divorced spouse who not only is entitled to receive distributions, but is also entitled to receive an interest in the firm's property, including good will. Naturally, these beneficiaries are not entitled to become members of the firm.

### *2.5.6 Internal Organization*

The LLC statutes are largely linked to general and limited partnerships, and corporations. To the extent that LLC statutes do not contain explicit linking provisions, the "pick and mix" of provisions of other business forms could entail implicit linking problems. If the statutes are silent on a particular issue, the import of general partnership provisions could imply that gaps should be filled with other partnership law rules. In the absence of statutory authority, courts could decide to extend general partnership principles to the LLC and to treat different business forms alike. For instance, since the Uniform Limited Liability Company Act (ULLCA) uses identical language to RUPA for its fiduciary duties,[57] it is obvious that there will be some undesired spillovers from one business form to the other. Second, even though most LLC statutes provide for decentralized management by default, it is also possible to opt for centralized management.[58] This raises the issue of whether other default rules should also differ according to the parties' choice. In this respect, ULLCA provides for different fiduciary duty provisions, but similar dissociation and dissolution provisions. Courts could view this as a legislative omission and decide to apply corporate law rules to centralized management LLCs when the underlying relational contract remains silent. The US practice reveals, however, that courts are well equipped to fill the gaps in a manner consistent with the preferences of the majority of the users of the LLC statute.[59]

57 See ULLCA (1995) §409.

58 See, *e.g.*, ULLCA (1995) §203 (stating that the articles of association must set forth whether the company is to be "manager-managed".

59 For instance, an Ohio appeals court found that where an operating agreement expressly allows competition between other businesses, the operating agreement overrides any claim based on the breach of fiduciary duties. See *McConnell v. Hunt Sports Enterprises*, 132 Ohio App. 3rd 657, 725 N.E.2d 1193 (1999).

**Table 4: "LLCs are catching up with corporations in the United States"**
Source: 2004 Reports of the Jurisdictions, International Association of Commercial Administrators (compiled by Larry E. Ribstein available at www.ideoblog.org).

| *Year* | *LLC filings* | *Corporate filings* |
|---|---|---|
| 2000 | 415,556 | 634,147 |
| 2001 | 457,701 | 610,257 |
| 2002 | 571,220 | 730,573 |
| 2003 | 702,336 | 748,951 |

## 2.6 European Union: The Evolution of New Business Forms (20th and 21st century)

The European debate on the design of limited liability business forms has gained momentum amid continuing demands by SMEs and professionals for targeted legislation. What forces explain the emergence of new closely held business forms? Over the last decade, Europe has witnessed US state lawmakers creating a variety of partnership-type structures that are designed to improve the conditions of firms doing business. In response to the apparent success of the US experiment, which has provided the necessary impetus to undertake reform, European policymakers have embraced the logic of these new entities and are now focused on creating new vehicles that are widely available for entrepreneurs, professionals and firms involved in cross-border joint ventures. The policy debate in the UK, for example, has centered on the problems of easy availability of limited liability for small businesses.

### *2.6.1 The United Kingdom: The Limited Liability Partnership (LLP)*

The introduction of the limited liability partnership (LLP) was motivated by a myriad of factors, including election politics, which contributed to its speedy passage. The Department of Trade and Industry (DTI) was directly involved in the establishment of the LLP. Prompted by competition from offshore LLP statutes, particularly that of Jersey,[60] UK lawmakers recently promulgated a Limited Liability Partnership Act.[61] The legislation introduces a vehicle that has legal personality, a partnership governance structure, limited liability, and partnership tax treatment.[62] In drafting this legislation, DTI responded to the pent-up demand from existing partnerships wishing to transfer to LLP

60 Limited Liability (Jersey) Law, 1996. Motivated by liability and tax considerations, British accountants (in particular Ernst & Young and Price Waterhouse) provided a wholly crafted statute to the Jersey legislature, a largely passive and accessible body that decided to enact the statute. In speedily adopting the LLP, Jersey signalled its commitment to a comprehensive set of business forms for foreign organizations. However, high switching costs and doubts about the prospective benefits of incorporating as a Jersey LLP may explain Jersey's failure to capture a share of the UK partnership market.

61 The Limited Liability Partnerships Act 2000, The Limited Liability Partnerships Regulations 2001, and Limited Liability Partnerships (Fees) (No. 2) Regulations 2001 came into force on April 6, 2001.

62 The Limited Liability Partnership Act 2000 and the Finance Act 2001 provide that LLPs are classified as partnerships for tax purposes.

status.[63] Although the LLP act was initially drafted to address the professional liability concerns of large accounting and other service providers in England, the statutory provisions, as enacted, cover all types of businesses.

Still even if this vehicle represents a new policy direction in partnership law, it cannot be viewed as creating a successful, low-cost solution for SMEs – notwithstanding the flexibility and access to lower cost rules afforded by the introduction of the Act. Among other considerations, firms that opt into the LLP form are required to comply with many of the provisions of Part VII of the Companies Act concerning the preparation of audits and publication of accounts; some provisions of the Companies Act relating to the registration of charges, the delivery of accounts, and the investigation of companies and their affairs; and some provisions of the Insolvency Act relating to voluntary agreements, administrative orders, and the winding-up of the business.[64] As a consequence, with respect to some operating formalities, the LLP resembles a corporation. In other respects, and chiefly its decision-making rules, the LLP is closer to a partnership. Still the new LLP makes it very costly for entrepreneurs and small firms in general to structure their relationships through this type of business form.

Whilst the LLP gives its internal participants limited liability, the disadvantages of the flimsy statute, which requires firms to comply with corporate default rules, outweigh the practical benefits of the legal form. Hence, unlike its US namesake, the UK LLP is not a general partnership with limited liability. On the contrary, like the US LLC, the UK LLP is a hybrid between a partnership and a corporation. Both business forms are intended to allow firms to obtain the benefits of limited liability while retaining the tax treatment of a partnership.[65] However, they are more similar to a corporation, in that many provisions of the statutes draw directly from the corporate model.[66]

In short, the United Kingdom has responded to the demands of a particular class of firms (i.e., multinational professional service firms) that possess the resources and capacity to draft a comprehensive operational agreement that meets their special requirements. The outcome is that, while the UK LLP extends limited liability to all types of firms, the effect of high transaction costs will arguably limit its suitability for most SMEs. While there were significant, unanticipated drawbacks during the pioneering stage of the LLP statutes,[67] the statutory framework may eventually evolve into a more efficient regime. Assuming that a large number of firms convert to the LLP form, the increasing use of the law should result in the creation of more beneficial statutory terms. If the LLP

63 In its draft Regulatory Impact Assessment, the DTI made a "tentative estimate" that around 60,000 regulated firms might eventually become LLPs.

64 It is important to note that the linkage to the company law regime relating to creditor protection is the trade-off for gaining access to limited liability. See Limited Liability Partnership Regulations 2001, SI 2001/1090.

65 The LLP Act was designed principally to help accountants escape personal liability. Unlike the first LLP statutes in the United States, the English legislation provides a full shield of limited liability.

66 The ULLCA draws many provisions from RUPA. However, many state statutes adopt a more corporate approach. As for the UK LLP, it is likely that where there is no agreement and the Regulations do not help, the default position is corporation law. This is reflected in section 1(5) of the LLPs Act 2000, which states that, except as far as otherwise provided by this Act or any other enactment, the law relating to partnerships does not apply to a limited liability partnership.

67 The LLP in the UK could be viewed as a compromise between the preferences of powerful interest groups, lawmakers and political actors, who had to act fast under pressure from the threat of regulatory competition.

should prove inflexible and ill-suited for small and medium-sized firms, lawmakers might – in light of the government's policy to provide the most competitive legal forms possible for commercial businesses seeking limited liability – eventually take steps to adopt new legislation to assist those firms that are effectively barred from switching to the LLP form.[68] However, there is little chance that Parliament, due to the absence of political pressures, will amend the LLP statute.

The LLP requires formal creation. The UK statute mandates that two persons must incorporate an LLP. During its legal existence, it is required to have two designated members at all times. Under the legislation, there are two types of members (designated v. other members). Besides the usual rights and duties governed by the agreement and general law, designated members carry additional responsibilities, including the right to sign the accounts on behalf of the members, delivering the accountants to Registrar of Companies, notifying the Registrar of any membership changes, signing and delivering the annual return form, and acting on behalf of the LLP after its dissolution. An incorporation document must be delivered to the Registrar of Companies.[69]

The accounts must be audited to show a "true and fair" view under UK GAAP.[70] The Consultative Committee of Accountancy Bodies has published its Statement of Recommended Practice (SORP) on accounting by Limited Liability Partnerships (LLPs).[71] SORP's aim is to confirm that LLPs have disclosed their financial statements in line with those of limited companies.[72] The effect of the guidelines has been the introduction of new interpretations in place of the earlier measures applicable for limited partnerships.

The constitution of an LLP is the creation of its members. The statute allows members to design their relations freely without publishing or disclosing their relational agreement.[73] While it is common practice to design a written agreement, there is no legal obligation to do so. Oral agreements are recognized.

In order to facilitate contracting, default provisions have been provided through the

68 Despite its complex and cumbersome quality, the earliest empirical evidence on registrations of LLPs, compiled by Jordans, shows that, in fact, SMEs are most attracted to this new limited liability vehicle. Astonishingly, more than 75% of the 600 or so LLPs registered since 6 April 2001 have been drawn from the wider business community. Allegedly, SMEs are attracted to the LLP, as this form has important advantages over other business forms, such as the close corporation and the general partnership. For instance, by forming an LLP a firm avoids paraphernalia associated with companies, while obtaining credibility. Moreover, the LLP might be viewed as a focal point around which a new network will arise. That professional firms are lagging behind other business firms could partly be explained by the reluctance of professionals to disclose their financial details. Nevertheless, the publication of the Statement of Recommended Practice for Accounting for LLPs is expected to increase the interest in the LLP even more. As at 8 July 2002, 2580 LLPs had been registered in England and Wales.

69 Limited Liability Partnerships Act 2000, §2.

70 There are exemptions from audit for LLPs with turnover up to a certain threshold. On 26 May 2000, this threshold was set at an amount of 1 million Pounds.

71 See SORP Accounting by limited liability partnerships at: www.ccab.org.uk

72 Initially there was significant resistance to the UK government mandating financial disclosure for LLPs. Many commentators assumed that the high cost of disclosure and privacy issues would limit the interest in the LLP. The Limited Liability Partnerships Regulations and accounting standards require that the financial statements should include, unless exempted by the requirements of the Companies Act 1985 as modified by the Regulations, the following items: 1) profit and loss statement, consolidated in the case of a group preparing accounts; 2) a statement of total recognized gains and losses pursuant to FRS 3, consolidated in the case of a group preparing accounts; 3) cash flow statement pursuant to FRS 1, consolidated in the case of a group preparing accounts; 4) a balance sheet, and a consolidated balance sheet in the case of a group preparing accounts; and 5) notes to the financial statements disclosed.

73 Limited Liability Partnerships Act 2000, §5.

Limited Liability Partnerships Regulations 2001. A key default provision provides for the management of the LLP, which is vested in its members. Moreover, there is also a default provision for the equal sharing of profits and relations. The Companies Act arguably will fill in the gaps where an agreement and the Regulations are silent.

But the application of Companies Act is not straightforward. For example, the question whether section 459 of the Companies Act can be extended to the LLP in cases where a member launches an action for minority oppression is complex indeed. Generally, it is suggested that the "unfair prejudice claim" under section 459 of the Companies Act 1985 should be limited in scope in that the basis for the claim against self-dealing transactions by the controlling shareholder should be a departure from an agreement among the shareholders. The Company Law Steering Group follows the House of Lords in *O'Neil v. Philips* in limiting "unfairly prejudicial conduct" to cases where the majority is acting contrary to some agreement or understanding with the minority.[74] The Steering Group's view on section 459 limits the right of minority shareholders to exit the company at a fair price when a controlling shareholder has acted opportunistically. In the case of the LLP, the issue turns on whether minority investors are protected by a mandatory buy out right irrespective of the circumstances and content of the LLP agreement. However, it seems that minority investors in LLPs hold a similar position as minority shareholders in a close corporation, which not only exposes them to financial risk, but could exclude them from participation in management and a claim on the financial returns. Extending section 459 to members of the LLP should, in effect, induce members to write an express agreement in respect of possible future conflicts. Since this business form attracts many smaller firms, it could be argued that the gaps in the legislation leave potential users of an LLP without satisfactory protective provisions.

Unless special legislation was provided, the LLP would have been taxed as a corporation. UK lawmakers introduced provisions in the Limited Liability Partnerships Act 2000 and the Finance Act 2001 that stipulate the LLP should be treated as a partnership for tax purposes only when it carries on a trade profession or other business with a view to profit. The partnership treatment reverts to the corporate rate if the LLP discontinues conducting a trade profession or business with a view to profit. To be sure, the UK government, which is concerned with limiting abusive tax evasion and illicit activities carried out through corporate forms, has made certain that its anti-avoidance legislation applies to the LLP, but has yet to provide sufficient guidance about the proper interpretation of these measures.

### *2.6.2 The United Kingdom: Other Reforms*

The LLP did not feature in the other law reform initiatives, which were designed to provide the most competitive closely held business forms possible. First, the DTI's Company Law Review Steering Group addressed amendments to the close corporation so as to meet the needs of small and closely held businesses. Although the UK close corporation is widely considered as being flexible, allowing business participants to tinker with

74 [1999] 1 W.L.R. 1092.

the provisions of the Companies Act 1985, practitioners and owners of small businesses have often expressed reservations about the cumbersome nature of the Companies Act regime.[75] Based on the "think small first" principle,[76] the Steering Group recommended a simplification of internal procedures, in the fields of decision-making procedures, corporate governance, and filing and disclosure regulations. It did not feel the need to create a new corporate vehicle for small firms, as the "Limited Liability Partnership Act 2000" has made available a new vehicle which may be especially beneficial for businesses that seek limited liability while preserving the less formal internal governance and decision-taking arrangements familiar to many owner-managed businesses.

Another reform initiative was the Law Commission's review of partnership law.[77] Inspired by the partnership reform process in the United States, the Law Commissioner for England and Wales and the Scottish Law Commission have begun to undertake fundamental revisions to traditional partnership law, which should lead to the design of an improved and stable unlimited liability vehicle for modern businesses. Particular reference is made to independent legal personality, continuity of business irrespective of changes of ownership, and a model partnership agreement. Since recent empirical research in the United Kingdom suggests that many businesses have been incorporated for reasons other than limited liability, partnership law reform is important to establish an efficient menu of business forms, which will provide an adequate choice of legal vehicles for firms at all levels. In this view, general partnerships focus on small business firms that may find the close corporation and LLP unduly burdensome.

Since the modernization of business organization law is apparently focused on increasing the competitiveness of indigenous businesses, and the current business forms, including the LLP, appear to be able to retain and even attract out-of-state businesses, there seems to be no need for the legislature to undertake another hybrid partnership law initiative. This complacent attitude will almost certainly change if other jurisdictions develop business structures that enhance their attractiveness as a location for businesses. The fact that lawmakers have taken steps to review of the Limited Partnerships Act 1907, which did not prove very popular in business practice until the mid-1980s, exemplifies the British policymaking concerns to maintain their competitive position in Europe (see Box 1). The threat of competition in combination with the lobbying efforts of venture capitalists and sophisticated investors will arguably make UK limited partnership law more suitable for venture capital investment. Naturally, the limited partnership law reform fits the government's objective of creating modern business forms supporting a competitive economy.

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75 In brief, corporate law appears to fail small firms in two key respects: 1) it imposes excessive regulation and 2) it is not transparent. As a consequence, non-compliance through regulatory fatigue or simple confusion abounds.

76 The "think small first" principle means that the Companies Act should focus first on the needs of small firms rather than public corporations, which require greater transparency due to the dispersed ownership structure. In other words, the default rules should be tailored to the needs of small firms rather than requiring these firms to opt out of suboptimal provisions

77 On 24 November 1997, the DTI requested the Law Commission and the Scottish Law Commission to undertake jointly a review of partnership law. The terms of reference were: To carry out a review of partnership law, with particular reference to independent legal personality; continuity of business irrespective of changes of ownership; simplification of solvent dissolution; a model partnership agreement; and to make recommendations. The review is to be conducted under the present law of partnership, namely the Partnership Act 1890 and the Limited Partnerships Act 1907.

**Box 1. Limited Partnership (LP)**

Prompted by the threat of competition in combination with the lobbying efforts of, among others, venture capitalists and sophisticated investors, UK lawmakers recently published a report on partnership law reform in which they propose modern limited partnership legislation. The reform intends to abolish the rule on the maximum number of partners – presently limited to twenty – and introduce “safe harbour” provisions, which, like those found in the Delaware Revised Uniform Limited Partnership Act and Jersey’s limited partnership form, clearly establish that limited partners may participate in the control of the firm so as to improve certainty and accessibility to foreign investors.

Indeed, following the needs of commercial solicitors, UK lawmakers have proposed safe harbour provisions that offers guidance for limited partners, such as large institutional investors, concerning a list of activities in respect of his permissible involvement in a partnership. These include participation in: 1) strategic decisions; 2) enforcement of rights; 3) approval of accounts of the limited partnership; 4) engagement in contractual work for the partnership; 5) acting as a director, employee or shareholder in a corporate general partner; 6) resolution of conflict of interest problems; and 7) consultation and advice.[78]

As for the entity-aggregate issue, UK lawmakers embrace the entity approach for the general and limited partnership form. They acknowledge that the legal entity status is a necessary shorthand device to define the property rights over with participants within a firm can contract. However, given the importance of tax considerations in choosing a business form, the possible uncertainty about tax authorities’ reaction to the introduction of bestowing partnerships with legal entity status, the UK lawmakers were forced to adopt a limited partnership without separate legal personality in order to circumvent cumbersome characterization issues. Given the need to attract more foreign investors, the special limited partnership without legal personality is obviously better able to preserve tax benefits overseas.[79]

Besides the preservation of tax transparency, legal clarity plays a pivotal role in private venture capital investments. The UK lawmakers rightly assume that the business parties involved in venture capital contracting create detailed legal agreements themselves. As a consequence, in place of applying default rules of the General and Limited Partnership to the special vehicle, which has several spillover disadvantages, the lawmakers explicitly delink the special limited partnership from the other partnership forms.[80] By doing so, lawmakers recognize that default rules may impede the introduction of new contractual and financial incentive mechanisms. Moreover, the stickiness of default rule provisions may lead to uncertainty as to the enforceability of contractual modifications of the default rules.

78 See Schedule 6 of the UK Partnership Bill (The Law Commission and the Scottish Law Commission, Partnership Law, Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965, 2003).

79 The Law Commission and the Scottish Law Commission, Partnership Law, Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965, 2003, p. 27: “Serious concerns have been expressed to us, particularly by the APP (Association of Partnership Practitioners), that giving legal personality to limited partnerships may affect their tax treatment overseas, and that uncertainty over that issue would affect their usefulness as a vehicle for investment and, therefore, be damaging to the economy.”

80 See Schedule 10 of the UK Partnership Bill (The Law Commission and the Scottish Law Commission, Partnership Law, Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965, 2003).

Yet, it is unclear whether it creates a successful, low-cost solution for investors and venture capitalists alike. Although the UK lawmakers disapply most of the general and limited partnership default rules, the special limited partnership is still to some extent linked to the other partnership forms. It is clear that the approach chosen by the UK lawmakers might lead to some uncertainty even though the contracting parties are professionals with significant bargaining power. Even though contract parties are willing to accept the challenge of drafting an agreement for the special limited partnership, transaction costs, information asymmetries and strategic behaviour could prevent them from bargaining their way to an optimal agreement. As a consequence, with respect to some operating formalities, such as fiduciary duties, the special limited partnership resembles a normal limited partnership.[81] In other respects, the special limited partnership constitutes a new partnership vehicle. In any event, the United Kingdom has clearly responded to the demands of a particular class of firms, such as investment funds, that possess the resources and capacity to draft comprehensive operational agreements that meet their special requirements.

81 See The Law Commission and the Scottish Law Commission, Partnership Law, Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965, 2003, p. 300: “At the same time, our recommended reforms in relation to the overriding duty of good faith and the statutory statement of duties of disclosure on joining a partnership are as applicable to the special limited partnership as to any other partnership as are many default rules, for example, in relation to the sharing of profits and losses and the management of the business.”

**Table 5: Comparison of LP Developments**

| *Characteristic* | *LP (Delaware)* | *LP UK (Special LP)* | *LP (Re-RULPA)* |
|---|---|---|---|
| *Relationship to general partnership act* | Linked | Linked (Schedule 10 de-links) | De-linked (but many RUPA provisions incorporated) |
| *Legal Personality* | Entity | Entity (No Legal Personality) | Entity |
| *Duration* | Specified | Perpetual; subject to change in partnership agreement (default rule: change of partners causes break up) | Perpetual; subject to change in partnership agreement |
| *Limited partner liability for entity debts* | None unless limited partner participates in the control of the business and persons transacting with the limited partnership could believe that the limited partner is a general partner | None, unless participation in management. However permitted activities in list. | None, regardless of whether the limited partnership is an LLLP, “even if the limited partner participates in the management and control of the limited partnership” |
| *Partner access to information - required records/ information* | All partners have right of access. Linked to general partnership | All partners have access. Linked to general partnership | List of required information; Act expressly states that partner does not have to show good cause; however, the partnership agreement may set reasonable restrictions on access to and use of required information, and limited partnership may impose reasonable restrictions on the use of information |
| *Limited partner duties* | None specified | Overriding duty of good faith; no duty to disclose and abstain from competition | No fiduciary duties “solely by reason of being a limited partner”; each limited partner is obliged to “discharge duties ... and exercise rights consistently with the obligation of good faith and fair dealing” |
| *General partner liability for entity debts* | Complete, automatic and formally inescapable (in practice, most modern limited partnerships have used a general partner that has its own liability shield; e.g., a corporation) | Unlimited liability | LLLP status available via a simple statement in the certificate of limited partnership; LLLP status provides a full liability shield to all general partners; if the limited partnership is not an LLLP, general partners are liable just as under RULPA |
| *General partner duties* | Linked to general partnership | Linked to general partnership | RUPA general partner duties imported; general partner’s non-compete duty continues during winding up |

**Table 5: Comparison of LP Developments (Continued)**

| *Characteristic* | *LP (Delaware)* | *LP UK (Special LP)* | *LP (Re-RULPA)* |
|---|---|---|---|
| *Allocation of profits, losses and distributions* | Linked to general partnership | Equal sharing | Allocates distributions according to contributions made |
| *Limited partner voluntary dissociation* | Linked to general partnership | Linked to general partnership | No "right to dissociate as a limited partner before the termination of the limited partnership"; power to dissociate expressly recognized, but can be eliminated by the partnership agreement |
| *General partner voluntary dissociation* | Linked to general partnership | Linked to general partnership | Right exists; dissociation before termination of the limited partnership is defined as wrongful |
| *Dissolution following dissociation of a general partner* | Occurs automatically unless agreements states otherwise. Linked to general partnership | No (Yes, unless agreement states differently) | If at least one general partner remains, no dissolution unless within 90 days after the dissociation the majority partners consent to dissolve the limited partnership; if no general partner remains, dissolution occurs 90 days after the dissociation, unless partners consent to continue the business and admit at least one new general partner |

### *2.6.3 France*

New developments in Europe are not only restricted to Commonwealth jurisdictions. The 1994 introduction of the *Société par Actions Simplifiée* (*SAS*) and its subsequent modification in 1999 is an example of responsive lawmaking in a civil law country.[82] The *SAS* is a limited liability vehicle that provides for a flexible organization and administrative structure, which restricts free transferability and the expulsion of minority shareholders. In recent years, the competition between states for real inflows of capital has caused member states to adopt a variety of new business forms designed to stem the outflow of taxable resources. The pressure of competition from other member states, which are viewed as having more suitable closely held business forms, stimulated French lawmakers to adopt a new organization structure with significant costs and benefits for firms.

Turning first to costs, the mandatory provisions in the French civil code relating to public corporations apply to the *SAS*, with the exception of provisions relating to management (Board of Directors, Executive board and Supervisory Board) and shareholders' meetings. A statutory auditor, however, must be appointed. It is clear that extending provisions of the publicly held corporation to the *SAS* framework may be costly and problematic. Moreover, there are additional mandatory rules that increase the burden on entrepreneurs and smaller businesses. In particular, the legislation requires that an *SAS* must have a minimum share capital of EUR 37,000. Also, the restrictions on the transferability

82 Law no. 94-1 of 3 January 1994 J.O.; Law no. 99-587 of 12 July 1999, J.O., 13 July 1999, p. 10396, D.S.L. 1999 p. 425, Art. 3.

of shares extend to the floatation of shares on public exchanges. Finally, the *SAS* must be represented by a President, who may be an individual or legal entity. The President incurs the same liability as the directors in a publicly held corporations, the *Société Anonyme* (*SA*). These measures, taken together, impose significant costs and sufficiently burdensome to cause difficulties for a large class of firms that might wish to exploit this form.

Nevertheless, the *SAS* creates the opportunity for partners in a joint venture – and for other purposes – to adopt a legal structure that is sufficiently flexible in the organization and control of the firm. This vehicle allows parties to choose the firm's decision-making structure and the contents of its bylaws. The *SAS* holds out the potential to provide cost-saving benefits that may attract new "incorporations", allowing France to compete effectively with Germany, the Netherlands and the United Kingdom. By making the corporate structure more adaptable to the business needs of SMEs and allowing its shareholders to be both individuals and legal entities, the French government would probably have increased the number of new domestic businesses, and perhaps a small subsection of SMEs.

Regardless of whether business activity increases as a result of the adoption of the *SAS*, critics point out that the complexity of the *SAS* may ultimately lead to severe incomplete contracting, since the statute fails to supply a comprehensive statutory template that the parties can fall back on when establishing the distribution and allocation of powers and responsibilities.

**Table 6: Comparison LLP (UK) and SAS**

| *Characteristic* | *LLP (UK)* | *SAS* |
|---|---|---|
| *Legal Personality* | Entity | Entity |
| *Management* | Decentralized. In absence of agreement every partner may take part in management | Parties are free to decide on the management structure. It is compulsory to have a "President". |
| *Formation* | Incorporation document (two or more members) | *SAS* acquires legal personality upon obtaining a registration number from the Clerk of the Commercial Court. Minimum share capital: 37,000 euro (half of which must be paid). (One or more members) |
| *Fiduciary Duties* | No general duty of good faith Specific duties in the regulations to account for competing activities and use of partnership property | Good faith. Articles of association could provide for more detailed rules. The statute provides special rules applying in situations sought to take the benefit of contracts with the *SAS* |
| *Financial Rights* | In absence of agreement equal sharing rights | If no agreement, sharing in proportion to the member's contribution |
| *Transferable Interests* | No public offerings allowed | No public offerings allowed |
| *Continuity of Life* | Change in membership of members does not lead to dissolution | Withdrawal does not dissolve the *SAS* |
| *Limited Liability* | Limited | Limited (capital requirements) |
| *Taxation* | Partnership | Corporate |

There are a substantial number of issues that parties cannot contract for themselves *ex ante* due to the absence of sufficient legal precedent to write joint venture agreements. Even if contract parties are willing to accept the challenge of drafting an agreement for the *SAS*, transaction costs, information asymmetries and strategic behaviour could prevent them from bargaining their way to an optimal agreement. While an *SAS* may provide more flexibility for closely held firms, the costs involved in complex legal drafting to adapt the public corporation framework to the needs of these firms will discourage a large number of firms from incorporating under the *SAS*. If this is the case, the difficulties in modifying the *SAS* to benefit small and medium-sized firms could prove problematic. Indeed, French lawmakers have been slow to revise the inefficient statutory provisions that have a costly impact on smaller firms.[83] As with the UK LLP, government lawmakers are likely to achieve much more by developing a variety of legal rules that are directly beneficial to closely held firms. By allowing SMEs to use the *SAS* framework without the value of corresponding benefits for these enterprises, French lawmakers, like their British counterparts, were apparently engaged in window-dressing activities, thereby demonstrating that they are business-friendly.

**Figure 4: The market shares of French business forms**
Source: Naomi R. Lamoreaux and Jean-Laurent Rosenthal, Organizing Middle-sized Firms in the United States and France, January 2005, working paper.

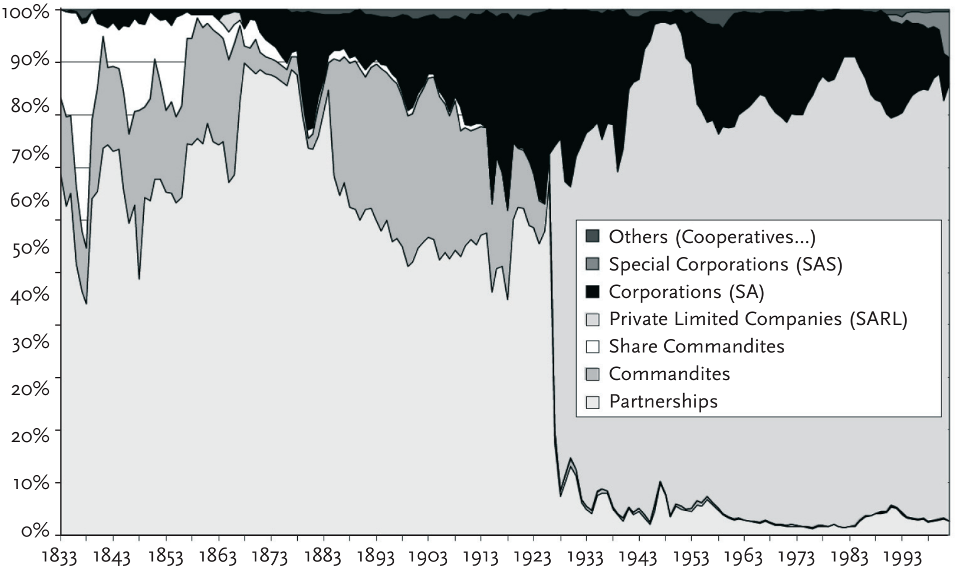


Figure 4 shows, however, that there is increasing demand for the *SAS*. However, the *Société*

83 The high awkward capital requirements prevented firms from organizing under the *SAS* statute. As a result, French lawmakers lowered the requirements in 1999.

*à Responsabilité Limitée* (*S.A.R.L.*) remains the dominant choice for closely held firms. Introduced in 2003, the *S.A.R.L.* is considered attractive because it allows incorporating parties to establish a firm within 24 hours and has a minimum capital of € 1. Moreover, the formation requirements have been kept to a minimum, permitting incorporations through the Internet. Lawmakers, in order to induce parties to select this form, have offered a series of financial inducements ranging from tax and social contribution reductions -during the first year of existence - to eased corporate seat requirements.

**Table 7: Comparison of French business forms**
Source: International Correspondence Lawyers (www.icl-directory.com).

| *Characteristic* | *Close Corporations Société à responsabilité limitée S.A.R.L.* | *Société par actions simplifiées S.A.S.* | *Publicly Held Corporation Société anonyme (S.A.)* |
|---|---|---|---|
| *Company law* | Code de commerce | Code de commerce | Code de commerce |
| *Company purpose* | Basically every legal, permanent or non-permanent, or non-material purpose | Basically every legal, permanent or non-permanent, or non-material purpose | Basically every legal, permanent or non-permanent, or non-material purpose |
| *Founders* | 1 (minimum) to 50 | 1 (minimum) | 7 (minimum) |
| *Capital requirements* | 1 EUR | 37,000 EUR | 37,000 EUR |
| *Liability* | Limited to capital invested, except in civil or criminal suits | Limited by shares, except in civil or criminal suits | Limited by shares, except in civil or criminal suits |
| *Costs of incorporation* | 300 EUR | 300 EUR + legal fees | 300 EUR + legal fees |
| *Incorporation* | Articles of association + registration at the Registry of Commerce + publication in legal gazette | Articles of association + registration at the Registry of Commerce + publication in legal gazette | Articles of association + registration at the Registry of Commerce + publication in legal gazette |
| *Company name* | Free + company form | Free + company form | Free + company form |
| *Formalities* | Moderate | Moderate | High |
| *Credit / funds* | Possible, but personal liability | Possible, but personal liability | Possible |
| *Accounting obligation* | Yes | Yes | Yes |
| *Management* | One or more directors, who must not be corporate entities, but do not need to be partners. | At least one chairman | Executive board (conseil d'administration) or managing board (directoire) and supervisory board (conseil de surveillance) |
| *Nationality* | Free | Free | Free |
| *Image* | Good | Good | Very good |
| *Taxation* | Corporate Tax | Corporate Tax | Corporate Tax |

### 2.6.4 Germany

While competitive pressures continue to mount, the German legislature has not engaged in fundamental corporate law reform in this area. However, there have been several amendments to its traditional partnership forms through the revision of the Commercial Law in 1998.[84] For instance, the German legislature followed the recommendation of the Commission of the European Communities that member states should introduce the continuity of partnerships into their national laws. In this view, the unsophisticated entrepreneurs should not be victimized by inefficient fall-back provisions that oblige them to dissolve their business (e.g., in the event of the unforeseen death of any partner).[85] In all likelihood, continuity of the business is the appropriate default rule. It may well reduce transaction costs, because most partners will be spared the need to reach a private agreement on this issue. In economic terms, the principle of continuity is closer to the bargain the parties would have reached themselves if transaction costs were zero.

The revision of the Commercial Code does not benefit partnerships generally, however.[86] It only applies to the commercial partnerships formed and registered for commercial purposes, such as the general partnership and the limited partnership.[87] The law concerning the civil partnership,[88] which does not have commercial objects (e.g., agriculture, forestry, educational and professional activities), does not recognize the continuity of the partnership as a legal principle. The death or bankruptcy of any partner causes the dissolution of a German civil partnership when nothing to the contrary has been agreed.

While there is no distinction between civil and commercial law in Commonwealth countries, the principle has been deeply rooted in continental European jurisdictions. In partnership law, it entails that professional service firms are prohibited in principle from using a commercial partnership. While the distinction may be explained by history rather than by compelling logic, there are nevertheless several important consequences attached to the commercial qualification of a partnership. Most importantly, commercial partnerships are generally characterized as legal entities either by code or by judicial usage. Typically, entity status can be acquired officially by registration. But even when legal personality is not explicitly conferred to commercial partnerships, which is the case in Germany, there is a preponderance of entity-based features:[89] the partnership has its own rights and obligations; the partnership may sue and be sued in its own name; and the partnership can hold title to property.

Yet the difference between civil and commercial partnerships is gradually diminishing over time. Commercial law reform in Germany has broadened the scope of general

84 The German legislature has reformed several provisions of partnership law as part of the *Handelsrechtsreformgesetzes* in 1998.

85 See §131(3) German Commercial Code (*Handelsgesetzbuch (HGB)*).

86 See §131(3) German Commercial Code (*Handelsgesetzbuch (HGB)*).

87 Business participants who want to form a partnership for the purpose of conducting a trade or business regulated by the commercial code must register as either a general partnership (*offene Handelsgesellschaft (oHG)*) or a limited partnership (*Kommanditgesellschaft (KG)*), which are governed by the second book of the German Commercial Code.

88 The German civil partnership (*Gesellschaft des bürglichen Rechts (GbR)*) is governed by §§705 and further of the German Civil Code (*Bürgerliches Gesetzbuch (BGB)*). The rules laid down in the civil code also apply to commercial partnerships to the extent that the Commercial Code is silent.

89 See §124 German Commercial Code (*Handelsgesetzbuch (HGB)*).

and limited partnerships to businesses not explicitly regulated by the commercial code.[90] The only prerequisite is that the partnership must be entered in the commercial register. Moreover, case law and commentary increasingly attribute entity features to the "external" civil partnership, which enters into legal relationships with third parties.[91] In fact, it might be argued that the German legislature has more or less confirmed the entity status of the civil partnership.[92]

Despite the improvement, the question of whether the civil partnership may sue and be sued in its own name is still open to dispute. Furthermore, despite the efforts to attribute entity features to partnerships, creditors generally maintain their right to enforce their claim against the partners individually. Partly because of the acceleration of malpractice claims, professionals organized as civil partnerships had to find another way to structure their business with some kind of limited liability protection. In order to meet their special needs, the German legislature promulgated a professional limited liability partnership (*Partnerschaftgesellschaft*) in 1995 and made considerable improvements to this new partnership-type form in 1998.[93] The German limited liability partnership offers the benefits of the ability of the partnership to sue and be sued in its own name and adopts techniques for the limitations of liabilities arising from contractual and tort claims against the partnership. For instance, partners not directly involved in a specific activity in which professional errors are committed are not personally liable for debts and obligations arising from these errors.[94]

In response to British legislative initiatives, German academics do recommend that domestic lawmakers become more involved in responsive (i.e., competitive) lawmaking. Corresponding pressures have not sufficiently emerged in practice to warrant German legislative attention to the competitive pressures highlighted in the academic debate. Proposals have been advanced to reform the German close corporation, the *GmbH*. Germany's popular business form has already created considerable learning and network effects in Germany, and has in the *GmbH & Co KG* the potential to combine favourable

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90 See §105(2) German Commercial Code (*Handelsgesetzbuch (HGB)*).

91 A variety of commentators have attributed legal personality to the so-called external civil partnerships. In continental European jurisdiction, the civil partnership may appear in two forms. The internal civil partnership is nothing more than a contract between members. A partner may deal with third parties for the common account of the members, but in his own name. The external civil partnership, on the other hand, enters into legal relationships with third parties. Another internal association is the participation association, which "is nothing more than a simple contract between the parties: it does not have any legal effects on third parties" (Heenen, 1975). Special legal provisions regulate the participation association. For instance, §§230-236 of the German Commercial Code govern the *Stille Gesellschaft*.

92 See §§ 190-191 German Business Transformation Act (*Umwandlungsgesetz (UmwG)*), state that a fully fledged legal entity can be transformed into a civil partnership.

93 Initially, the *Partnerschaftgesellschaft*, which is regulated by the *Gesetz über Partnerschaftsgesellschaften Angehöriger Freier Berufe* (*PartGG*), was not very popular. Indeed, at the time of enactment, case law also paved the way for professionals to incorporate. See *BGH NJW 1994. 786* and *BayObLG NJW 1995, 199*. Recently, the German legislature acknowledged professional corporations such as the *Anwalts-GmbH*. Professionals have the choice of either selecting the *Partnerschaft gesellschaft* or incorporating. Since both procedures appear to be costly and cumbersome to individuals (for instance, the *Partnerschaftgesellschaft* statute is linked awkwardly to both the civil and commercial partnership rules, they had often attempted to limit their liability by publicly limiting the authority to act for the partnership and adding "limited liability" (*mit beschränkter Haftung, mbH*), to the civil partnership's name. This attempt to introduce limited liability into the partnership form was rejected by the German Supreme Court (BGH v. 27.9.1999-ll ZR 371/98). The Court stated that a partnership's liability could not be limited by either a name extension or other indication.

94 See §8(2) *Gesetz über Partnerschaftsgesellschaften Angehöriger Freier Berufe* (*PartGG*).

tax treatment with the coveted limited liability protection. Germany has recently created laws and regulations clarifying the legal and fiscal position of this hybrid form.[95] In order to be competitive, it is argued that more needs to be done to make the *GmbH* internationally more attractive and competitive. For instance, consideration should be given to codifying "safe harbour" provisions that state to what extent a limited partner may participate in the control of the firm so as to improve certainty and accessibility to foreign investors. The law should also be more generous in liability protection for a limited partner, if the formation of the limited partnership or the admission of the limited partner has not been filed in the commercial register.[96] To this end, it has been suggested to reduce the minimum capital requirement from EUR 25,000 to EUR 1, to transplant the British wrongful trading rule,[97] and to create the option of a single layer member-managed *GmbH*. However, so far, the German lawmakers have only been able to agree on a compromise which lowers the capital requirement from EUR 25,000 to EUR 10,000.[98] The cumbersome rules on the preservation of the share capital and the notarial deed requirement for the transfer of the shares remain.

95 For example, the enactment of the conversion code *(Umwandlungsgesetz)* in 1994 simplified the procedure of converting from a *GmbH* or *GmbH & Co KG* to a *GmbH & Co KGaA*. The popularity of the *KGaA* may increase with the recognition of the German Supreme Court in 1997 (BGH v. 24.2.1997 – II ZB 11/96, BGHZ 134, 302) that a corporation could be the sole partner in a limited partnership with shares.

96 The §176(1) German Commercial Code (*Handelsgesetzbuch (HGB)*) states that a limited partner who agreed with the commencement of the business is unlimitedly liable for the limited partnerships' debts and obligations incurred before the registration of the partnership in the commercial register. §176(2) provides that a new limited partner is unlimitedly liable for debts and obligations incurred after his admission and before the amendment to the registration. A more generous provision, which is arguably necessary in order to attract foreign investors, could be found in the RULPA (1976) with the 1985 Amendments §303. This article gives an intended limited partner explicit protection from general partner liability if he erroneously believed he was a limited partner and did not give a third party any reasons to believe – in good faith – that he was actually a general partner at the time of a transaction. Re-RULPA §303 provides that a limited partner is not personally liable, even if the limited partner participates in the management and control of the limited partnership.

97 The *wrongful trading regulation* requires directors to monitor the firm's health and, if necessary, to take some remedial or preventive measures that prevent their firms from sliding into insolvency.

98 The new legislation comes into effect on 1 January 2006. Given the change in government after the federal election in September, it is unclear whether the intended second reform, which would further improve the German close corporation, will see the light of day before very soon.

**Table 8: Comparison of German business forms**
Source: International Correspondence Lawyers (www.icl-directory.com).

| *Characteristic* | *General Partnership - Offene Handels-gesellschaft (OHG)* | *Limited Partnership - Kommanditgesellschaft (KG)* | *Close corporation - Gesellschaft mit beschränkter Haftung (GmbH)* | *Publicly held corporation - Aktiengesellschaft (AG)* |
|---|---|---|---|---|
| *Company law* | §§ 105 - 160 HGB | §§ 161 - 177 HGB | GmbHG | AktG |
| *Company purpose* | Operating a commercial enterprise | Commercial company | Free | Commercial company |
| *Founders* | At least 2 founders | General Partner (Komplementär) + Limited Partners (Kommanditisten) | At least 1 founder "Ein-Mann-Gmbh" | At least 1 shareholder "Ich-AG" |
| *Capital requirements* | - | - | 10,000 EUR (effective 1/1/2006) | 50,000 EUR |
| *Liability* | Yes. All partners are jointly and severally liable for all debts. | Yes. General Partners with full liability and limited partners liability are limited to their fixed contribution to the partnership. | Limited to the amount of issued and paid up capital, except in civil or criminal suits | Limited by shares, except in civil or criminal suits |
| *Costs of incorporation* | 200 EUR registration fee + legal fee | 200 EUR registration fee + legal fee | Around 900 EUR incl. notary and publishing fee, registration fee + legal fee | Around 1,500 EUR incl. notary and publishing fee, registration fee + legal fee |
| *Incorporation* | Articles of association + registration at the Registry of Commerce | Articles of association + registration at the Registry of Commerce | Articles of association + notarial deed + registration at the Registry of Commerce + audit by the Local Court + publishing in a legal gazette | Articles of association + notarial deed + registration at the Registry of Commerce + audit by the Local Court + publishing in a legal gazette |
| *Company name* | Free + at least one name of the founders with the annex of the legal form | Free + the name of the General Partner with the annex of the legal form | Free with the annex of the legal form | Free with the annex of the legal form |
| *Formalities* | Low | Moderate | High | Very high |
| *Credit / funds* | Possible | Possible | Possible | Possible |
| *Accounting obligation* | Financial statements every year and must consist of a balance sheet and a profit and loss statement. | Financial statements every year and must consist of a balance sheet and a profit and loss statement. | Yes, to maintain proper books of accounts and to retain the accounting records and associated documents generally for 10 years. | Yes, to maintain proper books of accounts and to retain the accounting records and associated documents generally for 10 years + have to be audited by a qualified auditor. |
| *Management* | At least 1 management director | At least 1 management director, limited partners are excluded | At least 1 management director | Board of directors (Vorstand) + supervisory board (Aufsichtsrat) |

**Box 2. The Evolution of Business Forms in the EU and the US**

There are three key implications of the theory of legal evolution that significantly shape the landscape of business forms and influence the debate on business organization law reforms. First, the predominance of a particular legal view in the field of business organization law restricts the evolution of the law rather than enhances its development. Second, the standardization of business forms confers large increasing returns benefits to the users and their legal advisers, consequently limiting the development of modern innovative business forms. Most firms tend to rely on standard legal rules, which reduce costs as most parties are familiar with them, irrespective of the cumbersome and inefficient nature of many of the standard statutory provisions. What is more, even if a firm has additional incentives to use an innovative legal form, they are generally unlikely to select the vehicle, despite its potential, due the lack of certainty about its legal provisions. Third, firms have considerable financial and organizational constraints that do not allow them to influence the legislature to adopt business form statutes that match their needs. Even if the existing menu of business forms imposes considerable costs on firms which are required to either comply with highly formalistic and technical formalities or contract around obsolete provisions, these firms are usually not able to run up against the presence of concentrated interest groups defending the status quo.

Hence, even if incentives to overhaul business organization law are clearly present, the reform process is subject to sources of path dependence that inhibit the evolution of new business forms. Nevertheless, if we compare and weigh up the competing interests on the supply and demand sides of legislation, we cannot predict with certitude the effects of path dependence on legal change in a particular jurisdiction. The outcome will depend largely on the effect that each interest has on the evolutionary process. If certain pressures are not present in a jurisdiction, or are mitigated by unspecified mechanisms, the influence of path dependence factors on business forms is likely to be commensurately weaker.

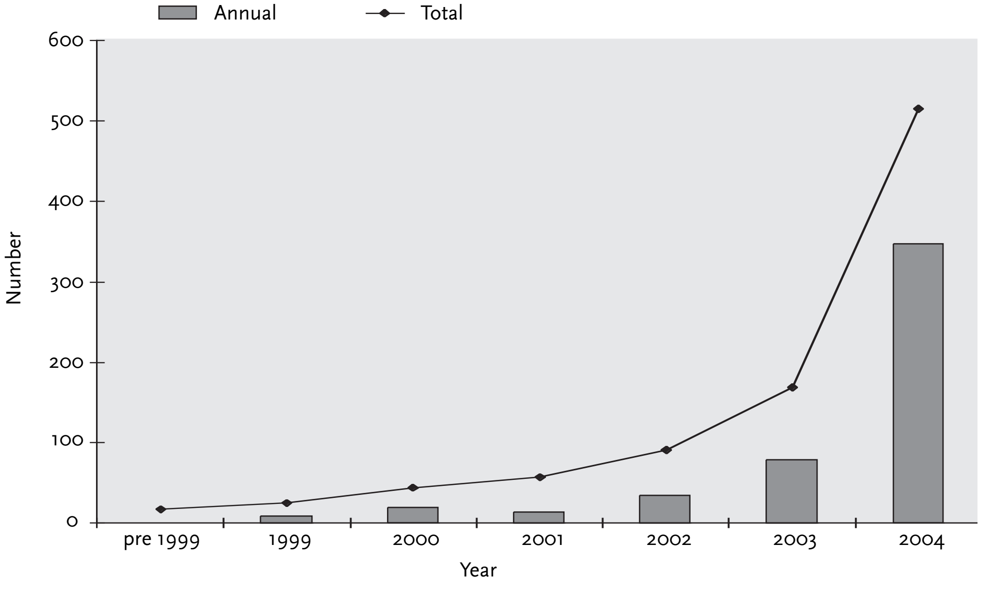
Despite the increased pressures from SME organizations and professionals, law reforms tend to be piecemeal and reactionary, leading to the creation of inefficient legal codes and a paucity of limited liability vehicles. As in the US, business forms should be viewed as products that jurisdictions supply in response to the demands of firms, the consumers of these laws. Unsurprisingly, new business forms may be necessary to modify the current framework, which seems to be inefficient and burdensome for closely held firms of all kinds.

There are a number of explanations for the persistence of inefficient rules for closely held firms in Europe. First, even if a given business form would make closely held firms more efficient, it may not be in the interest of most lobby groups (i.e., professional advisors and creditors) to modify the law to allow more efficient business forms to emerge. Predictably, legislatures respond by failing to adopt value-increasing legislation from which they could derive valuable tax revenues and other economic benefits. Lawmakers present a good case for adapting the existing, sub-optimal regime to meet the needs of closely held firms. Second, there are few incentives to introduce legal innovations. The standardization of provisions in corporate codes may account for the lock-in to the existing mandatory framework. When increasing return benefits are present, the value of the existing provisions increases. In most European member states, the majority of closely held firms are organized under the provisions of close corporation codes. These codes not only create considerable learning benefits, but firms also expect to obtain further benefits as new firms incorporate under the same code. These benefits explain why firms have an incentive to continue to use this legal regime. Newly formed firms are likely to migrate to the business corporation statutes that confer larger benefits to the user. Moreover, because the "standardized" corporate form offers certainty, business lawyers, when advising clients about choice of business form decisions, tend to recommend the close corporation – even if this is sub-optimal.

The conclusion is that continuous use of the close corporation, even if not ideally suited to a wide range of closely held firms, will serve to reduce the incentives for lawmakers to innovate. Given the way in which lawmakers have responded to date, the emergence of new legal innovations responsive to the needs of closely held firms appears to be unlikely, especially in the absence of fully-fledged competitive lawmaking. In most European jurisdictions, the SME business community is not likely to play a featured role in the evolution of business forms. The national lawmaking process is led by politicians and civil servants who give high priority to the preferences of large firms. Thus, unless national lawmakers find a compelling reason to actively develop statutory changes, closely held firms are likely to be locked into an inefficient framework.

The advent of competitive pressures from offshore jurisdictions, however, has created some incentives for national policymakers to generate new statutory measures. The enactment of the LLP statute in the United Kingdom in order to stem the outflow of professional firms to Jersey, which created an LLP statute in 1996, is an example of competitive lawmaking in Europe. A second factor, coinciding with these changes, is the effect of European case law that seems to encourage regulatory competition within the European Union. In an important sense, a competitive environment for business forms did not develop due to the siège réel doctrine that governed in most member states. In recent years, however, the combination of new decisions by the European Court of Justice (ECJ) and the legislative blockage in the EC's corporation law harmonization program has stimulated considerable interest in the competition between jurisdictions. While the real seat doctrine continues to restrict firm mobility for established companies, the ECJ's recent judgments in Centros, Überseeing and Inspire Art (see Appendix 1) has encouraged firm mobility for start-ups. Member states, such as the UK, may gain by competing to supply flexible business organization forms for closely held businesses. In fact, some of this sort of competition already takes place as a number of continental European business have selected the UK limited company due to the minimum capital requirement exemption. To exemplify this, Figure 5 reports numbers of "German" companies incorporating in the UK.

**Figure 5: "German" companies incorporating in UK**
Source: John Armour, Who should make corporate law? EC legislation versus regulatory competition Current Legal Problems (2005 forthcoming) available at: ssrn.com/abstract=757205.




## 2.7 Japan: Current and Future Developments

In an era in which the average firm size is decreasing, the creation of new business forms appears to be based on a compelling logic. Supplying low cost business vehicles targeted at SMEs and professionals serves to strengthen the job market needs while facilitating growth opportunities for developing and mature economies alike. The introduction of the limited liability company (LLC) and the limited liability partnership (LLP) in the United States, for example, allows closely held firms to access limited liability by means of a perfunctory filing, reduce complexity and limit transaction costs, resulting in more capital being available for the actual operations of the business. Evidence from the United States also shows that the introduction of new business forms provides the necessary impetus to help erode antiquated tax and burdensome mandatory legal rules.

In Japan, the creation of new partnership-type business forms has risen to the top of the lawmaking agenda. The policy debate is centered on the problems of easy availability of limited liability for small businesses. Given the apparent success of the new vehicles in the United States, Japanese lawmakers have recently introduced legislation allowing firms to organize as an LLC or LLP. By making the best of both worlds available cheaply to SMEs and high tech start-ups, policymakers and lawmakers help to level the playing field between large multinational businesses and their small and informal counterparts. Arguably, business forms which supply firms with a favourable tax treatment, partnership-type ease of operation and flexibility, and limited liability with a minimum of "red tape" are most important at a time when SMEs are facing increased risks to starting and operating a venture.

### 2.7.1 Corporation Law

As argued earlier, Japan currently distinguishes between a joint stock company and a closely held corporation. However, a package of legislative reform measures, that are comprised in The New Company Law and submitted to the Diet in March 2005, would effectively eliminate this legal distinction. In effect, the New Company Law abolishes the *Yugen Kaisha* (*YK*), the close corporation, and leaves a modernized *Kabushiki Kaisha* (*KK*) in place (grandfathering the existing *YKs*). The *KK* will be liberalized through the relaxation of the minimum capital requirements (reducing the JPY 10M to net assets of JPY 3M). Further, closely held *KKs*, which restricts in its articles of association the free transferability of shares, will only require one director to be appointed instead of three. The appointment of a statutory auditor for the *KK* is not mandated if an officer is appointed who has the qualifications of tax accountant or accountant. While a suitably modernized *KK* will surely attract a number of closely held firms, the legislation acknowledged that the amendments introduced will not be sufficiently attractive to those individuals or established companies that are interested in a converting to a more flexible business form, such as the LLC.

### 2.7.2 Godo Kaisha – Japanese LLC

The New Company Law provides for the introduction of a new business organization law form, the Limited Liability Company (LLC). The LLC is a partnership type form that bundles together limited liability, decentralized management by default, unanimous consent to transferability of members' interests, fiduciary duties and no requirement to publish financial records. The Japanese vehicle bears a strong resemblance to the US LLC (e.g., voting and distribution rights are proportionate to the members' contributions), but diverges in a number of important respects, including: 1) contributions to the LLC will be limited to cash or property, but no services, know-how or other agreements are permitted; and 2) the LLC will be receive corporate, but not pass-through tax treatment.

### 2.7.3 Yigensekinin Jigyo Kumiai – Japanese LLP

Lawmakers have introduced to the Diet a Limited Liability Partnership Bill, which is designed to encourage the creation of business partnerships among SMEs, joint ventures and other strategic partnerships between high tech companies and research institutions. The LLP Law provides for the introduction of a vehicle that is characterized by limited liability, a flexible organization structure, pass-through taxation, and restrictions on the free transferability of partners' interests. Despite these attractive features, the legislation mandates a number of highly restrictive and costly features including: 1) registration of the LLP agreement; 2) public disclosure of financial information including the profit loss statements and the balance sheet; 3) the mandatory obligation of partners to participate in LLP management and its operation; and 4) the right of partners to exit at will.

**Table 9: Need for the LLP in Japan**
Source: Presentation by the Ministry of Economy, Trade and Industry (Dr. Y. Ishii) at the RIETI Workshop on Close Corporations and Partnerships in Tokyo on 26 August 2005 (organized by the Research Institute of Economy, Trade & Industry).

| | | *Internal Relationship among Members* | |
|---|---|---|---|
| | | *Fixed Organizational Structure* | *Flexible Organizational Structure* |
| *External Relationship with Creditors* | *Limited Liability* | **Joint Ventures, ICT industry, Start-ups** Need flexible management structure | **LLP** Promote ICT and service industries. Joint Ventures, start-ups, upgrade industrial structure |
| | *Unlimited Liability* | | **Services Industries Start-ups** Need limited liability protection |

**Table 10: LLP-type Organizations in the US, Europe and Japan**
Source: Presentation by the Ministry of Economy, Trade and Industry (Dr. Y. Ishii) at the RIETI Workshop on Close Corporations and Partnerships in Tokyo on 26 August 2005 (organized by the Research Institute of Economy, Trade & Industry).

| | | *Internal Relationship among Members* | |
|---|---|---|---|
| | | *Fixed Organizational Structure* | *Flexible Organizational Structure* |
| *External Relationship with Creditors* | *Limited Liability* | **Corporation-type organizations** [US] Corporation, [UK] Company, [Germany] AG, GmbH, [France] SA, SARL, [Japan] KK, YK | **LLP-type organization (hybrid)** [US] LLC, LLP, [UK] LLP, [Germany] None (but GmbH&Co.KG), [France] SAS, [Japan] LLP |
| | *Unlimited Liability* | | **Partnership-type organization** [US] General Partnership (GP), Limited Partnership (LP), [UK] GP, LP, [Germany] KG, OHG, GbR, [France] SCS, SNC, [Japan] Gomei-Kaisha, Goshi-Kaisha, Kumiai |

The LLP appears to offer a number of attractive components that should stimulate business activity. Compared to the LLC, there are a number of distinct features which lend market credibility to this vehicle and link the match the needs of a wide variety of closely held firms. However, the mandatory character of the legislation, particularly the demanding financial disclosure requirements and registration rules, call into question the attractiveness of the form for SMEs and other firms that are reluctant to disclose market sensitive information. If we compare the LLP to similar legislation in the US, the contrast is remarkable in two respects: 1) the US LLP is in fact not more than a general partnership with limited liability protection; and 2) the flexibility of the US LLC and LLP contribute greatly to its cost advantages in contrast with other company law forms, such as the public corporation.

**Table 11: Japanese LLP and proposed LLC legislation**
Source: Presentation by the Ministry of Economy, Trade and Industry (Dr. Y. Ishii) at the RIETI Workshop on Close Corporations and Partnerships in Tokyo on 26 August 2005 (organized by the Research Institute of Economy, Trade & Industry).

| *Characteristic* | *LLP*<br>*Limited Liability Partnership*<br>*(Yigensekinin-jigyo-kumiai)* | *LLC*<br>*Limited Liability Company*<br>*(Godo-kaisha)* |
|---|---|---|
| *Law* | The LLP Law<br>Ministry of Economy, Trade and Industry<br>> 1 August 2005 | Commerce Code<br>Ministry of Justice<br>> April 2006 (?) |
| *Limited liability* | Yes | Yes |
| *Flexible management structure* | Flexible profit/loss allocation<br>Flexible management structure | Flexible profit/loss allocation<br>Flexible management structure |
| *Tax treatment* | Partnership taxation<br>(Pass-through Taxation) | Corporate taxation (?) |

## 3 Governance of Unincorporated Forms

Where historical patterns seem to dominate the European business organization law reforms, Japan has embraced an "innovation approach" which appears to break with the past by enacting new legislation that facilitates the creation of new start ups and joint ventures. Lawmakers are currently engaged in an ambitious reform effort to modernize the Japanese company law framework. These bottom up reforms can be viewed as a response to the demand for more flexible business vehicles which are better tailored to joint venturing among competitive industries in the human capital intensive sector. Unlike the US and Europe (see Box 2), the new Japanese forms were not shaped by the competitive lawmaking pressures directly, but have apparently been influenced by institutional learning and expert advice by industry, as well as the indirect influence of overseas legal developments. This ongoing reform process may eventually yield an interesting set of hybrid structures that supply efficient and flexible set of legal rules for most entrepreneurs, SMEs, and joint-ventures.

There may be something to the Japanese approach to devising new organizational law forms. Innovation in business organization law reform has a number of distinct characteristics that may ensure a high degree of success in terms of the effectiveness of these forms. To the extent that inherent economic benefits of novel legal structures outweigh the network effects, the new organizational forms provide significant advantages to private actors. Legal reforms that place significant costs on regulators and courts to invest in research, implementing measures and enforcement, can reduce, without corresponding benefits, the incentives for lawmakers to innovate. Nevertheless, lawmakers could internalize the advantages of creating new business organizational law forms by developing new rules and institutions that offer a workable menu of beneficial provisions and are attractive enough to serve as a focal point upon which new networks arise. Ultimately, the capacity of countries to provide successful business organization law reforms hinges on the ability of their courts to actively influence the actual contents of the statutes (as well as providing effective enforcement) as the gains from improving the provisions will promote the functionality of the forms over time. This chapter discusses the main components of legal business forms that are responsible for limiting transaction costs, curbing opportunism and creating organizational structures that are compatible with entrepreneurial expectations.

### 3.1 The Function of Legal Business Forms

From the perspective of law and economics, statutory and judicial organizational law offers standard form contracts that help to economize on transaction costs such as drafting, information and enforcement costs, and to limit opportunism and fill gaps in the relational contract. From this perspective, business organization law offers models that cover the relationships between the participants inside the firm and the representation of the firm in their dealings with outside participants, such as creditors. The business statutes act as a set of "off-the-rack" terms upon which business participants can fall back when establishing the distribution and allocation of powers and responsibilities for varying levels of control and commitment. That is not to say that business organization law provides economic actors with a set of all-encompassing standard form agreements. The theoretical and empirical contributions to the literature on incomplete contracts have shown that providing a set of default terms that deal with every possible contingency is a complex and uncertain process. Theories of the firm therefore suggest that, besides the statutory and judicial default rules, the ownership structure of the legal business forms and the interaction between explicit and implicit contracts help the parties and institutions involved in dispute resolution to fill the inherent gaps in the relationship.

Let us again consider the close corporation, which is the preferred vehicle for closely held business firms around the world. Some might argue that the close corporation paradigm reveals the triviality of the supply of legal business forms. The success story of the close corporation in many jurisdictions is testimony to the fact that business participants often neutralize the law's effect by making contractual adjustments, and hence the rule of the law appears not to matter. Although there are some costs involved in preparing a relational agreement, closely held firms should rely heavily on carefully drafted and customized agreements. The drafting process forces the business participants to think through and clarify their intentions in a calm and deliberative atmosphere, which can help them to avoid misunderstandings and litigation.

Yet even when economic actors could easily bear the transaction costs of contracting around statutory terms, default rule analysts have suggested that they may nevertheless be loath to contract around these terms. Empirical evidence from the United States illustrates that even though business participants would theoretically be better off opting into the special close corporation rules, in practice these opt-in provisions have not been widely used. It is, moreover, not always possible to effectively contract around the statutory provisions of corporate statutes, in that the contractual variations may not always be fully enforced.[99] The standardization of the general corporation statute due to network and learning effects suggested lower legal formation and operation costs than the not yet standardized "innovations" with respect to close corporations. As a result, a menu of legal business forms that offer sets of default rules that meet the needs of small business relationships is more attractive.

As participants in a firm tend to react strategically to rules, the wrong rule could produce significant inefficiencies much greater than the nominal costs of contracting around a rule. For instance, the supply of the inefficient default rule could have a detrimental effect on relational arrangements in firms that are mainly governed by extra-

99 Hochstetler and Svejda (1985) state: "[o]rganizing the close corporation as a partnership, however, runs counter to the idea expressed in some judicial opinions that a close corporation must be run like a publicly held corporation – not as a partnership. Corporations cannot revert to partnership practices in the management of the business whenever they so desire. Thus, courts' decisions have invalidated partnership arrangements in close corporations for being contrary to public policy. Specifically, courts have held that the parties cannot be partners as between themselves, and a corporation as to the rest of the world. A corporation cannot serve as the mere instrumentality of a partnership because a corporation is a distinct type of business organization and its characteristics cannot be mingled with those of a partnership".

legal and social norms, as are many small closely held business firms. Even if the parties are completely unaware of the default rules *ex ante* and start their business on trust and reputation, midstream awareness of the legal rules might crowd out interpersonal trust and replace it with institutional trust in the legal system. Moreover, overconfidence, overoptimism and excitement about the prospects of a new business venture prevent participants from engaging in business planning and contemplating methods for addressing future conflicts of interest. Because participants must either trust each other or forgo the deal, they often shun tailoring their business arrangement, thereby intentionally leaving gaps in their relational contract. Furthermore, bargaining theory in law and economics recognizes that even if the contract parties are willing to accept the challenge of drafting an agreement and transaction costs are marginal, information asymmetries and strategic behaviour could prevent them from bargaining their way to the optimal governance structure.[100]

Certainly, if economic actors lack the technology necessary to enable the negotiation and composition of a contract term *ex ante*, they are likely to eventually seek the advice of a sophisticated legal practitioner, who would force them to engage in efficient business planning. His performance, however, does not necessarily lead to a higher expected firm value. For instance, even if lawyers are willing to draft a comprehensive agreement, the hope of a fruitful relationship could be quashed. Their attempt to address all future contingencies may very well result in delaying rather than promoting the coveted bargaining process. Conversely, it is submitted that lawyers tend to recommend simple boilerplate standardized agreements rather than customized and more optimal contracts. In fact, lawyers contribute significantly to the “lock-in” effect in the context of business organization law. There are several reasons for this. If a particular lawyer spends time and money on customizing an alternative term that will benefit other lawyers and their clients generally, he may face a potential free-rider problem. This may entail that the drafting and designing of innovative contract terms is not always cost-effective. The possible failure of the new term, which might damage his professional reputation and even ruin his career, tends to confine the individual lawyer to a more passive role.

The upshot is that governmental lawmakers, i.e. legislatures and judges, should implement, administer and enforce business form legislation. There are several advantages in putting the responsibility of business form design in governmental hands. In addition to economies of scale, the publicity of the legislative process reduces the information costs for potential users of the statutes. Moreover, new networks are more likely to arise around legislative products. Most importantly, the implementation and enforcement of mandatory rules and entity status cannot easily be accomplished by private legislators.[101]

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100 It might be argued that the cost of drafting a customized agreement is minimal, because forms for special clauses abound in libraries and lawyers’ files. However, the internal participants in many closely held firms seem to be reluctant to deviate from statutory default rules.

101 Even though the design of legal rules could be privatized, the implementation, administration and enforcement of the law is better done by governmental agencies.

## 3.2 Rules versus Standards

An economic analysis provides valuable insights into the extent to which statutory provisions should be drafted as vague standards or specific and narrow rules.[102] Although the costs of promulgating rules exceed those of drafting standards, rules may internalize much of the transaction costs. In this respect, the benefits of rules are twofold. First, firms may spend less in learning the content of the law. Second, firms may become better informed about rules than standards and thus better conform their behaviour to the law. Yet even if it is necessary to promulgate a standard because costs prevent the *ex ante* drafting of specific terms, lawmakers may be able to convey inherent benefits to firms by allowing them to opt out and bargaining around stringent standards such as fiduciary duties.

Clear and simple default rules are typically economically efficient for small businesses in which all owners are active participants. Three reasons explain the efficiency effects. First, economic actors who choose to do business in a joint ownership relationship without contemplating a business form or formalized agreement will likely find in the statute what they would have agreed upon had they negotiated a relational agreement. Second, the majority of business parties who intentionally opt into the partnership business form need not contract around the particular rules. Third, since the default rules mimic the hypothetical provisions that a majority of the partners would have bargained for if they could contract without cost, opting into a business form statute is a substitute for private bargaining, thereby reducing transaction and litigation costs.

In practice, ventures of different varieties and complexities could fall within the ambit of a set of rules. Parties may choose a business form with little information about each other's commitment and trustworthiness. Because of this asymmetry of information and the consequential incompleteness of the relational contract, it has been argued that majoritarian default rules may not always be desirable. Backstop rules that parties would not have contracted for could be more efficient at times. For instance, if it is costly for the courts to come up with a tailored rule that the parties would have wanted, it may appear more efficient to design a default rule that forces parties to contract explicitly. These "penalty default rules" are also appropriate to situations in which parties can act opportunistically because they withhold private information. By devising penalty default rules, such as the equal distribution rule, lawmakers can induce parties to contract around the default, simultaneously revealing information to less informed parties.

## 3.3 A Menu of Business Forms

The design of model business statutes should be tailored so as to supply the widest range of closely held firms with flexible legal rules. This would allow choice of business forms to send a clearer signal about the parties' organizational needs and preferences. There are only few jurisdictions, such as the US, UK and now Japan, that appear to be sufficiently responsive to these needs. New business forms tend to be efficient because they offer firms default terms that limit the drafting and information cost burdens while providing

102 Rules stand for *ex ante* creation of the law, while standards entail *ex post* creation of the law (Kaplow, 1992).

flexibility and limited liability. Hence, the creation of "off-the-rack" standard form contracts designed to meet the needs of a variety of closely held firms is the legal equivalent of a simple, low-cost firm formation. To the extent that the new business statutes offer firms and legal decision-makers a set of simple and coherent terms, the legislation will provide an acceptably low-cost vehicle for business planning and operation and the resolution of conflicts. The supply of clear and simple default rules can be regarded as value-enhancing. The adoption of default terms will also provide firms with opportunities that might not otherwise be available. The imposition of mandatory provisions, on the other hand, could have the effect of increasing the incidence of standardization in the field of business forms, and could well lead to a number of legal and institutional barriers to innovation.

The question, however, is of how many business form statutes there should be. The evolution of business forms in the United States may provide some tentative answers. It is argued that the current menu of choices in the United States (consisting of the general partnership, LLP, LLLP, LLC and a flexible corporate form, among others) efficiently reflects firms' needs. The impact of regulatory competition on the emergence and development of these business forms indicates that lawmakers contemplating reform must have taken the wishes and requirements of business firms into account. However, as most business forms are still evolving in the United States, it may be too simple merely to emulate the US approach, particularly given its distinct legal and economic culture. For instance, the US menu does not supply straightforward answers to the question of the extent to which business forms should be linked to each other. On the one hand, the development of the LLLP and the Re-RULPA suggests that the linkage between general and limited partnership law resulted in confusion in interpreting and applying limited partnership statutes. On the other hand, the evolution of the LLC reflects a tendency towards a process of ultimate linking – i.e., combining separate business forms into a single unified form.

## 3.4 "Think Small First": The Limited Liability Partnership

By first devising and adopting a modernized limited liability partnership form for the smallest closely held firms, the corporate form and other new partnership-type business forms, such as the LLC, could target other firms with distinctive characteristics that go beyond the scope of these smallest enterprises. To be sure, there is less need for liability protection for these very small firms, as their members are required by most creditors to guarantee personally the firm's debts and obligations. However, it simply cannot be denied that many small firms choose a business form that furnishes them with the protective feature of limited liability. An LLP form should be formally linked to the default provisions of standard general partnerships. This could be achieved simply by making the LLP provisions part of the general partnership statute. Even though limited liability diminishes the harm that partners can inflict on each other – and hence partners would require different and less strict fiduciary duty protection, the potential users of LLPs arguably expect the same default rules as if they were organized as a standard partnership.

In this regard, we will take the Revised Uniform Partnership Act (RUPA) in the United States as a starting point for the internal governance structure of an LLP form. The key features of RUPA are designed to offer standard, "off-the-rack" provisions that reduce transaction costs, provide a framework for the allocation of authority and power over the firm's resources, and supply, without losing their flexibility, a set of incentive instruments in case the implicit contracts and norms are not sufficient.

## 3.5 Internal Governance

### *3.5.1 Limited Liability Partnership (LLP)*

In order to offer a clear and simple framework to economic actors who decide to opt in a joint ownership structure, RUPA bestows entity status on the business relationship, thereby providing for the weak form of asset partitioning.[103] It also clarifies that, except as otherwise provided in the partnership agreement, the partnership owns the firm-specific assets.[104] In order to give "multital" effect to the joint ownership structure, RUPA explicitly states that assets acquired in the name of the partnership or purchased with partnership assets are presumed to be partnership property.[105] The fact that the partners own the firm and so have joint control over the items of firm-specific capital to a certain extent prevents them from engaging in opportunistic conduct. Since partners share equally in the firm's profits and losses by default,[106] arguably they have a high-powered incentive to monitor the firm.

The partnership form creates an ownership structure that gives the partners joint management and control rights.[107] In the absence of an agreement to the contrary, important decisions, such as an amendment to the partnership agreement, must be approved by all the partners. In order to keep decision-making costs down, however, matters arising in the ordinary course of the business may be decided by the majority of the partners.[108] In addition, joint ownership rights imply that each partner, as an agent of the firm, is by default empowered to bind the partnership entity to third parties.[109]

### *3.5.2 Limited Liability Company (LLC)*

Although the controlling members or shareholders ("majority") in closely held firms are often closely involved in management, a legal rule that provides for decentralized management directly by the controlling and minority members or shareholders ("minority")

103 See RUPA (1997) §201(a).
104 See RUPA (1997) §203.
105 See RUPA (1997) §204.
106 See RUPA (1997) §401(b).
107 See RUPA (1997) §401(f) and (j).
108 Under RUPA default rules (and partnership law in general), each partner has one vote rather than apportioning votes by the value of money contributions as under corporate law.
109 See RUPA (1997) §301. RUPA (1997) §303 provides for an optional statement of partnership authority containing "the names of the partners authorized to execute an instrument transferring real property held in the name of the partnership" and specifying "the authority, or limitations on the authority, of some or all of the partners to enter into other transactions on behalf of the partnership and any other matter."

is not optimal for larger firms that wish to attract external capital and attempt to limit their exposure to risk and opportunism through a combination of contractual measures and the active monitoring of management. The principal-agent literature shows that the failure to legally separate ownership from control will limit the benefits of specialization in the firm's decision-making. For example, if minority is prepared to undertake the financial risk for the firm's ventures, it does not necessarily follow that these members will be equally suited and talented to make appropriate management decisions about the allocation of firm resources. Second, the full integration of ownership and control means undifferentiated management decision-making, which entails a more cumbersome, costly, and restricted process. Finally, a complete member dominated firm will suffer higher costs due to the absence of monitoring and intervention devices to intervene on behalf of investors. The transfer of effective control to a management team, which may be directly or indirectly related to the majority, avoids the bureaucratic costs of collective decision-making.

Thus seen, the LLC could be considered as a legal organizational form providing a differentiated management and control structure in which members elect directors and participate in certain fundamental decisions, and directors establish policy, select managers, perform monitoring functions, and act as the firm's agents. Because the majority elects the directors and, hence, is able to control the management of the corporation, minority is particularly vulnerable to opportunistic acts by majority. There are numerous strategies at the disposal of majority to extract resources from firms they control. These include: 1) distributions of cash and property to confer benefits on the members; 2) dilutive share issues; 3) interested transactions; 4) allocation of corporate opportunities; 5) allocation of business activities; and 6) selective disclosure of non-public information.

Indeed, there are reasons to believe that managers who are directly or indirectly controlled by the majority, will not always take the minority's best interests into account. The law regarding the LLC form can help to discourage divergence from the minority's interests by providing rules that limit the managers' power to act solely on the directions and instructions of the majority. For instance, a legal rule could instruct director-managers to take into account the interest of the minority and other stakeholders in exercising their powers. Moreover, member approval may be required when weak management intends to enter into substantial property dealings on behalf of the firm.

The safest way to ensure that the interests of the minority are represented on the board of directors is the use of different classes of shares that have identical financial rights but are entitled to vote separately as classes for the election of specified numbers of board members. Another option is cumulative voting: a voting system that gives the minority more power, by allowing them to cast all of their board of director votes for a single candidate. Cumulative voting, however, may easily be eliminated or minimized by the majority. For instance, the majority may alter the articles of association or remove the minority's director without cause and replace him or her with a more congenial person. Given the potential distributional implications of cumulative voting, the majority will be reluctant to adopt such a measure. Exit rules and fiduciary duties, in contrast, may prove to be better mechanisms to diminish opportunistic behaviour.

## 3.6 Exit Rules

Business participants in closely held firms often find it cost-effective to avoid writing explicit terms that govern disruptions. Arguably, this is true in a context of strong relational ties based on trust. Yet over-optimism regarding the success and trustworthiness of business parties at the time of formation sometimes leads them to underestimate the possibility of dissension when the venture matures. Naturally, the partners can amicably overcome possible problems ensuing from disagreement and disruption by working things out *ex post*, without reference to any legal rule or contractual provision. Often parties are unable to resolve conflicts through mediation or norms that have been established over time. Once the dissatisfaction or distrust disrupts the relationship, the exasperated participants are usually unable to negotiate their way out of the dispute.[110]

Obviously, the problems that arise in endgame settings can have a particularly heavy impact on both the firm and its participants. For instance, internal strife often entails disagreement about the consequences of the dissolution of the relationship, thereby encouraging opportunistic behaviour. Moreover, given the limited market for and the restricted transferability of interests in a closely held firm, business partners could be locked into a very unpleasant investment in which hold-up problems abound.[111] In fact, an intense dispute may lead to a serious deadlock in the event of business decisions being taken only by the unanimous consent of all the partners.[112] Nevertheless, even if the deadlock problem is resolved by adopting the principle of majority rule, the relationship often remains unstable.[113] In close corporations, which are characterized by the majority rule and statutory norms of centralized management, a dissatisfied minority partner often attempts to obstruct the successful operation of the firm by making mischief between the other parties, thereby causing high bargaining costs and great uncertainty.

The failure of business parties to bargain for contractual provisions that deal with dissension and deadlocks could suggest that the partners prefer flexible, *ex post* gap-filling by courts or arbitrators. For instance, judges and arbitrators could assume an easy buyout right for the dissatisfied partner if the business relationship makes the minority vulnerable to opportunistic exploitation by the majority. Nevertheless, judicial gap-filling is not only costly and time-consuming, but may also be prone to error. Judicial intervention can create a potential judicial wild card that creates costly uncertainty. It is submitted

110 Problems usually arise when the original founders of the firm die or retire and their interests pass into the hands of their heirs and successors.

111 In publicly held firms, a passive dissatisfied shareholder can easily dispose of his shares through the market. The sensitivity of management to the market price for the stock and the fact that stock prices are highly responsive to corporate earnings tend to assure the dissatisfied shareholder of a reasonable price when he liquidates his investment through the market. In closely held firms, however, one often finds restrictions on interest transferability. Three basic types of restrictions are commonly employed: first refusals, first options and consent restraints. Since the principal contribution to these firms is human capital, partners have a real interest in knowing and controlling the identity of their fellow partners (*intuitu personae*). The human capital factor may exacerbate possible disputes: the business participants in closely held firms have large percentages of their wealth tied up in one firm, thus sacrificing the advantage of risk diversification. Unlike financial capital, human capital is not easily diversified. Usually a person cannot conduct more than one or two separate ventures at any given time and hope to maintain productive activities.

112 Unanimity agreements do protect the minority against opportunistic behaviour by the majority, but it creates incentives for the minority to behave opportunistically toward the majority to extract disproportionate concessions.

113 The principle of majority rule gives the majority control over the firm.

that whilst intra-firm controversies are often observable to the exasperated parties, they may not be easily verified by a judge or arbitrator, and even less so when personal relationships in the family or between friends are involved. The difficulty in predicting the judicial outcome explains why relatively few disputes seem to end up in court.

In light of the foregoing discussion, the absence of statutory guidance, which could be adopted *ex ante*, may have a detrimental effect on both the firm and its participants. When end-period terms are prohibitively costly to arrange *ex ante* by the participants themselves and are not easily verifiable by courts and arbitrators *ex post*, responsive legislatures appear better suited to supplying the default rules for endgame settings. As such, the logic of providing these rules is to lower costs for the parties and to create a degree of predictability that could operate as a sanction against opportunism. Because exit mechanisms provide safety nets to ensure the parties' control rights and authority over the firm-specific assets, the question of which "default exit rule" is socially efficient is crucial. The default rule must act both as an incentive instrument and as a tool to discipline possible opportunistic abuse. These rules must be designed to contribute to the optimal governance equilibrium in the firm.

### *3.6.1 Limited Liability Partnership (LLP)*

What should the statutory standard form provide? Upon first inspection, two categories of default exit rule could be contemplated. First, partners may have the right to compel the dissolution of the firm and liquidation of its assets. Second, partners may withdraw and/or be expelled from the firm and receive the "fair" value of their ownership interests. Of course, both the dissolution and dissociation concepts may be subject to several rules, which severely limit the voluntary and involuntary exit of participants.

Historically, in partnership law, a disruption of the partners' relationship causes the dissolution of the original entity and accordingly permits the sale of its assets.[114] Because the human capital component is often the firm's single most valuable asset, a "joint venture" will surely not survive when a significant partner is dissociated, by disagreement, for example. There is, however, a tension between the benefits and costs of dissolution. On the one hand, the default dissolution rule could limit opportunism if one partner has reason to believe that the other has misappropriated assets or opportunities of the enterprise. The threat of dissolution and liquidation serves as a disincentive if both parties suffer significant costs. On the other hand, the cost of dissolution is often high due to the loss of goodwill as a going concern value, and the effect of draconian legal default rules when entrepreneurs have failed to opt out at the start-up phase.

Due to these high costs, policymakers and scholars argue that the "dynamite" approach of dissolving the firm is too unstable and that a less interventionist approach could yield more value by allowing the firm to continue without triggering its dissolution. Dissociation provisions that adhere to the entity characteristic of continuity of life

114 As used in this paper, "dissolution" alludes to the end of the firm. Dissolution does not normally entail the end of the partnership's existence. A partnership usually continues after dissolution until the winding-up of its affairs is completed.

supply a low-cost means for firms to plan for changes in the internal organization and business environment. This suggests that default dissociation rules represent the most optimal choice, because they are closest to what the majority would have agreed upon, had they considered the issue in advance. Indeed, empirical research shows that in many cases, independent of the default settings, one or more partners continue to operate the business. That is not to say that dissociation provisions are entirely without difficulties. Thorny calculation issues, particularly concerning the valuation of interest and whether payment should be deferred, abound in endgame settings, since the "fair value" of interests is likely to be non-verifiable by courts or arbitrators. Consequently, it is submitted that statutory *ex ante* rules are also best equipped to provide guidance in relation to valuation issues.[115] For example, RUPA (1997) §701(b) takes as its starting point that a dissociating partner should receive the same amount in a buyout as he would if the partnership were dissolved. However, goodwill will be taken into account, since the buyout price is "equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern."[116] If the partners do not reach an agreement on the buyout price, they can have the price determined by the court.[117]

In light of the valuation problems and possible disruption of the going concern, an easy disinvestment from the firm may encourage opportunistic behaviour. Partners may misuse automatic withdrawal remedies to threaten to impose large costs on the firm, thereby appropriating a portion of the quasi-rents. There is a trade-off between the disadvantage of being locked into a dissatisfying investment and the threat of partners' opportunism, which is endemic to closely held firms and should be considered in the design of the default exit rules. The RUPA drafters provided that partners are allowed to exit their investment by dissociating from the partnership,[118] thereby triggering its dissolution and compelling the liquidation of the firm's assets.[119] In order to balance the costs and benefits, however, they have tried to limit the potential damage to a going concern caused by the dissolution approach. Under RUPA, not every departure of a partner causes the partnership to be dissolved. For instance, if a partner is expelled pursuant to the partnership agreement, a partner becomes a debtor in bankruptcy, or if a partner dies, there will be a buyout of the partner's interest under Article 7, without triggering the dissolution

115 The non-verifiability of the value provides an incentive for the business participants to advance different estimates. The disassociating partners have a strategic incentive to propose a high valuation, whereas the continuing participants understandably aspire to a low valuation. A deferred payment may be necessary when there are limited sources of funds, which will enable the firm or the remaining participants to purchase the dissociating partner's interest.

116 RUPA (1997) §701(b) "provides how the "buyout price" is to be determined. The terms "fair market value" or "fair value" were not used because they are often considered terms of art having a special meaning depending on the context, such as in tax or corporate law. "Buyout price" is a new term. It is intended that the term be developed as an independent concept appropriate to the partnership buyout situation, while drawing on valuation principles developed elsewhere."

117 See RUPA (1997) §701(i). Since bargaining often leads to valuation problems and the value is often difficult for courts to determine, other valuation procedures could prove more efficient. US commentators have developed several alternatives to the bargaining rules of Chapter 11 of the US Bankruptcy Code, which governs the reorganizations of corporations in financial distress. Perhaps these alternatives could be adjusted and adapted to the buyout procedures in closely held firms.

118 See RUPA (1997) Articles 6, 7 and 8.

119 See RUPA (1997) §§ 601(1) and 801(1).

of the partnership itself.[120] To be sure, the dissolution rules seem to suit jointly owned, closely held firms in which the partners' investments are indispensable and crucial to the generation of surplus. Yet a partner could use RUPA's dissolution mechanism opportunistically. For instance, a minority partner (*i.e.*, a partner with a smaller firm-specific investment than other partners) could threaten to use RUPA's "dynamite" approach of blasting the partnership apart to force the majority to satisfy the minority's demands. If partners fear that the minority may expropriate the surplus created by the specific investments, they will tend to under-invest. The exit rights could thus act as a disincentive for risk-averse partners to invest in relationship-specific assets. Yet even though partnership law allows any partner to disinvest at any time, non-legal sanctions usually constrain both the minority and majority from opportunistic behaviour in closely held relationships. In addition, partnership law generally balances the costs and benefits of the disinvestment mechanism by using enhanced notions of fiduciary duties, good faith and credibility, or by making the dissociating partner personally liable in damages for "wrongful" termination of the relationship.

### *3.6.2 Limited Liability Company (LLC)*

In contrast, LLC law default rules should traditionally "lock in" the participants by giving them only a limited right to dissociate. To be sure, the lack of a liquid market in LLC interests arguably deprives the participants in such a firm of an effective exit mechanism. But, the lock-in effect of the LLC form may help to prevent an abusive use of a buyout right, thereby furthering (at least to some extent) the stability of the firm. Yet judges could recognize that intimate and idiosyncratic relationships, which will often be organized as LLCs, require an investment to be less permanent. In this view, the corporate norms of centralized management and the principle of majority rule are conducive to minority oppression, in which case the minority may face an indefinite future.

This argument ignores however the fact that joint ownership structures are often formed by business parties that have no familial relationship and are not willing to completely surrender their autonomy. Their relationship is not based on how well they know and trust each other, but rather on their self-interested incentive to invest physical and human capital in their business venture. Some commentators have argued that

120 Nevertheless, the partnership at will (i.e., "a partnership in which the partners have not agreed to remain partners until the expiration of a definite term or the completion of a particular undertaking" (see RUPA (1997) §101(8)) without a partnership agreement dissolves, winds up its affairs and liquidates its assets upon the withdrawal of a single partner. However, RUPA (1997) §802(b) provides that "[a]t any time after the dissolution of a partnership and before the winding up of its business is completed, all of the partners, including any dissociating partner other than a wrongfully dissociating partner, may waive the right to have the partnership's business wound up and the partnership terminated." Thus, if partners have not contractually waived the ability of a single partner to cause dissolution, partners will be required to do something positive to achieve continuity. It is argued that it would be more efficient to require an action to bring about dissolution. Conversely, the RUPA default rule asserts that the partners who wish to continue a partnership for a definite term or particular undertaking cannot be forced to liquidate the business by a partner who withdraws prematurely in violation of the partnership agreement. See RUPA (1997: §801(2)(i)). Moreover, the partner who wrongfully dissociates from a term-partnership is not entitled to payment of any portion of the buyout price until the expiration of the term or completion of the undertaking, unless the partner establishes to the satisfaction of the court that earlier payment will not cause undue hardship to the business of the partnership. See RUPA (1997: §701(h)).

when there is a high density of firm-specific assets in which all the parties invest significantly, both the majority and minority should be locked into the business and judicial intervention should be limited. To demonstrate this, let us consider a high-tech start-up established to develop an innovative idea. Since the investments of the parties involved are firm-specific in the development phase, in that the value is much higher to insiders than to outsiders, an easy exit rule could entail substantial losses to the participants. For instance, the firm usually holds specific assets that cannot easily be unbundled without significant loss of value. Moreover, the start-up firm usually lacks the liquidity to pay the leaving party the buyout price. From this perspective, the close corporation with its limitations on exit and the general principle of no *non pro rata* distributions appears to offer a framework for high-tech start-ups that largely helps to prevent opportunistic behaviour. To the extent that business parties opt into an LLC framework to "lock in" and protect their firm-specific investments, the judicial discretion to intervene will do more harm than good.[121]

Lawmakers who focus on the internal governance structures of business forms should thus give consideration to the role the different remedy regimes play in choice-of-form decisions. Rather than seeking the convergence of partnership and close corporation rules, responsive lawmakers must be willing to offer a menu of business forms with different involuntary and voluntary exit provisions. In view of minimizing the costs of statutory ambiguity, such a menu would better serve the various needs of closely held firms. Ideally, the law should maintain and even expand the different exit rules, even though the parties could tailor their scope contractually. Alternative exit defaults may be necessary to allow parties to meaningfully customize them to their relationship without fearing contrary judicial intervention. An expanded menu of business forms would not only mitigate statutory ambiguity, but would also give parties the opportunity to signal their intentions by choosing a particular business form. For their part, the courts should give parties incentives to choose *ex ante* by penalizing them for inefficient choices. Only if it is likely that the court will be better able to provide an efficient governance structure *ex post* should the courts tailor the relational agreement or decide that the parties actually meant to organize as another business form. In doing so, the court must consider whether transaction costs or opportunistic behaviour have led to defects in the business form selection.

## 3.7 Fiduciary Duties

It is submitted that extra-legal mechanisms, such as trust and loss of reputation, can lessen but not eliminate the inefficient subtraction of firm-specific investments. When gains of opportunism can be very large, legal standards are needed to prevent parties

121 To be sure, earnings of a close corporation are often distributed as salaries, bonuses and retirement benefits. By setting their own salaries, controlling shareholders may hold up minority shareholders. However, it is submitted that courts can more easily determine whether close corporation salaries are excessive than challenge the discretion of the board to decide on their dividend policy or employment policy.

from engaging in opportunistic behaviour. As prerequisites for these standards of performance, minority and majority opportunism must be discouraged, and the self-enforcing character of the relationship must be preserved. In this respect, legal scholars usually point to the function of fiduciary duties.

Fiduciary duties have evolved differently across a range of contexts involving different types of parties and consensual relationships. For instance, traditional partnership law has developed broad and strict fiduciary duties. It is submitted that in the context of partnerships, enhanced fiduciary duties are justified because the consensual relationship is built upon mutual trust and the utmost good faith. Broad fiduciary duties are a core principle of traditional partnership law in all jurisdictions. Partners expect honesty, fair dealing and mutuality of effort from each other. As in a marriage, they owe each other the duty of the highest loyalty and trust. In his famous and often quoted opinion in *Meinhard v Salmon*,[122] the American Judge Cardozo emphasizes that fiduciary relations are about trust by stating that "many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honour the most sensitive, is then the standard of behaviour."

In this view, even though partnerships can be described as contractual in the broad sense that the partners have entered the relationship voluntarily, fiduciary duties are moral concepts of the highest order, and are not contractually modifiable. The keystone of the partnership relationship lies in the partners' commitment to abnegate short-term self-interest and to promote the welfare of the aggregate of partners rather than their own. Partnership law therefore traditionally provides for broad fiduciary duties that lessen the risk of opportunistic conduct. These duties are necessarily open-ended standards of performance that can be separated into: 1) a duty of care and loyalty; 2) a duty to disclose information; 3) a duty to preclude from self-dealing transactions, personal use of partnership assets, usurpation of partnership opportunities, and competition with the partnership; and 4) a duty of good faith and fair dealing. Because fiduciary duties are open-ended and vague, it might be argued that a breach of fiduciary duty is often hard for an outside party such as a court to verify, and consequently will only assist in preventing opportunism to a limited extent. For instance, even though fiduciary duties reflect concern about the potential abuse of automatic exit rules in endgame settings, the moral mandate approach rejects the notion that fiduciary duties have only a limited remedy function, which is only brought into play when the trust-based relationship breaks down and *ex post* renegotiation is cumbersome. Yet proponents of strict and broad fiduciary duties suggest that these high standards of performance have a distinct function that supplements the remedial actions provided by statute. Fiduciary duties help to foster the development and internalization of trust and norms in a particular business relationship. These rules not only perform an important role in diverting expropriation, but also assure business stability by encouraging the partners to surrender autonomy and

122 *Meinhard v Salmon*, 249 NY 458, 164 NE 545 (1928).

abnegate self-interested behaviour. In this way, the open-ended, overly broad judicial language levels the playing field in relational contracts and induces trust behaviour in firms, in that fiduciary duties provide a legal incentive for the parties to cooperate and forego opportunistic behaviour. In this respect, fiduciary duties have a prophylactic function.

Traditionally, the broad scope of the fiduciary duties distinguishes partnerships from corporations. While managers stand in a fiduciary relationship to the corporation and its shareholders, managers of corporations appear to have a more relaxed set of fiduciary duties. In corporations, the legal concept of fiduciary duty has two quite different functions. First, managers are generally expected to perform their duties with the care of a prudent person who manages his own affairs of equal gravity. Second, the managers owe the corporation a duty of loyalty that limits the possibility of self-dealing transactions, prohibits managers from usurping corporate opportunities and forbids unfair competition with the corporation. In short, fiduciary duties offer protection against the managers' pursuit of personal interest and excessively negligent behaviour. They cannot be used to discipline directors in the performance of their official duties, thereby second-guessing managers' business judgements.

Because the corporate law fiduciary standards applicable to publicly held corporations generally apply equally to close corporations, it is not quite clear whether shareholders in the latter owe each other a fiduciary duty. As noted earlier, in some jurisdictions courts increasingly extend the application of strict partnership-type fiduciary duties to shareholders of close corporations. Because there are no capital market forces that help to constrain opportunistic behaviour, and complete contingent relational contracts are unfeasible, there really is something to the partnership metaphor. It might be argued that in close corporations, where management functions are (at least to some extent) transferred from directors to shareholders, strict fiduciary duties are justified to prevent the greater threat of opportunistic behaviour. However, the convergence of fiduciary duties in partnerships and close corporations also seems to have its limitations. Some law and economics scholars argue that strict and broad fiduciary duties at all levels of closely held firms could be counterproductive. In this view, broad fiduciary duties could encourage parties to engage in over-monitoring at the expense of productivity.

### *3.7.1 Limited Liability Partnership (LLP)*

In light of this discussion, many lawyer economists believe that fiduciary duties should vary across the type of business form. They question whether broad fiduciary duties are optimal under different circumstances and recognize that opportunism in closely held relationships is not always best addressed by imposing broad and vague fiduciary duties. They conjecture that if fiduciary duties are varied to suit various relationships, the parties' *ex ante* adoption of a particular business form sends a signal about their organizational preferences. Viewed in this context, a menu of business forms should offer a range of fiduciary terms, shifting from relational contracts in which the parties retain substantial autonomy to an organization in which self-interest is subordinate to the firm's collective interest. For instance, the selection of a limited liability partnership could send a public signal that broad fiduciary duties apply to the relationship in a wide variety of circumstances.

Both the strict interpretation of fiduciary duty for closely held firms and the menu approach raise the vexed question of the possibility of opting out of fiduciary duties. In order to answer this question, one should distinguish between the fiduciarian and the contractarian views (Vestal, 1993 and 1995). While the former defends restrictions on fiduciary waivers in closely held business forms, the latter considers fiduciary duties as default rules that the parties should be permitted to opt out of upon mutual agreement. While the critics of the fiduciary approach seem to acknowledge that opting out is possible by selecting another business form, they argue that bargaining around fiduciary duties could contribute to norm erosion in the short term, and may induce a norm change in the long term. In the contractarian approach, the parties to a particular transaction are in the best position to reflect their relational wishes in a contract. In this respect, the rules of fiduciary duty are nothing more than penalty default rules from which the contracting parties are free to depart.

In the United States, the disagreement between fiduciarians and contractarians has made partnership-type business forms a troublesome battleground for lawmakers. The drafters of the RUPA have struggled to take the viewpoints of both groups into account. As a result, RUPA reflects both the fiduciarian and the contractarian approach, thereby causing confusion and ambiguity. Upon first inspection, the statute maintains high standards of fiduciary duties, but a closer look reveals that partnership law reform has been accompanied by a significant reduction in the fiduciary duties of partners in the United States. Under the predecessor of RUPA,[123] partnership fiduciary duties were broad and vague.[124] Even though the courts have defined the partners' fiduciary obligations as duties of loyalty, care, disclosure, fairness and honesty to the partnership and their co-partners, the concept of fiduciary duty could be expanded or shortened at the discretion of the courts. In contrast, RUPA has defined the scope of fiduciary duties within a partnership. RUPA (1997) §404 provides that the only fiduciary duties a partner owes to the partnership and the other partners are those of loyalty and care, and defines these duties in exclusive terms.[125] The duty with respect to the disclosure of information is contained in §403 and so is not a fiduciary duty.[126] The obligation of good faith and fair dealing, imposed on the partners in §404(d), is also viewed as a contractual concept rather than a fiduciary duty. In this respect, RUPA conceives the partnership relationship merely as a contractual relationship, thereby restraining the judicial discretion to impose other fiduciary duties than those defined in the statute. It may be argued that the courts will be left some leeway to expand the partners' duties and obligations, which are included within the non-fiduciary obligation of good faith and fair dealing. However, RUPA (1997) §404(d) appears to preclude claims based on bad faith and unfair dealing by stating that the partners have (only) an obligation of good faith and fair dealing in the discharge of their duties.

123 The Uniform Partnership Act (UPA) (1914).
124 See UPA (1914) §21.
125 See RUPA (1997) §404(a). RUPA (1997) §404(b) and (c) define the duty of care and the duty of loyalty.
126 The list in RUPA (1997) §404 fails to include obligations that have been considered part of a partner's fiduciary duties under UPA (1914).

It follows that the drafting of RUPA with respect to standards of behaviour was guided by the goals of the larger sophisticated partnerships in which the partners are represented by legal advisors. Indeed, in order to make clear that a partner is not a trustee and is not held to the same standards as a trustee, §404(e) permits a partner to pursue self-interest without violating a duty or obligation under the statute or partnership agreement. In light of the "think small first" paradigm, a better approach would be to impose an open-ended and broad fiduciary duty. There are three types of justifications for this wide scope of fiduciary duties. First, the focus on business relationships between relatives and long-standing acquaintances, in which trust plays a pivotal role, justifies the adoption of very broad fiduciary duties. The law would simply prescribe what parties actually believed and expected without being detrimental to the self-governing character of the relationship. Because partners in these relationships usually have only a vague awareness of the governing rules, broad fiduciary duties are not expected to undermine trust among the business participants or entail over-monitoring. The collective approach and the abnegation of self-interest in small closely held relationships provide the foundation for broad fiduciary duties and underline the complementary aspect between legal and extra-legal standards.

Second, if one views business relationships in terms of a continuum of businesses varying in "firmness", a menu of business forms should ideally provide several levels of duties between the contracting parties. Consequently, it might be argued that a limited liability partnership statute should maintain a high level of fiduciary duties. Certainly, in order to produce guidelines for the application of fiduciary duties, legislators could define specific duties that comprise a partner's fiduciary obligations.[127] By providing more clarity, the statute could reduce litigation costs, since disputes could more easily be solved at a preliminary stage before trial. However, these variations should not be exclusive. Other statutes could then design duties that are less vague and open-ended and are tailored to meet the needs of more "arm's length" relationships.

Third, by imposing broad fiduciary duties to limited liability partnerships, lawmakers avoid ambiguities in legislation that could undermine the trust between partners in small and often family-related firms. The RUPA approach, which distinguishes between fiduciary duties and obligations of disclosure, good faith and fair dealing, thereby acknowledging the partner's own self-interests, seems to confuse matters and in so doing supports opportunistic behaviour *ex post* despite trustworthy preferences *ex ante*.

This brings us to the question of whether the notion of fiduciary duties should be mandatory or a default rule that the parties could tailor or waive contractually. RUPA (1997) §103 greatly limits the parties' freedom to contract around fiduciary duties and good faith obligations. The fiduciary duties of loyalty or care and the obligation of good faith and fair dealing can be modified by agreement, subject to a reasonableness test. Moreover, the partners are not allowed to entirely eliminate these duties and obligations.

127 For instance, RUPA (1997) §404(b) provides several specific rules that make up a partner's duty of loyalty: 1) to refrain from appropriating a partnership opportunity; 2) to refrain from dealing with the partnership as a party having an interest adverse to the partnership; and 3) refrain from competing with the partnership.

Because partners may want to state their preferences in a partnership agreement *ex ante*, they should be allowed to tailor the scope of the fiduciary obligations contractually or to opt out of the statutory regime entirely. To be sure, it is argued that a mandatory rule is desirable in partnership law, since it: 1) emphasizes the importance of trustworthy behaviour; 2) levels the playing field between the partners by protecting parties against oppressive contracts and unforeseeable harm; and 3) prevents deleterious social consequences in that the ability to opt out fosters exploitation and abuse. However, mandatory fiduciary duties in partnerships involving less legally sophisticated people may do more harm than good when parties do not seek to completely surrender their autonomy upon entry into partnership. In this view, it seems more efficient to endorse the penalty default approach under which the party that suggests opting out signals its intentions. In addition, the contractual notion of good faith helps to prevent unreasonable and opportunistic contractual modifications.

#### *3.7.2 Limited Liability Company (LLC)*

Even if parties could design the fiduciary duties for their relationship, it is important that the role of fiduciary duties varies across business forms. Parties that want to remain unaffected by statutory fiduciary duties may, despite the default rule status of these duties, be reluctant to choose the partnership form. For instance, for the sake of fairness, courts may be inclined to impose fiduciary duties when disputes between parties arise. Furthermore, given the "stickiness" of default rules, parties may be loath to contract around or waive fiduciary duties. Finally, the level of protection of contractual good faith may be higher when parties decide to employ the partnership form (which could imply that the firm is a fraternal association) than in other business forms, like the LLC. If partners are well informed and represented by legal advisors, the parties may be best positioned to bargain into the duties that suit them *ex ante*. As noted earlier, courts may find it difficult to observe *ex post* what parties would have wanted at the formation stage. In this context, it is suggested that a business form that does not impose broad fiduciary duties is a more efficient choice. Sophisticated parties that want to disclose their trustworthy character will face few strategic impediments to opting into partnership-type fiduciary duties.

The next section on distributions shows that lawmakers may want to consider including a duty of loyalty provision in LLC statutes that could discourage non-pro-rata distributions. But first the optimal default rule for LLPs will de discussed.

### 3.8 Distributions

#### *3.8.1 Limited Liability Partnership (LLP)*

An analysis of the "equal sharing rule" elicits the role of partnership law as a standard form contract for the smallest and most informal kind of business arrangements, which are largely governed by social norms and economic incentives. However, while comparing partnership law statutes of several jurisdictions, it is not immediately clear that the equal sharing rule is an efficient default rule in these circumstances. For instance, German partnership law traditionally provide for dividing profits and losses according to the value of the partners' contributions.[128] In the United States, the "equal sharing rule", which is enshrined in RUPA,[129] has raised significant policy issues. It might be argued that because partners often contribute unequally to capital or services and alter the partnership agreement accordingly, it is difficult to hold that the equal sharing rule is the majoritarian rule that most parties would have wanted. Moreover, courts in the United States have often refused to apply the statutory default rule to a sort of "service partnership" in which one or more partners contribute only human capital and other partners offer mainly capital in exchange for a share in the profits. To be sure, given the importance of human capital for the success of many business ventures, lawmakers increasingly recognize the fairness of the equal sharing rule compared to a proportionality rule in which the partners' service contribution is equal to that of the partner with the smallest capital contribution. However, if partnership losses arise, lawmakers tend to think it is unfair for a services-only partner in an unprofitable partnership to bear an equal share of the losses. It does not seem right for a partner to run the risk of losing all the value of his service contribution while a capital partner would lose only a part of the value of his investment.

Does this mean that the equal sharing default rule is misguided? As discussed, partnership legislation should focus on conventional firms, which are least likely to enter into a tailored partnership agreement. These partnerships are typically characterized by a small number of owners who participate in management and contribute substantial personal wealth to the firm, including financial and human capital. In these circumstances, equal sharing of profits and losses is arguably the majoritarian default, which at the same time corresponds to the implicit contracts and norms that govern these types of firms, and hence minimizes transaction costs for the majority of small partnerships.

While the equal sharing rule is efficient in simple and egalitarian partnerships largely characterized by symmetric information and bargaining power, it appears to be a poor fit when partners are not relatives or long-standing acquaintances, contribute unequal sums of capital, differ in skill and have asymmetric information.

Thus seen, the equal sharing rule could be viewed as a penalizing, information-forcing default rule in all but the egalitarian partnerships. More legally sophisticated partners who find equal sharing inappropriate will be likely to contract around the default rule if another division of the profits and losses is necessary to provide the required incentives to invest in relationship-specific assets. *Ex post* judicial costs will therefore be minimized. Indeed, it is submitted that judicial attempts to determine an efficient sharing rule *ex post* could entail a costly and "sticky" precedent, which in turn makes the "partnership sharing rule" opaque and more complex, thereby encouraging litigation. Nevertheless, the equal sharing rule appears to lack an adequate information-forcing quality. If the better-informed partner is most crucial to generate surplus, he will be unlikely to agree

128 See German Commercial Code (*Handelsgesetzbuch (HGB)*) §120-121 (In a German civil partnership, the default rule is equal sharing; see German Civil Code (*Bürgerliches Gesetzbuch (BGB)*), §722).

129 RUPA (1997) §401(b) provides that "[e]ach partner is entitled to an equal share of the partnership profits and is chargeable with a share of the partnership losses in proportion to the partner's share of the profits."

to an equal division of profits. As a consequence, the equal sharing rule will force him to renegotiate the issue, thereby informing the other parties about the legal rules that govern their relationship. However, since a partner's share in the losses generally follows the division of profits, knowledgeable parties are more likely not to raise the issue when the firm is engaged in a risky business. If one takes the example of a service partnership in which a legally sophisticated capital partner has an information advantage over the services-only partner, one may expect the service partner's lack of information to be exploited. In this case, a default rule under which the capital partner would bear all the losses has a better penalizing effect. Yet such a rule would have a detrimental effect if the services-only partner (and not the capital partner) were more knowledgeable, since it invites the first to gamble with the capital partner's investment.

On balance, lawmakers should provide for an equal sharing rule, as it corresponds better to the "think small first" paradigm. That is not to say that in some circumstances the equal sharing rule has an information-enforcing effect, but lawmakers involved in designing business organization law should first take the transaction-cost-reducing function of default rules into account and be very careful in imposing non-majoritarian defaults. In fact, the "stickiness" of default rules in closely held business relationships arguably challenges the efficiency of penalty defaults. This is particularly true of business forms that govern relationships between parties that are usually ignorant of the legal default rules, such as many small closely held firms. To the extent that partnership law's assumption of equal treatment is overly optimistic in joint ownership situations that involve information asymmetries between parties of unequal ability, other partnership-type business forms could provide alternatives to the partnership's default rule. To the extent that firm participants do not like the "off-the-rack" provisions provided by the partnership statute, they may either be permitted to draft around them or they may choose another form. It is therefore argued that the LLC should provide for a different default rule.[130]

### *3.8.2 Limited Liability Company (LLC)*

As we have seen, LLC statutes preferably provide for the members to be locked-in the firm. The advantages of being locked-in do not, of course, apply across the board. For instance, judicial intervention is justified to prevent so-called non-pro-rata distributions that are not based on any agreement among the business participants. In so far as this principle is crucial to the strategy of allowing the majority to manage the LLC in the members' interest, it is necessary to strictly enforce this principle. Indeed, the "non-pro-rata distribution" principle corresponds with important features of limited liability company law that help to prevent the opportunistic transfer of wealth from the minority to the majority.

LLC law can play an interesting role in solving problems involving non-pro-rata distributions. First, it can provide the participants with a rule stating that all shareholders share in the profit in proportion to their stake in the firm, unless otherwise agreed upon. In the

130 It might be argued that in the case of an LLC, lawmakers should choose a sharing rule based on the parties' contributions.

event of dissolution, the law can provide that the residual assets of the firm – anything left after creditors are paid and other obligations fulfilled – will be divided pro-rata among the shareholders. Thus seen, statutory LLC rules help to align the interests of the majority and the minority. Indeed, when non-pro-rata distributions are prevented, the majority, in maximizing the value of his stake, likewise maximizes the value for the minority.

The duty of loyalty provides a safety valve against harmful evasion of the rules of "non-pro-rata" distributions. The duty of loyalty establishes that the majority may not profit from his position at the expense of the welfare of the minority. In this regard, the duty of loyalty operates in tandem with non-legal mechanisms, such as self-enforcing norms of trust and reputation, to curb opportunism. Apart from the unusual situations, the duty of loyalty could function well to protect investors against one-time acts of substantial self-dealing. To be sure, it has been argued that judicial gap filling is prone to error. However, it is submitted that courts can more easily determine whether financial distributions are made correctly than decide in cases involving the protection of minority's employment, managing and decision-making rights in the firm. Practice learns that judicial intervention in the latter conflicts is far too unpredictable due to unverifiable factors and could undermine the self-regulatory mechanisms required for stable, cooperative business relationships.

## 3.9 Information Rights

In order for the duty of loyalty to function effectively, the minority investors should have mechanisms to easily detect opportunistic conduct. Herein lies a second reason for intervention by the judiciary. To be sure, the minority may gather public information. The main source of this information is the periodical publication of the company's annual reports. In Europe, close corporations are obliged to publish audited annual reports under law.[131] For instance, the Fourth European Companies Directive extended disclosure requirements in general to all close corporations.[132] The Fourth Directive contains detailed requirements for the preparation of balance sheets, profit and loss statements, and annual reports. Although the directive demands that the accounts give a true and fair view of the assets, liabilities, financial position and results of the company, the information is not always accurate. For instance, in the Netherlands, the annual accounts must be adopted by the shareholders within five months following the end of the financial

131 In contrast, a US non-listed corporation which has total assets exceeding $10,000,000 and more than five hundred shareholders must publish its accounts (Securities Exchange Act of 1934 §12(g)).

132 The extension of mandatory disclosure requirements to closely companies was resisted strongly by some continental jurisdictions, like Germany and France. Germany's reluctance to implement the Council Directive [EEC 90/605 of 8 November 19990], extending the 4th Directive to partnerships and limited partnerships with corporate general partners, perfectly exemplified the resistance. Although the Germany government agreed on further extension of the directive, after the EU lawmakers announced further exemptions to SMEs, it initially deferred implementing the amendment. Only after the ECJ's judgment in Case C-272/97 *Commission v. Germany*, the German government changed the law according to the amending directive. Under the extension, some smaller enterprises are exempted from the publication of certain information. Member states, under the Fourth Directive, are given powers to exempt small companies from their audit requirements and allow them to create shortened profit and loss statements, an abridged set of notes and the choice to publish an annual report. Similarly, medium sized firms are allowed to draw up shortened statements.

year. But companies may extend this period to thirteen months, which, obviously, will severely diminish the reliability of the disclosed information.

Moreover, annual reports do not fully disclose information about the possible expropriation of the firm's benefits. Direct and indirect transactions between the corporation and the controlling shareholder can affect the accuracy of the financial reports. There is satisfactory transparency regarding such transactions for all listed companies within the European Union under IAS 24.[133] Publicly held companies will be required to prepare, for each financial year starting on or after 1 January 2005, consolidated accounts in conformity with the IAS. With respect to related party transactions, this change implies that publicly held companies be mandated to disclose the nature of the relationship, the types of transactions and the details of the transactions necessary for an understanding of the financial statements.[134] In related party relationships where control exists, disclosure of the relationship is required even if there have been no transactions.[135]

At present, the Accounting Directives require only that non-listed companies disclose information about transactions with affiliated businesses, which are only one type of related party. However, the European Commission has recently launched an Action Plan on further Modernizing Company Law and Enhancing Corporate Governance in the European Union in response to the High Level Group of Company Law Experts report.[136] This Action Plan seeks to address the remaining gaps in the harmonization process and strengthen the Commission's role as a driving force in corporation law reform in the European Union. The Action Plan aims to strengthen shareholders' rights and protection for employees, creditors and the other interested parties and to foster the efficiency and competitiveness of European firms. The Action Plan proposes that greater transparency should be required from unlisted companies. Disclosure should be limited to what is material, in other words to those elements which are significant for an assessment of the financial statements. The recent Commission proposal to amend the Fourth and Seventh Directives in relation to related parties proposes an extension of IAS 24 to smaller non-listed companies. EC regulators defend the requirement on the grounds that: 1) related party transactions are very often material for non-listed companies; and 2) disclosure would not be too cumbersome, as these firms usually do not have complicated off-balance sheet arrangements.[137]

133 International Accounting Standards (IASs) are developed by the International Accounting Standards Committee (IASC), whose purpose is to develop a single set of global accounting standards. Further to the restructuring of the IASC, the new Board on 1 April 2001, as one of its first decisions, renamed the IASC as the International Accounting Standards Board (IASB) and, as far as future international accounting standards are concerned, renamed IAS as International Financial Reporting Standards (IFRS). These standards should, wherever possible and provided that they ensure a high degree of transparency and comparability for financial reporting in the Community, be made obligatory for use by all publicly traded Community companies.

134 IAS 24.22.

135 IAS 24.20. In December 2003, the IASB issued a revised version of IAS 24, which expands and clarifies the disclosure of related party transactions.

136 Communication from the Commission, Modernizing Company Law and Enhancing Corporate Governance in the European Union—A Plan to Move Forward (available at europa.eu.int).

137 European Commission, Proposal to Amend the Fourth and Seventh Company Law Directives.

In contrast, mandatory disclosure is restricted in the US to publicly held firms.[138] Nevertheless, individual member of privately held firms are entitled to substantial information. For example, the Uniform Limited Liability Company Act provides:[139]

> "A limited liability company shall provide members and their agents and attorneys access to its records, if any, at the company's principal office or other reasonable locations specified in the operating agreement. The company shall provide former members and their agents and attorneys access for proper purposes to records pertaining to the period during which they were members. The right of access provides the opportunity to inspect and copy records during ordinary business hours. The company may impose a reasonable charge, limited to the costs of labor and material, for copies of records furnished."

Engaging in information gathering about opportunistic transactions influenced by the majority are obviously "proper purposes" under this legal provision.

To the extent that mandatory disclosure enhances stakeholder protection and has financial market implications, this mechanism may have considerable benefits. The purpose of mandatory disclosure is twofold. Firstly, other stakeholders than shareholders and managers will have access to information. Secondly, and perhaps more importantly, it encourages business participants, in particular, managers to analyze and understand the business. When they are used to communicate openly and clearly, the costs of mandatory disclosure will diminish significantly. To be sure, companies' shareholders may have other direct techniques to acquire information about the performance and financial situation of the company.

However, the benefits of mandatory disclosure may be overstated. In this view, the costs outweigh the benefits due to loss of personal privacy, loss of competitive position, undermining of private property rights, direct compliance costs, and administrative costs. Naturally, business participants have an incentive to avoid mandatory disclosure and incur restructuring costs, because they are reluctant to disclose sensitive information. Another significant problem is that the information is not always timely and accurate and therefore few sophisticated parties would rely on such information financial information alone. Even though the benefits and costs of disclosure do not affect all firms equally, mandatory disclosure is more likely to promote an effective, low cost regulatory landscape that generates significant economic benefits by disciplining entrepreneurs, on the one hand, and offering enhanced protections for stakeholders, on the other hand.

138 In contrast, a US non-listed company which has total assets exceeding $10,000,000 and more than five hundred shareholders must publish its accounts (Securities Exchange Act of 1934 §12(g)).

139 ULLCA §408.

### 3.10 Limited Liability and Capital Requirements

Critics have questioned the efficiency of extending fully-fledged limited liability protection to partnership-type business forms. Proponents contend that, by virtue of their organizational structure, these new business forms create the conditions for opportunism, which may harm minority participants. More importantly, critics are concerned about third parties. They argue that limited liability is not wholly efficient in the context of closely held firms. In their view, the proliferation of LLP and LLC statutes is only an indication of the legislatures' responsiveness to the business lawyers, who supported these new business forms so as to increase fee revenues, and other special interest groups.

For instance, the rapid enactment of new statutes in the United States is due to numerous state legislatures promulgating LLC legislation almost without hesitation, thereby failing to consider public welfare aspects. When other interest groups (*e.g.*, trial lawyers) opposed the expansion of limited liability beyond the realm of corporations, because of the possibility of creditors being detrimentally affected, they were generally no match for their opponents. The upshot is that even if a variety of legal restraints, such as mandatory insurance and minimum capital requirements, are necessary to avoid the adverse consequences of expanding limited liability, legislatures are politically blocked by a sub-optimal trend in a competitive federal system. Furthermore, to the extent that the extension of limited liability to partnership-type business forms is a piece of interest group legislation, courts are unlikely to respond with a coherent set of principles to guide judicial veil piercing, which could limit the effects of excessive risk-taking in certain cases by allowing creditors to reach the personal assets of internal firm participants.

Nevertheless, law and economics scholars are divided about the merits of the efficiency of limited liability. On the one hand, proponents argue that limited liability fosters entrepreneurship, facilitates capital formation and protects firms against the troublesome developments in liability law. The debate on the efficacy of limited liability for partnership-type business forms traced the outlines of the debate in corporate law on the subject of the extent to which limited liability should be restricted or curtailed. On the other hand, opponents have questioned the efficiency presumption of limited liability for closely held firms. In this view, the efficiency presumption of limited liability for closely held firms is under threat due to a series of interventions about its suitability in this context. The basic argument here is that limited liability is thought to have little impact on monitoring costs, liquidity, and risk diversification in firms that often do not separate ownership from control, have no intention of raising outside capital, and in which parties are often required to place all their eggs in a single basket. In fact, limited liability introduces the prospect of opportunistic behaviour, *i.e.*, attempts by the participants to shift the risk of business failure to outsiders. More recently, building on earlier analyses, some have argued that limited liability should not be considered as part of the essential role of business organization law, unlike conferring legal entity status.

Because there is little empirical evidence to support either the efficiency or inefficiency of limited liability for closely held firms, this is a very complex question to which there is no straightforward answer. Despite the absence of evidence, most scholars find that the benefits of extending limited liability to closely held forms outweigh the costs. It has been argued that the rapid diffusion of limited liability within the United States contravenes the argument that LLC statutes are inefficient. In reality, the ready acceptance of tort limited liability by all 51 jurisdictions shows that the pent-up demand for limited liability was significant, and the absence of notable opposition by the malpractice and tort law lobbies indicates that the perception of risks was not so excessive as to justify expenditure to block adoption of this new form. Alternatively, the rapid adoption of LLC statutes merely reflected the delayed, but necessary, response by businesses and legislatures to tort law litigation movement, which had increased costs for parties overall.

Of course, the uncertainty surrounding the efficiency of limited liability does not lend support to those who seek to introduce federal regulations, such as minimum capital requirements, to protect voluntary and involuntary creditors to the firm. The reliance on these signalling devices to balance the levels of risk-taking is deceptive. By their very nature, these devices – which are often poorly designed and outdated – tend to impede innovation, entry and investment, and consequently create unnecessary barriers to trade and social welfare – figures 6 and 7 give an overview of the paid-in minimum capital requirements in a number of jurisdiction as a fraction of GNI per capita in 2005 (associated with the number of start-up procedures).[140] In any event, direct creditors, which are not the main beneficiaries of such legislation, are able to bargain efficiently so as to avoid any risk that may arise in connection with any contracts involving such firms. More perversely perhaps, involuntary creditors are often unable, to adequately protect themselves under these devices, given their lack of information and bargaining power. For some type of firms, reputational barriers may well prove a more effective constraint when embarking upon risky projects. We must also bear in mind that firms will be much better off when they use limited liability vehicles that are acceptable to customers, banks, employees and regulatory bodies in the state in which they are geographically located. The conclusion is that the market for limited liability forms is unlikely to increase the risks for most parties, and in light of the degree of openness and competition in the market, will ultimately produce business organization laws that parties will prefer.

140 See *infra* footnote 147.

**Figure 6: Minimum capital requirements (in 21 OECD countries)**
Source: World Bank-International Finance Corporation (IFC) at www.doingbusiness.org.

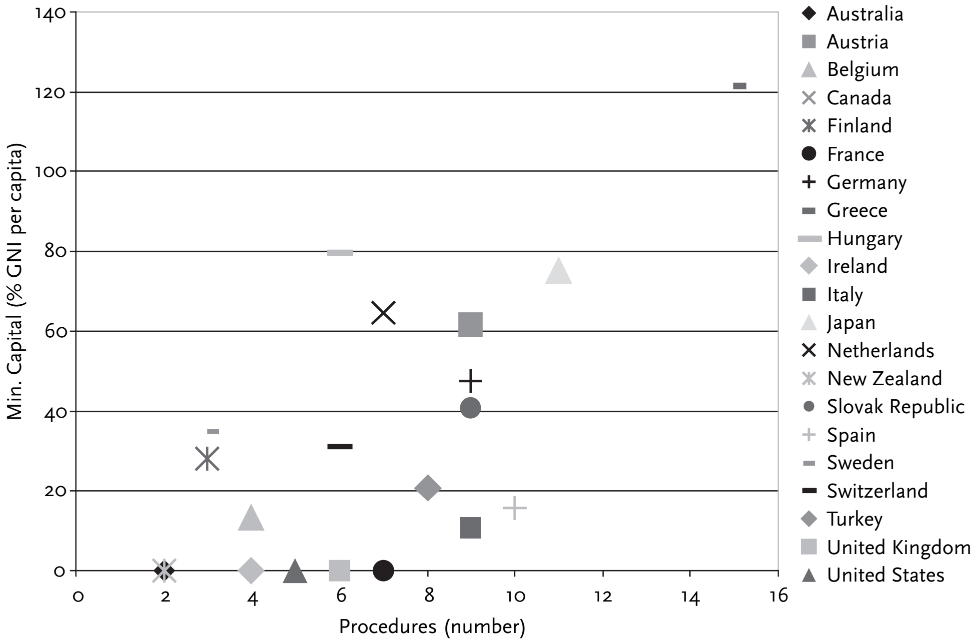
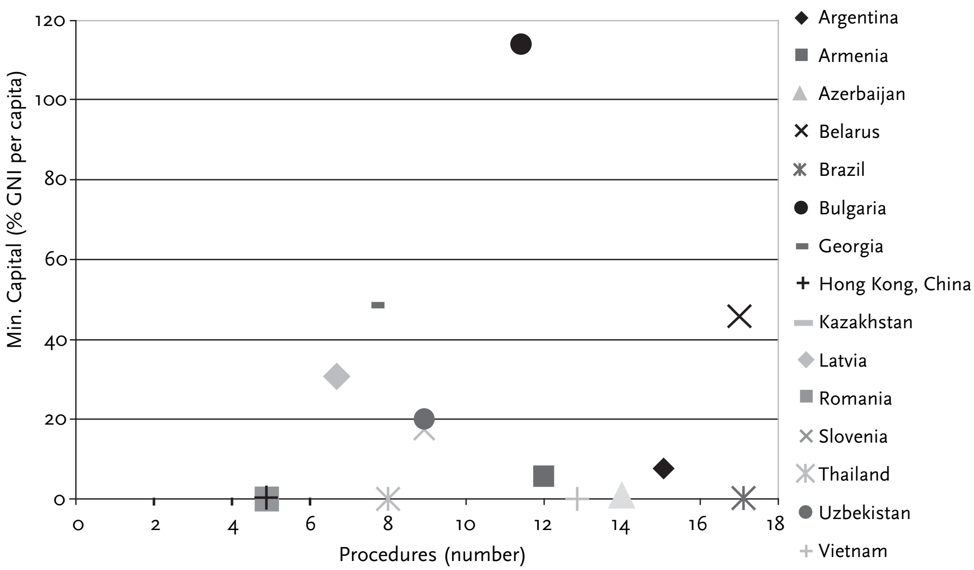


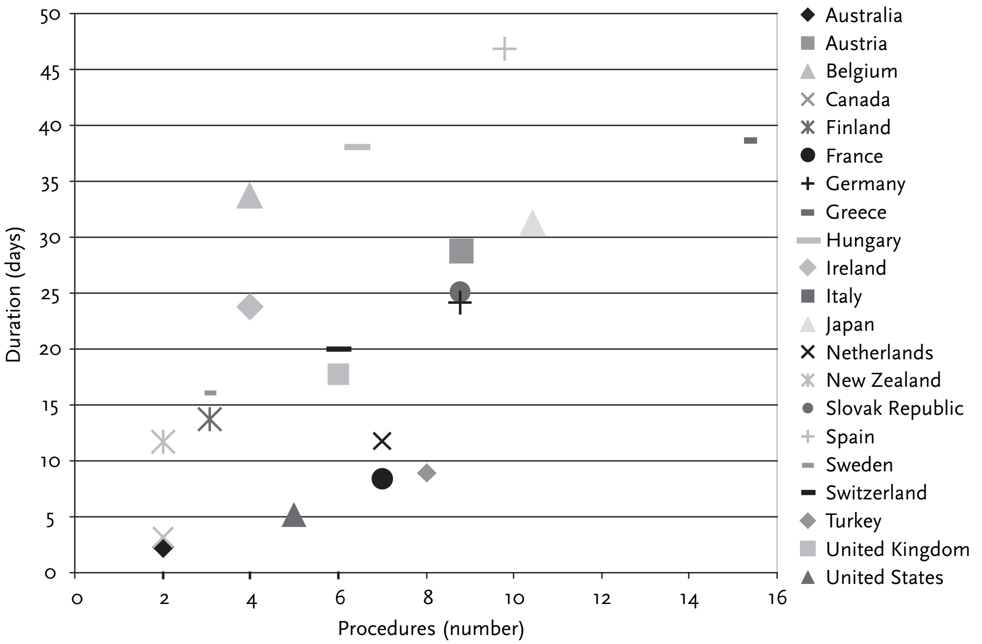

**Figure 7: Minimum capital requirements (in 17 non-OECD countries)**
Source: World Bank-International Finance Corporation (IFC) at www.doingbusiness.org.



## 3.11 Formation

In the United States, an LLP and LLC are formed simply by filing the articles of organization with the Secretary of State office in any jurisdiction. These articles must disclose only a few facts, including the name of the firm and the name and address of the registered agent. Theoretically, the formation of new partnership-type business forms should be possible without professional assistance. Entrepreneurs should be able to create this form rapidly over the Internet. By streamlining the process, lawmakers make it possible to establish businesses in the same way as buying books or CDs online. Filed information should be electronically available upon a moderate payment. In this way, the government would keep pace with new developments in computer technology and e-commerce. Indeed, electronic company formation – without the necessary paperwork – allows a firm to have its legal business form registered in a very short time without incurring any additional transaction costs. Figures 8 and 9 report the time and direct cost (as a fraction of GNI per capita in 2005) associated with the procedures firm founders in 21 OECD countries have to complete in order to start a business. Figures 10 and 11 do the same for 17 non-OECD countries.[141]

**Figure 8: Minimum time required to start up a business (in 21 OECD countries)**
Source: World Bank-International Finance Corporation (IFC) at www.doingbusiness.org.




141 Procedures are defined as interactions of the entrepreneur with third parties, such as government agencies, lawyers, auditors, and notaries. These procedures are officially required to start up a business. It is assumed that the business is structured as the most popular legal business form in a country. As is noted earlier, the close corporation is still the choice of business form in most jurisdictions around the world.

**Figure 9: The cost of start-up (in 21 OECD countries)**
Source: World Bank-International Finance Corporation (IFC) at www.doingbusiness.org.

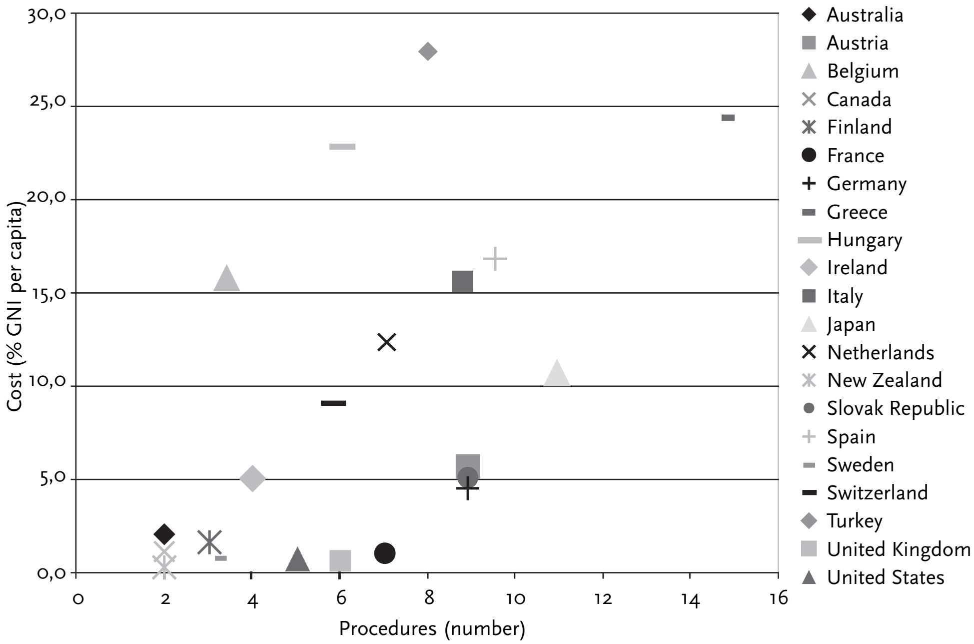



**Figure 10: Minimum time required to start up a business (in 17 non-OECD countries)**
Source: World Bank-International Finance Corporation (IFC) at www.doingbusiness.org.

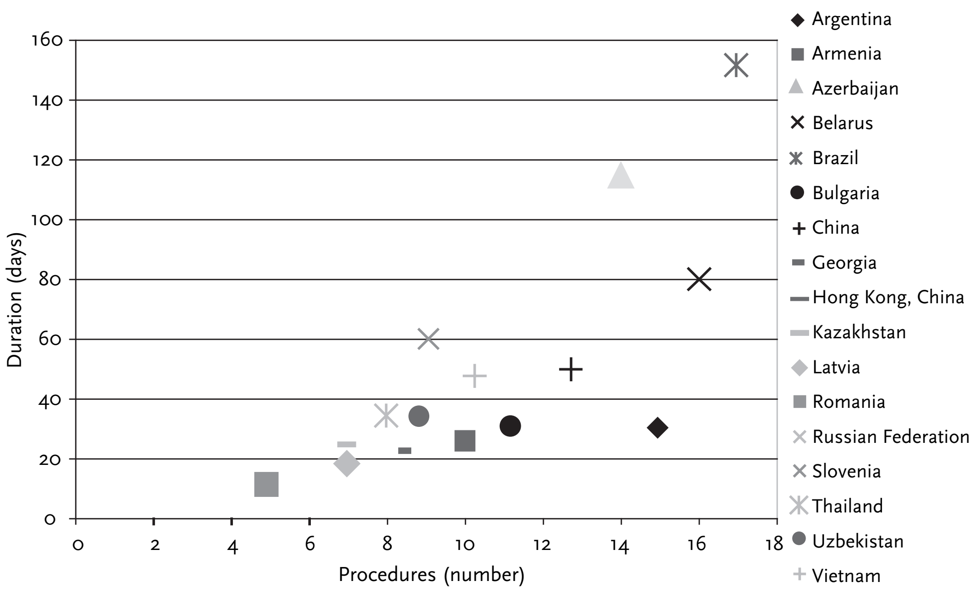
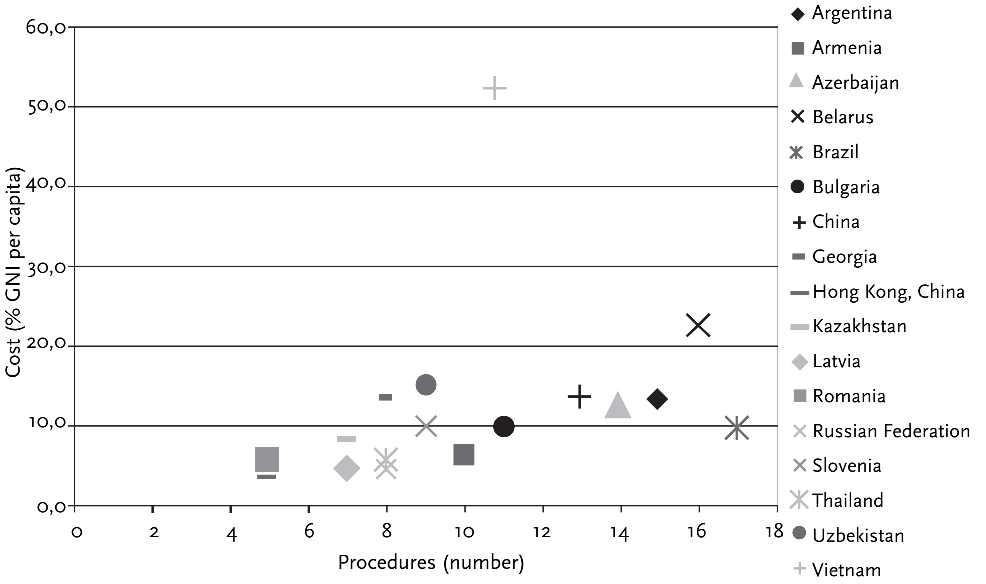


**Figure 11: The cost of start-up (in 17 non-OECD countries)**
Source: World Bank-International Finance Corporation (IFC) at www.doingbusiness.org.



## Conclusion

There are good theoretical and practical reasons for analyzing the pressures that have given rise to closely held firms in Europe and the US and the recent introduction of new forms in Japan. All these reforms are likely to stimulate and ensure renewed growth and increased welfare. It can be expected that the new business opportunities arising out of these reforms will serve to continue and extend the pattern of innovation and development which has occurred over the last half century and into the future.

Meanwhile, we have seen that closely held business forms and their governance problems differ substantially from that of publicly held firms and therefore can be fruitfully analyzed not only in terms of addressing the agency problem arising from concentrated ownership and control but also in terms of designing rules that facilitate efficient contracting among internal and external relations within the firm. If academic research is to inform and improve governance, it is therefore of paramount importance to analyze the corporate governance issues in closely held firms. For these reasons, we have attempted to strengthen our understanding of partnership-type business forms in Europe, the United States and Japan by analyzing the factors that contribute to the creation of a modern framework designed to meet the needs of many types of firms and offers advantages such as simplification of rules, a lower tax burden and considerable freedom in the choice of legal arrangements.

Finally, we have shown that a menu of self-standing business vehicles could provide an important role in improving the performance of this class of firms depends on the extent to which market participants have demanded such arrangements and policymakers have in turn responded to such requests with new forms that offer immediate improvements over older forms. Whether a country's reforms are a success also depends on whether the improvements proposed also create mechanisms (incentive and information systems) that address recognized internal organizational problems that we have discussed. Policymakers and analysts can therefore contribute to the development of a modern and efficient legal framework by advising on modifications and improvements that contribute to evolutionary change in this area.

**Table 9: LLP and LLC legislation**

| *Characteristic* | *LLP* | *LLC* |
|---|---|---|
| *Legal Personality* | Entity | Entity |
| *Management* | Decentralized. In absence of agreement every partner may take part in management | Centralized, unless the operating agreement specifies otherwise |
| *Formation* | Incorporation document (filing through the internet): name, place of business | Incorporation document (filing through the internet): name, place of business |
| *Fiduciary Duties* | Broad fiduciary duties (default rule) | Good faith and a duty of loyalty as a safety net against non-pro-rata distributions |
| *Financial Rights* | In absence of agreement equal sharing rights | If no agreement, sharing in proportion to the member's contribution. LLC law must provide clear rules against non-pro-rata distributions |
| *Information Rights* | Broad fiduciary duties and participation in management | Individual information right |
| *Transferable Interests* | No | Yes, restrictions are imposed by state laws, securities laws and LLC operating agreement |
| *Exit* | Right to withdraw from the partnership against payment of fair market value of the partner's interest. Fiduciary duties provide safety net against abusive use of this mechanism | Lock-in |
| *Continuity of life* | Change in membership of members does not lead to dissolution | Change in membership of members does not lead to dissolution |
| *Limited Liability* | Limited (no capital requirements) | Limited (no capital requirements) |
| *Taxation* | Partnership | Partnership / Corporate |

## Appendix 1: The European Case Law and the Road to Regulatory Competition

In *Centros*,[142] the ECJ decided that it is contrary to the Treaty for Denmark to refuse to register a branch of a firm organized as a close corporation in the United Kingdom solely to evade the application of the minimum capital requirements. Apparently, minimum capital requirements are not essential requirements to protect the interests of creditors of closely held firms.[143] The court found that such creditors are protected by the disclosure requirements applicable to close corporations on the ground of the Fourth and Eleventh Directives on annual and consolidated accounts.[144] The ECJ argued furthermore that that it is possible to adopt measures that are less restrictive and interfere less in fundamental freedoms. In addition, the ECJ noted that the Danish authorities were not precluded from entering into an agreement with the British authorities to overcome potential efficiencies from a British firm doing business in Denmark only.

Even though regulatory competition may not be the aim of the ECJ's intervention, the above analysis shows that *Centros* could very well usher in a new era of competitive lawmaking with regard to corporate law in Europe. Of course, commentators may take refuge behind a phalanx of obscure and convoluted statements in the ECJ's decision in order to defend the real seat doctrine. That said, the conclusion that *Centros* stimulates regulatory competition, in the case of secondary establishments and new companies, is in line with the policy laid down by the European Commission in the 1985 White Paper on Completing the Internal Market. This new approach to lawmaking aims to limit harmonization efforts to the essential minimum, and provides for mutual recognition of national regulations.

It is only to be expected that the ECJ will continue along the path it set about developing in *Centros*. The *Centros* decision constitutes an initial step in the evolution of the ECJ's jurisprudence on freedom of establishment and mutual recognition of companies in Europe. Indeed the *Überseering* judgment should be considered an extension of *Centros*, as this ruling represents the view of the ECJ that companies enjoy freedom of establishment and mutual recognition based on Articles 43 and 48 of the Treaty. In *Überseering*,[145] the ECJ rejected the German principles of case law, under which the Dutch corporation was denied legal entity status and the corresponding right to file an action, against a corpo-

142 Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstryelsen* [1999] ECR I-1459.

143 Most European member states view minimum capital as essential to obtaining limited liability protection. However, these minimum capital requirements do not pass the four-factor test. See *Centros* §34: "it should be borne in mind that, according to the Court's case law, national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it."

144 The ECJ seems to follow the Second Directive on the formation of publicly held corporations and the maintenance and alteration of their capital. See *Centros* §36. For a short comment on the efficiency of capital maintenance rules.

145 Case C-208/00 *Überseering BV v Nordic Construction Co Baumanagement GmbH.*

ration for breach of contract, in a German court. The Court's decision in *Überseering* has been extensively studied by other scholars and will require only brief summary here. The ECJ held that where a firm incorporated in accordance with the law of a member state (A) in which it has its registered office, is deemed, under the law of another member state (B), to have moved its actual centre of administration to member state B, Articles 43 EC and 48 EC preclude member state B from denying the legal capacity and, consequently, the capacity to bring legal proceedings before its national courts for the purpose of enforcing rights under a contract with a firm established in member state B.

The ECJ initially distinguished its *Daily Mail*[146] judgment and *Überseering*, differentiating between the freedom of movement concerning immigration of companies, in which case member states cannot impose any additional requirements, and emigration where the national legislator has wide discretion. According to the *Überseering* Court, companies are best understood as "creatures of national legal orders".[147] Thus, if a corporation is validly formed under the national laws of one member state, another member state must accept this. The ECJ thereby effectively rejected the application of the real seat doctrine when it ruled that *Überseering* had the legal capacity in Germany despite being incorporated in the Netherlands, and its shareholders living in Germany. The ECJ's recent judgment in *Inspire Art* constitutes yet another landmark ruling in the field of the freedom of establishment.[148] This case involved a close corporation established under English law with its statutory seat in Folkestone. Its sole shareholder and director, however, had his domicile in the Netherlands and no business was conducted in the UK. Apparently the corporation was established under English law in order to avoid the stringent rules of Dutch corporation law. A branch of the corporation was registered in the *Handelregister* of the Chamber of Commerce in Amsterdam. But, *Inspire Art* refused to register as a pseudo-foreign company and therefore did not comply with one of the obligations under Dutch law imposed on foreign companies. The Chamber of Commerce brought this as a test case before the *Kantonrechter* in Amsterdam, claiming *Inspire Art* had violated Dutch law. It petitioned the *Kantonrechter* to order *Inspire Art* to complete its registration to the effect that *Inspire Art* is a pseudo-foreign company and therefore required to comply with the minimum capital requirements. The *Kantongerecht* submitted two questions to the ECJ: 1) whether Articles 43 and 48 are to be seen as precluding The Netherlands from setting additional demands such as those found in Articles 2-5 of the *Wet op de formeel buitenlandse vennootschappen* (*WFBV*-Dutch law on pseudo-foreign companies); 2) if the provisions in the *WFBV* are found to be incompatible with European law, must Article 46 be interpreted in such a way that Articles 43 and 48 do not preclude The Netherlands from applying rules such as those setforth in the *WFBV*, on grounds of creditor protection?

The ECJ held that Article 1 of the *WFBV*, which required *Inspire Art* to register under as a pseudo-foreign company, was contrary to Article 2 of the Eleventh Council Directive because it does not allow any disclosure requirement not provided for by the directive.

146 Case 81/87 *The Queen v. H.M. Treasury & Commissioners of Inland Revenue, ex p. Daily Mail and General Trust Plc* [1988] ECR 5483.

147 Paragraph 40 of the *Überseering* decision.

148 Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd.*

In terms of the second issue before the ECJ, the Court referred to its earlier judgment and ruled that it was immaterial for the applicability of the freedom of establishment that a corporation, established in a certain member state, carries out its operations in another member state. Moreover, the ECJ held that the minimum capital requirements for pseudo-foreign companies mandated by the *WFBV* were in violation of the freedom of establishment, as they were not justified by the exception of Article 46 or any other requirement in the general interest.

In the ECJ's judgment in *Inspire Art* the ECJ has extended the earlier case law by applying the *Überseering* rule to the entire legal system of the member states. Unlike *Centros* and *Überseering*, however, *Inspire Art* involved questions of substantive corporation law. Indeed, after the *Überseering* judgment, the issue often raised involved the extent national law may be applied to so-called pseudo foreign companies in the areas other than legal personality or right of standing in court. Having ruled that the disclosure requirement in Article 1 of the WFBV is in violation of the Eleventh Directive and the minimum capital requirements are in violation of the freedom of establishment, the major implication of *Inspire Art* is that the WFBV cannot be maintained in its present form and other member states must follow suit in altering their laws that conflict with this judgment.

This appendix critically examined the ECJ's recent case law on the freedom of establishment and its implications for the free movement of companies and the real seat doctrine. We have seen that while *Centros* did not involve a strict real seat context, the Courts ruling can easily be interpreted to imply that the validity of the view that an incorporation in one member state cannot be called into question in another simply because its central administration is not located in its state of incorporation. Even though the *Centros* case does not touch directly on the real seat doctrine, the broad contours of the ECJ's developing jurisprudence in this area is arguably clear. *Überseering* continues to develop this line of reasoning and *Inspire Art* extends this view, moreover, to substantive law.

We have argued that the real seat doctrine poses serious barriers to the freedom of establishment. However, the recent ECJ decisions have considerably reduced the scope of the real seat doctrine. To be sure, the mutual recognition of companies alone is insufficient to support the emergence of a market for incorporations in the EU. Serious obstacles, which has until now been left unaddressed by the ECJ, such as the absence of a reincorporation procedure and the issue of exit taxes continue to serve as serious barriers to the freedom of establishment and restrict the cross-border mobility of companies. Inevitably the ECJ will confront these issues, but we suspect that the Court will take few steps, as signaled in *Überseering* judgment, to restrict member state discretion in these areas.

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