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The New Company Law - What Matters in an Innovative Economy?

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Abstract

Lower barriers of entry for new firms and more flexibility in structuring a business organization are the two important factors motivating the introduction of the new company law. In general, policymakers use new company law initiatives to encourage entrepreneurship, innovation, and cooperative arrangements. This paper distinguishes the different strands of company law reforms arising in the United States, Europe and Asia and points to the underlying conditions that shape the markedly different reform outputs. Our empirical analysis points to three important factors – (1) private ordering, (2) fiscal transparency, and (3) limited liability – that effect the incentives for new firm creation. However, we find that many of the new company law reforms are incomplete. Nevertheless, these new company law reforms retain the ability to generate rents due to their adaptability and responsiveness to social and economic change.

Keywords: New Company Law, Innovation, Contracts, Incomplete Law, Corporate Taxation

JEL Classifications: G38, K22, L24

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The New Company Law: What Matters in an Innovative Economy?[-]

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1. INTRODUCTION

Ideally new company law vehicles are the result of legislative processes that are initiated for the most part to create mechanisms designed to reduce agency costs and satisfy the contracting interests of business parties, such as investors, firm founders and joint venture partners (Kraakman, et al 2004). The voluminous literature on law and society explains that lawmakers are public regarding actors who will identify which rules are efficient across different firms and time, and replace inefficient rules accordingly. Thus conceived, the ideal and actual function of lawmaking is to attempt to increase social welfare by correcting market failures. Lawmakers supposedly regulate company forms in the public interest.[1]

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1 This view corresponds to the 'public interest theory'. The public interest paradigm of lawmaking emphasizes the government's role in correcting market imperfections such as monopoly pricing and pollution (Laffont and Tirole 1993, 475).

Criticism of this public interest theory of lawmaking has largely focused on two shortcomings. First, legislation is not primarily the result of efficiency considerations. Second, despite similar external market pressures, differences in company law forms continue to persist. Even though there have been recent instances of formal legal convergence, current lawmaking procedures and pre-existing conditions tend to lock the evolution of company law structures into a particular path, thereby maintaining diversity between individual jurisdictions.[2]

At the other end of the spectrum is the view that competitive pressures induce lawmakers to adopt the company law rules that are value-increasing. Under these circumstances, lawmakers, eager to please investors and other businesses parties, identify practices seen as enhancing firms' economic performance, will introduce company law reforms that have the potential to be more cost-effective, and suitably adapted to firms' changing business needs. Firms and their internal participants are viewed as consumers in a market for company law, in which lawmakers seek to design a predictable legal product that reduces firms' costs (Romano 1993).

Consequently, as national boundaries are of diminishing significance, the cross-fertilization of legal concepts is not so much a choice as a necessity. In many countries there is a revival of interest in company law reform projects and the introduction of new hybrid governance structures that presumptively could lead to formal convergence, as reform projects spread around the world through a combination of outright borrowing and more subtle imitation. Due largely to the worldwide development of the Internet, it is relatively easy for lawmakers to take notice of foreign legal business forms that have already been tried and tested in a legal system with similar business, social and political dimensions. If we take this a step further, the drive towards new company law at all business levels could eventually lead to more efficiency, as countries adopt rules and institutions representing the best possible outcome. This theory is based on the premise that unless a country's lawmakers consider foreign legislative approaches and solutions, the domestic economy will fall behind its competitors.

Indeed, as the influence of 'legal transplants' from the United States is felt more and more in company law reform projects in both Europe and Asia, it might be expected that non-US jurisdictions will eventually display similar patterns of legal evolution as we currently see in the United States. For instance, the last decade has witnessed the rise of new legal entities and US transplants in countries that represent both common law and civil law traditions. In the United Kingdom, the promulgation of the Limited Liability Partnership (LLP) was prompted by competition from offshore LLP statutes, particularly that of Jersey

2 Gilson (2001) distinguishes between functional convergence (when existing institutions are flexible enough to respond to the demands of changed circumstances without altering

where Price Waterhouse and Ernst & Young promoted the new legislation based on a similar law enacted in State of Delaware. The Department of Trade and Industry (DTI), which was directly involved in the introduction of the LLP in the United Kingdom, did not, however, just adopt the US LLP – which simply added the limited liability feature to its general partnership law provisions. Ultimately, the DTI created a stand-alone, hybrid company form that is situated between a partnership and a corporation.

Similarly, a Limited Liability Partnerships Act 2005, inspired by the Delaware LLP, came into effect on 11 April 2005 in Singapore. The Company Legislation and Regulatory Framework Committee (CFRFC) spurred the introduction of an LLP in Singapore in order to expand the governance options to be considered by small and medium-sized businesses, professionals and investment funds. Importantly, Japan, which has a tradition to follow Germany's company law model, has recently been inspired by the success of legal innovation in the United States and the United Kingdom, resulting in the introduced two new legal forms: the LLP (*Yigensekinin-jigyo-kumiai*) and LLC (*Godo-kaisha*). These hybrid entities, which are intended to supply Japanese firms with more contractual flexibility, are arguably more suitable for firms involved in multinational joint ventures in the human capital intensive and financial services sectors.

As politicians and business groups across Asia reflect on the changes in Japanese company law, which are seen as offering organizational advantages to firms in knowledge intensive industries, lawmakers in other Asian competitive countries, such as India and China, are already sequencing reforms that will lead to the introduction of the LLP. To the extent that India, for example, is a latecomer in adopting LLP legislation, the delay seems to have provided opportunities for lawmakers to learn from the tried and tested experiences in other jurisdictions. Effort to improve on the LLP structure, based on learning outcomes in other countries, may well benefit Indian professional firms, who are increasingly involved in international transactions, by giving them a business form that is adaptive to their competitive and litigious environment. The reform is seen as desirable, moreover, as it can help induce the introduction of more business start-ups. Similar arguments are used to the same effect by the Chinese Standing Committee of the National People's Congress, which already adopted major revisions to China's company law on 27 October 2005, including the introduction of one-person companies, lower capital requirements,[3] improved information rights and other corporate governance techniques. This laid the

institutions' formal characteristics) and formal convergence resulting in legislative action necessary to alter the existing institutions.

3 For limited liability companies, the minimum capital has been decreased from RMB 100,000 to RMB 30,000 (approx. US$ 3,750). A one-person company could be set up with a minimum capital of approx. US$ 12,500.

basis for China's top legislature to open the discussion, in April 2006, on introducing LLPs in order to stimulate venture capital investment and create a level-playing field to facilitate a competitive advantage for Chinese professional firms that increasingly operate in the global market. Importantly, the type of reforms proposed in Asia point to significant inherent benefits in terms of increased flexibility for the firms that adopt new hybrid legal forms. As they are cheaply available and combine the best of the partnership and corporate world, these flexible legal forms contain features that make them better suited to professional firms, start-ups, small family firms, and financial funds.

These developments suggest that there may be significant benefits for businesses and investors in jurisdiction that make available more productive business forms. Why do we not see a proliferation of new hybrid business forms in continental Europe? After all, the European Court of Justice decisions in the *Centros*, *Überseering* and *Inspire Art* only recently set in train the basis for the cross-border movement of administrative headquarters and the migration of new firms to more favourable jurisdictions. The ECJ case law has improved corporate mobility dramatically as a large number of continental European privately held firms have been influenced, by the absence of minimum capital requirements, to incorporate in the UK as limited companies (Becht, et al, 2005). We have to keep in mind, however, that those European firms incorporating in the UK are mostly 'round-trippers', which means that a large percentage of businesses in continental Europe could benefit directly from the development of more efficient hybrid entities in their own jurisdiction. But, they need a coalition of groups to crack open the policymaking agenda and induce national legislatures to introduce new limited liability vehicles. These reasons may be enough to explain that the impact of the ECJ's decisions has only led to patching-up initiatives in most Member States, influencing some legislatures to eliminate or reduce minimum capital for private companies. As a consequence, the demand for upgraded company law unhindered by capital maintenance requirements is relatively high across the European Union, while the introduction of new hybrid business forms is mainly viewed as unnecessary since they contribute to increased costs attributed mainly to transition issues and enhanced choice (Freedman 1999).

As we will see in section 3 of this paper, there are three main implications for a theory of legal evolution that significantly shape the landscape of and influence the debate on company law reforms. First, the predominance of particular legal elites or traditions in the field of company law restricts the evolution of the law rather than enhancing its development.[4] Second, the standardization of legal business forms confers large increasing returns benefits

4 Clark (1989) distinguishes among three approaches to lawmaking: (1) contractual rule making, (2) elite rule making, and (3) traditional rule making.

to the users and their legal advisers, arguably limiting the development of modern innovative business forms. Most legal advisers 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. Proponents of traditional rules argue that, 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 to the lack of certainty about its legal provisions. Third, start-up and smaller 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 regulations 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 company law are clearly present, the reform process is reinforced by sources of path dependence that inhibit the evolution of innovative legal 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 reactions and forces, the influence of path dependence factors on business forms is likely to be commensurately weaker. The application of the idea of path dependence to law shows that legal institutions evolve along a historical path and can therefore become locked-in and resistant to change. In turn, this inflexibility often leads to inefficiencies, as legal rules fail to respond to changes in the underlying social and economic conditions.

That is not to say that new hybrid business forms provide efficient and all-encompassing governance frameworks and solutions, but they arguably can play a pivotal role in transaction planning and cooperative bargaining among business participants. Opponents to new legal forms attempt to frustrate and ridicule the need of new company law. One common view is that a firm can tinker with the existing legal framework by simply adjusting the statutory provisions or combining existing legal forms to a structure that is responsive to its needs. The balance of evidence suggests, however, that substantially modifying the company law statutes involves significant costs (e.g., increased information costs and uncertainty, distortions in the signalling function of business forms, decreased coherence of terms, erroneous gap-filling by courts and other negative spill-over effects) that outweigh possible benefits. In this paper, we show how new separate business statutes are or should be more efficient in providing firms, at different levels, with a legal structure that does

not impose burdens or create distortions and, hence, would have significant cost advantages.

This paper provides an analytic framework for the development of new legal forms for closely held professional and business firms. Thus, we interpret how differences in legal forms may persist across jurisdictions, and offer some predictions on the evolution of new legal forms. In interpreting the process by which business forms have evolved so far, this paper seeks to identify the parties that help to set the agenda for the reform of company law, and which considerations have been instrumental in stimulating the recent instigation of new law reform strategies. In order to clear up the common misconception that the law evolves towards efficiency, this paper applies concepts of comparative law, economics and political science to legal evolution of closely held forms.

The next section begins by examining the contractual theory of the firm. The contractual theory gives important insights into the legal structure of business organizations. Not only does this approach has the capacity to point to common problems that arise in this environment, but it also emphasizes the key function of law in defining the governance structure of the firm, supplying important contractual provisions *ex ante*, and supporting the enforcement of implicit contracts and internalized norms *ex post*. From this perspective, statutory and judicial company law should offer standardized, contractual, products that help to economize on transaction costs, such as drafting, information and enforcement costs, and to limit opportunism and fill gaps in the business context. In other words, efficient company law offers models that cover the relationships between the business participants inside the firm and the representation of the firm in its dealings with outside participants, such as creditors. Company law statutes act thus 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 (Easterbrook and Fischel 1991). Finally, the theoretical and empirical contributions to the literature on incomplete contracts emphasizes that providing a set of default rules that deal with every possible contingency is a complex and uncertain process. Building on this literature, economic theories of the firm suggest that, besides the statutory and judicial default rules, the incentive and ownership structure of company law forms and the interaction between explicit and implicit contracts help the parties and institutions involved in filling the inherent gaps in the relationship, thereby preventing possible conflicts.

Although the function of company law as a means for incentive design and transaction planning appears to be underrated by lawmakers and academics (Friedman 2004), the introduction of new hybrid business forms indicates that contractual rule-making sometimes prevails over so-called elite and traditional rule-making (Clark 1989). In that case, section 3 argues that the path

dependence story does not necessarily imply that legal innovations are inherently inefficient. We argue that devising new and separate company law forms is more efficient as they offer distinct sets of rules and norms for businesses. Indeed, a separate set of legal arrangements has substantial contracting benefits for the firm's participants by allowing them to define their expectations *ex ante* – less hindered by existing doctrines and traditions – and, hence, assist judiciaries in solving governance problems and other conflicts *ex post*. As a matter of fact, practicing lawyers and business advisors appear to be willing to embrace new company law convinced that from both a tax and business perspective hybrid business forms obtain the most efficient result. Section 4 provides empirical evidence for the popularity and effectiveness of new legal products in the United States, Europe and Asia. It seems that the selection of legal entities requires balancing limited liability protection against, on the one hand, tax benefits and, on the other hand, contractual freedom to organize and structure the firm. Empirical research from the United States confirms the importance of forms that combine limited liability with partnership-type taxation and flexibility. The recent developments in Asia suggest that lawmakers and academics cannot afford to remain in denial of the fact that the 'new company law' will eventually prevail over the existing partnership and corporate forms. Section 5 concludes.

2. COMPANY LAW AS A PRODUCT

It is often said that economic concepts are fundamental to the analysis of company law reform. This approach casts a different light on the role and function of company law than traditional theories of law and society. Understanding these concepts, as adapted to company law, helps lawmakers to identify the needs and requirements of the participants in business firms, but also to define the role of the law in offering an effective governance structure for business parties to pursue economic objectives. The contractual theory of the firm, which dominates the thinking of efficiency-minded lawmakers, can assist lawmakers in identifying the central problems that business parties encounter, and the role that company law plays in helping to resolve these problems. In a Coasean world with complete and perfect information, and no transaction costs, we do not need to worry about company law. The business parties will be able to contract into the most efficient governance structure themselves. In the real world, however, lawmakers could approximate the hypothetical world by offering legal products, in the form of default and possibly mandatory rules, that minimize transaction costs and remove impediments to private ordering arrangements between the business parties.

In this section, we explore the extent to which lawmakers are able to draft comprehensive and self-explanatory legal provisions that stipulate each party's rights and obligations in each state of the world. We argue that while the standard terms of company law statutes can resolve governance problems, companies must often rely on behavioural rules and norms to resolve contractual incompleteness and other intra-corporate conflicts. Consequently, for a variety of reasons, it is submitted that company law is intrinsically incomplete. This section shows that efficiency-minded lawmakers should assist parties in selecting an appropriate set of governance rules which best suite their business needs by supplying standard contractual forms that develop litigation and case law and thereby increasing legal certainty and enhancing the effectiveness of law enforcement.

2.1 Why is Company Law Inherently Incomplete?

Proponents of the contractual theory view company law as a nexus-of-contracts. The nexus-of-contracts theory treats business forms as products that serve as a nexus for a set of relational contracts among its participants (Jensen and Meckling 1976). From this perspective, the contractual theory of the firm is arguably an appropriate and socially desirable concept, since it draws attention to the variety of needs, i.e., rights and duties, of participants involved in different firms (Hart 1995). Nonetheless, the nexus-of-contracts theory of the firm only partly explains why firms require a particular type of product. Moreover, the theory's narrowly conceptualized assumptions – i.e., that: 1) the firm is best viewed as a set of incentive contracts; 2) the function of the legal system is to supply rules and standards that are *ex ante* efficient; 3) rationally informed firm participants will bargain themselves into efficient governance structures; and 4) the firm's contracts are self-enforcing and do not require judicial enforcement – are successfully challenged.

In general, the complaint against the nexus-of-contracts theory is not that relational contracts are irrelevant to understanding the internal organization of the firm, but that it is difficult and costly to write *ex ante* complete contracts inside the firm. For one thing, people intend to act rationally, but they are simply not able to foresee and describe all future contingencies in a contract. Economists claim that people are 'boundedly rational' (Williamson 1985). More importantly, even if contingencies can be dealt with contractually, information asymmetries and strategic bargaining often prevent efficient and complete contracts from emerging (Bolton and Dewatripont 2005). In short, relational contracts are often incomplete due to the difficulties to 1) foresee some contingencies at the outset of the relationship; 2) specify all contingencies in the contract; 3) monitor the performance of the other participants; and 4) enforce the relational contracts.

Viewing the firm as an incomplete contract thus provides a broader understanding of the legal mechanisms required for the optimal production and design of company law and governance frameworks, and, more significantly, of the importance of having a variety of frameworks in general. Incomplete contract theories, which in many ways build on and formalize the concepts and ideas of transaction costs economics, attempt to explain how structuring as a particular type of firm helps to prevent opportunistic behaviour. Indeed, when parties can simply write a complete contract, they specify in full detail what each party must do in each state of the world and how the surplus should be shared. In practice, bounded rationality and private information inevitably entail contractual incompleteness. Consequently, firm participants may have to renegotiate the contract to react to unforeseen contingencies, which may lead to an opportunistic attempt by one of them to obtain more of the *ex post* return on investment.

In line with the incomplete contract paradigm, a company law framework could be viewed as a product, i.e., a 'standard set of governance rules', that represents different points on the continuum of types of firms. This continuum ranges from an organization in which the owners themselves retain substantial autonomy to organizations that involve an increasing surrender of 'individual autonomy' in favour of reciprocity and 'firm autonomy'. On the scale of firmness, autonomy seems to shift from relational contracts with self-interested owners to organizations in which self-interest becomes more subordinate to the firm's collective interest. It is argued that organizational arrangements that have more firmness rank higher in terms of autonomy and, in traditional legal terms, are more easily perceived as entities (Lamoreaux 1998). In this view, close corporations have relatively more firmness than general partnerships. In comparison with general partnerships, close corporations have governance structures which are more based on hierarchy than consensus, 'lock-in' firm specific assets and, hence, decrease an individual's ability to engage in opportunistic behaviour by threatening to break up the business relationship. At the same time, however, individuals may have information and skills to pursue their personal interest and to compete against the firm, whereas general partnership law contains provisions prohibiting individual partners from competition against the firm. It follows that legal business forms present different solutions to the failings of the firm as an autonomous organization, and so rate differently on the scale of firmness.

In the second best world of incomplete law (Pistor and Xu 2003), lawmakers do not supply business forms that offer comprehensive and unambiguous guidance in all future contingencies, but determine, among other things, in company law statutes how control over the firm's resources is allocated, how hierarchy is created within the firm, and which implied fiduciary terms and principles will assist courts in filling possible future gaps in the relational

business contract. Company law thus acts as a facilitator, enabling business participants to move towards the most optimal governance equilibrium within a firm. To see this, let us consider some of the key features of a corporation, which is the main choice of governance mechanisms for listed firms: 1) a corporation is a legal entity that holds the firm's assets; 2) a corporation creates centralized management, to which the shareholders delegate important control rights,[5] and 3) the limited liability feature allows shareholders, many of whom are wealth constrained and risk-averse, to diversify their risks. These principles facilitate the separation of ownership and control, thereby reducing agency costs associated with the delegation of control rights. In a typical publicly held corporation the shareholders are 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 company's share price, lack the expertise and competency to take part in decision-making process. As a consequence, the incomplete contracts theory of the firm recognizes that delegating residual control rights is necessary to facilitate management's participation in the firm and to give management sufficient incentives to undertake relationship-specific investments as well as to fill possible gaps in the corporate contract.

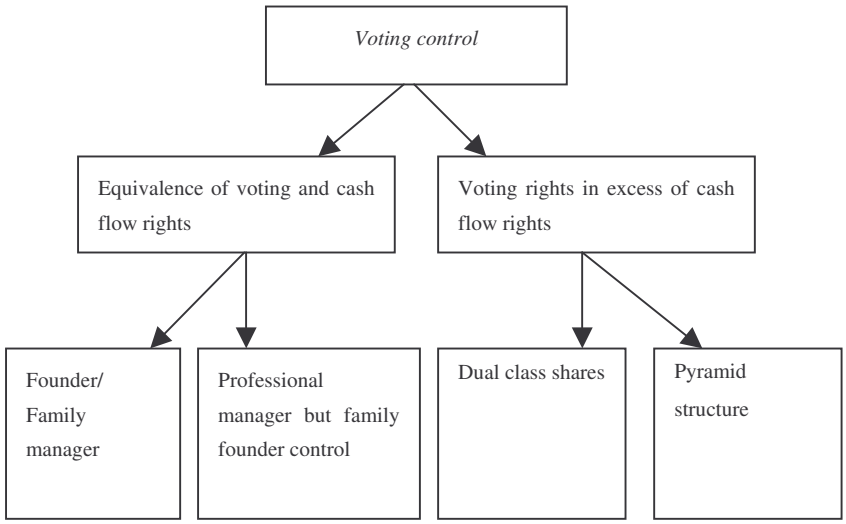
2.2 A Critique of a 'One-Size-Fits-All' Company Law

As we have seen, the corporation is best viewed as a particular standard form contract which offers limited liability, continuity, transferability of interests and, most importantly, centralized management (Rock and Wachter 2000). Whilst the corporation may provide an effective nexus for implicit and explicit contracts and market relationships between shareholders, managers, creditors and other stakeholders, it does not, correspondingly, offer a clear solution for the problems that occur in multi-owner closely held companies in which the identity of the shareholders is a much more important characteristic due to (1) the relatively small number of shareholders, (2) no ready market for the corporate stock, and (3) substantial (majority) shareholder participation in management, direction and operation of the firm. First, the centralized management feature is poorly tailored to fit the governance needs of closely held firms. When ownership and control are typically not completely severed, as is the case in these firms, the delegation of control rights is not so important and precarious as in publicly held companies. Second, the majority rule and statutory norms of centralized

5 The centralized management feature is not only necessary to facilitate management's participation in the firm, but also to attract specialized and competent managers and, more importantly, to give them sufficient incentives to encourage innovation and wealth creation.

management, which characterize the corporate form, creates an opportunity to oppress minority shareholders by, among other things, appropriating corporate opportunities and distributing cash and property to majority shareholders. *Figure 1* depicts some instances in which the majority shareholder may assume voting control. Even if shareholders, ostensibly, have no majority stake in a corporation's equity, dual class shares and pyramid structures often serve the purpose of remaining in control.

Figure 1. Voting control within the firm



Source: P Halpern 'Systematic Perspectives on Corporate Governance Systems' Working Paper University of Toronto 1999.

The fact that we observe numerous multi-ownership structures employing the corporate form suggests that company law rules may, in general, be trivial in the sense that these firms are able to effectively contract around and adapt the corporate governance structure as they deem fit. In fact, the close corporation accounts for more than 55% of registered businesses and 90% of output in OECD countries. 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 structure reinforces and even strengthens the use of this form, arguably excluding the choice for other business forms. Nevertheless, the success story of the close corporation in many jurisdictions could give eloquent testimony to the fact that business participants often neutralize the law's detrimental effect by either relying on *ex post* gap-filling by courts or by making contractual adjustments *ex ante* (Dixit 2004). Hence, the rules of company law appear not to matter, since deviations from

statutory provisions are common and often predictable in the event of the corporation being employed by firms seeking only legal entity status and limited liability protection.

In this view the corporate form may function effectively and appropriately in an incomplete contracting setting. Legal entity status, for instance, is necessary 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 firm 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's 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, as it is virtually impossible to assure the business creditors of the existence of the necessary agreements with their personal creditors (Hansmann and Kraakman 2000).[6] The second (and secondary) purpose for choosing the corporate form is the limited liability feature. Its function is to protect owners by limiting creditors of the entity to pursue claims on the owners' individual and separate assets. Limited liability promotes partnerships and inter-firm cooperation by limiting monitoring costs, externalizing risk and facilitating the sectorial and geographical diversification of business projects.

In closely held businesses, however, corporate rules may be insufficient to provide an adequate basis to govern relations between the majority and minority and the firm itself. Suppose, for example, that the majority shareholders take the decision to eliminate certain minority interests under the principle of majority rule thereby assuming complete control and squeezing out their views and wishes. Although this is a standard corporate transaction, no doubt many minority shareholders, who consider themselves partners in the enterprise with equal say and decision-making powers, will be unhappily surprised.

Similarly, while most closely held firms are governed by extra-legal mechanisms, corporate law rules could be used opportunistically encouraging disputes and litigation when the rules do not match expectations of investors. Indeed, the weight of economic evidence seems to confirm the view that business parties may be loath to bear the transaction costs of contracting around inadequate statutory terms.[7] Studies from the United States illustrate that even

6 Hansmann and Kraakman (2000) call the separation between the firm's assets and the personal assets of the participants inside the firm affirmative asset partitioning. They view affirmative asset partitioning as the core defining characteristic of a legal entity. That is not to say that there are no other transaction cost advantages attached to the use of the corporate form that is bestowed with 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.

7 An empirical survey in the United States found that deviations from state-supplied default settings are uncommon (Hochstetler and Svejda 1985).

though business participants would theoretically be better off opting into specifically available close corporation rules, in practice these opt-in provisions have not been widely used. 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. To be sure, judges and arbitrators could offer a solution to a puzzling and disturbing gap in the corporate contract, such as an easy buyout right for the dissatisfied partner, if the incomplete contract makes the minority vulnerable to opportunistic exploitation by the majority (Oesterle 1995). However, 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 (Mahoney 1998). It is submitted 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.[8] As a consequence, many analysts think the judicial role should be limited, in the case of contractual incompleteness, to the selective enforcement of contracts according to their written terms. Indeed, the difficulty in predicting the judicial outcome explains why relatively few disputes seem to end up in court.[9]

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. 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 (Ayres 1998). 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-legal and social norms. Even if the parties are completely unaware of the default rules *ex ante* and start their business on the basis of 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, over-optimism 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 avoid tailoring their business arrangement, thereby intentionally leaving gaps in their relational contract. Furthermore, bargaining

8 O'Neill (1998: 591) illustrates the artificiality of the family/market dichotomy with a US case, *United States v Chestman, 947 F.2d 551 (2d Cir. 1991)*, in which the Second Circuit surprisingly ruled that marriage creates a confidential business relationship.

9 Easterbrook and Fischel (1986) note that the available economic models of litigation indicate that the more trouble parties have in predicting how a judge will decide, the less likely they are to resolve their differences short of litigation, even when there are only two parties.

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.[10]

The upshot is that governmental lawmakers, i.e. legislatures, 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 arguably more likely to arise around legislative products. It is, therefore, suggested that the legislatures and courts should resolve the high costs of internal and external rules not only by adopting a deregulatory policy towards the laws relating to the governance of closely held business firms, but also by introducing an alternative legal vehicle between the existing partnership and corporate forms. To take the example of the close corporation, one is inclined to point to the troublesome nature of 'over-regulation' with respect to multi-ownership arrangements. The corporate form usually does not give unlimited freedom of contract in devising the ownership and governance structure of the firm. The mandatory and formal nature of provisions in the corporate statute could trump the terms set forth in the agreement between the participants, thereby making the enforceability of the contractual provisions a cumbersome process.

Central to this view is the claim that relaxing the provisions of investor and creditor protection will provide a clear set of benefits to the participants in closely held firms. The goal of regulatory reform must be to balance the interests of third parties and the benefits to firms of modifying the statutory structure of close corporations so as to meet the interests of, for instance, entrepreneurs and joint venturers. To be sure, domestic legislators and judges have offered several judicial and statutory solutions to meet the special needs of the variety of closely held firms. Even though the framework of corporate law is not optimal for these types of firms, courts have attempted to resolve intra-firm conflicts by reference to partnership law principles. However, an acknowledged problem with this approach to the legal control of closely held firms is the risk of ignoring the needs of other types of firms that operate as close corporations. It is well known that legal rules for firms with capital symmetry should differ from the rules for those without. For instance, equal rights in management, automatic buyout rights and broad fiduciary duties that govern 'partnership corporations' are not automatically suitable for start-up corporations financed by venture capital

10 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 (Oesterle 1995, 920).

(Rock and Wachter 1999). The deregulatory approach tends to increase the cost of statutory ambiguity, including legal research, litigation and judicial system costs (Ramsay 1992). A more efficient regulatory response, which involves determining the appropriate level of regulation, ultimately requires cost-benefit decisions to ascertain the necessary policy changes. In pursuing this goal, lawmakers should, as we have seen, view legal business forms as products and focus on designing legislation that contains clear and simple fall-back provisions tailored to the requirements of firms characterized by multi-ownership. Because participants in these firms sometimes start their business ventures with a handshake rather than an articulate agreement,[11] a business form statute should ideally supply a set of default terms that the majority of parties would have bargained for in a costless world (Easterbrook and Fischel 1991). By doing so, lawmakers not only help to minimize transaction costs for firms that wish to enter into customized agreements, but also reduce the costs of statutory ambiguity.

2.3 The Rise of New 'Company Law' Products

In the previous subsection, we explored the limitations of arguments in support of the one-size-fits-all approach. It is our contention that the problem with this approach stems from the inability of a single set of statutory measures to govern the needs of many types of firms. Indeed, the shift away from the extant partnership and corporate forms as a business vehicle for closely held firms in jurisdictions that introduced new company forms is not surprising. The effect is most obvious in the United States where the relatively simple landscape of company law has changed dramatically over the last two decades. 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. 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.

The LLC is yet another, and more successful, legal production that combines partnership features with corporate characteristics. The introduction of the LLC

However, the internal participants in many closely held firms seem, nevertheless, to be reluctant to deviate from statutory default rules.

11 Even billion-dollar joint ventures often operate under a short and simple agreement (Lewis 1999).

bundled together limited liability, a flexible governance structure and preferential tax treatment and also require less ongoing paperwork than corporations. Also, it provides an almost total shield against personal liability without cumbersome formation and capital maintenance rules. 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.[12] Before the Internal Revenue Services (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. 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.[13] 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.[14] After this ruling, other states jumped on the LLC bandwagon, slowly and hesitantly at first, but after 1990, LLC legislation swept rapidly through the United States, largely because of competitive pressures and domestic interest groups, especially legal practitioners who viewed the LLC as better-suited to the needs and expectations of their clients. LLC provisions have been adopted in all 51 US jurisdictions by the close of 1996 (see *Table 1*).

The emergence of and experimentation with the LLC 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 IRS 'check-the-box' regulations, which became effective on 1 January 1997, 'unincorporated' associations are taxed as partnerships unless

12 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).

13 Revenue ruling 88-76, 1988.

14 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.

they affirmatively elect to be taxed as corporations.[15] The 'check-the-box' regulations triggered yet a third wave of amendments of the LLC statutes, thereby encouraging the development of corporate-type LLCs and the adoption of a wide variety of LLC statutes. *Table 1*, for example, shows the variety in enactment dates, fees charged for incorporation, and the type of fiduciary duties regime. In terms of fiduciary duties, the table distinguishes between: ULLCA §409 (Uniform Limited Liability Company Act) which mandates the duty of loyalty and care in a member-managed company; UPA §21 (Uniform Partnership Act), which requires the members to act as a trustee for any profits derived without the consent of other partners; 8 Delaware Code §144 authorizes that the company is bound by the transactions entered into by directors and officers; MBCA §8.30 (Model Business Corporation Act) which provides the standards of duty of faith and duty of care for directors; and RULPA §107 (Revised Uniform Limited Partnership Act) which does not bind parties to fiduciary duties. *Table 2* compares the LLP – as regulated in RUPA (Revised Uniform Partnership Act) – and the LLC – as it appears in the Uniform Limited Company Act and the Delaware Limited Liability Act.

Table 1: The Development of LLC Legislation, in particular fiduciary duties, in the United States

State	Enacted	Adopted ULLCA	ULLCA § 409	UPA § 21	8 Del. Code § 144	MBCA § 8.30	RULPA § 107 3rd Party Analogy
Alabama	1993	Yes	Yes				X
Alaska	1994				X	X	
Arizona	1993						X
Arkansas	1993			X			
California	1994			X			
Colorado	1990					X	
Connecticut	1993			X		X	
Delaware	1992						X
Florida	1982				X	X	
Georgia	1994					X	
Hawaii	1997	Yes	Yes				
Idaho	1993			X			
Illinois	1994	Most	Yes, but not exclusive				
Indiana	1993			X			
Iowa	1992				X	X	
Kansas	1990						X
Kentucky	1994			X			

15 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. Consequently, LLC income is treated as if it were personal income realized by the members, and is taxes to the members as individuals. In contrast, corporate income is taxed first to the corporation and later, if it is distributed as dividend, to the shareholders individually.

Louisiana	1992			X	X	X	
Maine	1994			X		X	
Maryland	1992						X
Massachusetts	1995						
Michigan	1993			X		X	
Minnesota	1993				X	X	
Mississipi	1994					X	X
Missouri	1993			X		X	
Montana	1993	Yes					
Nebraska	1993						
Nevada	1993						
New Hampshire	1993			X			
New Jersey	1993						X
New Mexico	1993			X	X		
New York	1994				X	X	
North Carolina	1993			X		X	
North Dakota	1993				X	X	
Ohio	1994				X	X	
Oklahoma	1992			X		X	
Oregon	1994		X			X	
Pennsylvania	1995			X			
Rhode Island	1992			X		X	
South Carolina	1994	Yes	Yes				
South Dakota	1993	Yes	Yes				
Tennessee	1994			X	X	X	
Texas	1991				X		
Utah	1991						
Vermont	1996	Yes	Yes				
Virginia	1991					X	X
Washington	1994			X			
West Virginia	1992	Yes	Yes				
Wisconsin	1999				X		
Wyoming	1977						
Washington DC	1994						X

Source: Adapted from www.LLCweb.com and Murdoch 2001 (Limited Liability Companies in the Decade of the 1990s).

If we agree that company law is incomplete and view lawmakers as just another producer in the overall economy, the introduction of the hybrid business forms appears to be nothing more than product innovation based on the compelling logic of firms seeking easy access to a range of governance structures designed to have limited liability protection, reduce complexity and limit transaction costs. However, it follows from the above discussion that new business forms do not immediately provide business parties with an optimal and comprehensive governance structure. In fact, the analysis in the next section shows that competing legal elites and traditions, incumbent interest groups, and other path dependence factors tend to significantly shape the landscape of legal business forms and influence the debate about the introduction of innovative company law. We will focus on the main components of the legal production

process in order to show some of the deficiencies in new modern business forms in the United States, Europe and Asia. The extent to which some aspects of the 'elite law making' and 'traditional law making' processes pervade the entire lawmaking structure will be evaluated.

Table 2: Comparison US LLP and US LLC

Characteristic	**LLP (RUPA)**	**LLC (ULLCA)**	**LLC (Delaware LLC)**
Legal Personality	Yes	Yes	Yes
Management	Decentralized	Decentralized (default) Centralized (opt-in)	Decentralized (unless otherwise provided in the LLC agreement, the management is vested in LLC members in proportion to the then current percentage or other interest of members in the profits)
Formation	Informal by two or more partners	Public filing of the articles of organization with the secretary of state (one or more members)	In order to form an LLC, one or more authorized persons must execute a certificate of formation, which must be filed in the office of the Secretary of State
Autonomy of Articles of Organization	Partnership: relationship governed by written and oral agreements	If operating agreement is inconsistent with the Articles of Organization: (1) the operating agreement controls the internal affairs, (2) the Articles control as to third parties who reasonably rely on the Articles (the Articles must set forth only a limited and specific information, such as the name of the company and the address of the initial designated office)	It is the policy to give maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements
Notarization of Articles of Incorporation	No	No	No
Fiduciary Duties	Duties of loyalty and care. Obligation of good faith and fair dealing	Duties of loyalty and care. Obligation of good faith and fair dealing	Access to in formation and records
Financial Rights	Equal sharing (default rules)	If no agreement, sharing in proportion to the members' contribution to capital	If no agreement, profits and losses will be allocated on the basis of the agreed value of the contributions
Transferable Interests	Generally, no	Yes, restrictions are imposed by the Act, securities laws and operating agreement	Yes, restrictions are imposed by the Act, securities laws and operating agreement
Continuity of Life	Withdrawal does not automatically dissolve the LLP	Withdrawal does not automatically dissolve the LLC	Possibility to resign from an LLC is limited; resignation does not

			automatically dissolve the LLC
Limited Liability	Yes	Yes	Yes
Financial Statements	No need to disclose records publicly; partners	Members have access to records. No mandatory disclosure	Members have access to records. No mandatory disclosure
Taxation	Pass-through ('check-the-box')	Pass-through ('check-the-box')	Pass-through ('check-the-box')
Linkage	Linked to general partnership form	Some provisions are similar to RUPA	De-linked

3. THE PRODUCTION OF COMPANY LAW: THREE REFORM STRATEGIES

This section introduces three lawmaking strategies that are often deployed by policymakers in company law reform projects. The first strategy involves legislative and political processes that result in a mere updating of the existing company law statute. It is predicted that, in general, lawmakers are not likely to engage in innovative rule making, but will supply only a superficial 'upgrade' in the existing legal product range. As this strategy is motivated by concerns to mimic results achieved by reforms to business forms in other competitive jurisdictions, as witnessed in continental Europe, these revisions are not likely to implicate the interests of the controlling elites and interest groups. A second strategy, involving the introduction of a new business form explicitly linked to the traditional company law framework can lead to genuine change that will increase the overall quality of law for firms generally. As will be discussed, the difference between the first and second strategy is that the reforms yielded by the latter strategy may hold out potential costs savings for several classes of firms. Finally, the third strategy is moved by exogenous and interest groups pressures with the effect of the promulgation of a new innovative legal statute. It is important to recognize that jurisdictions can use any combination of the above-referred strategies when considering reforms, and that there may be additional incentives not mentioned above that motivate legislative outcomes.

Rather than making a strict distinction between the different reform strategies, that could be used to explain the multiple paths of company law development, this section argues that reform measures undertaken by national level governments are best seen in terms of a spectrum of possible reform paths. It ranges from countries that belong to a strong legal tradition that curb deviations from the existing regime via countries with weakly organized centralized governments and strong organized pressure groups that break down the resistance to legislative change to competitive and entrepreneurial jurisdictions that attempt to offer an up-to-date legal product range. On the one

end of the spectrum, reformers find it difficult to make changes due to the high switching costs and institutional rules and political mechanisms that effectively define and control the items on the legislative reform agenda. On the other side of the spectrum, there is the presence of incentives to innovate and the type of institutional infrastructure under which we can expect pressure groups to have agenda-setting powers that may well explain the result of new company forms. Illustrations of recent national company law reforms allow us to see how the trajectory of trends tends to map on to the spectrum of legal reform.

Figure 2: The Company Law Reform Spectrum



3.1 The First Strategy: 'Patching-up' Revisions

The first strategy only leads to legal upgrades leaving the core of the company law system untouched. In this part, we seek to understand the variations in national legal rules and structures that are responsible for the persistence of inefficient company law rules and structures that policymakers cannot simply alter. It seems that the inferior outcome could largely be explained by strong path dependence factors, such as the influence of legal elites and traditions, and the effect of increasing returns on the lawmaking process. Naturally there are varying degrees of path dependence which are reflected in the diversity of recent company law developments. However, in terms of generalization, strong path dependence is a common phenomenon in legal systems that are dominated by legal elites and traditions bereft of the 'law-as-a-product' dimension. Ironically, if legal products – like regular products – gain popularity and expand utilization, increasing returns can magnify the benefits of defending the *status quo*, resulting in a similar evolution pattern. This party explains why European jurisdictions are still loath to overhaul their company laws even though the ECJ, as noted above, has opened the door towards a market for company law products. After a short discussion about what causes the strong path dependence, the paper will turn to introduce factors that have proven to be effective in changing the company law reform path.

3.1.1 Elites and Traditions in Company Law

In this part we show how lawmakers traditionally shape and structure the company law reform process. It is submitted that legislators, judges, practitioners, regulatory agencies, professional groups and legal scholars constitute an elite lawmaking group that is responsible for interpreting, preserving and developing the law (Watson 1985). These legal professionals produce different kinds of texts, such as statutes, judicial decisions and scholarly writings, which one school of comparative law academics calls 'legal formants' (Sacco 1991; Monateri and Sacco 1998).[16] The law does not consist solely of these texts, but should instead be viewed as a series of formulations that complement each other (Schlesinger, at al 1998). Still the law and its evolution appear more like a battleground on which lawmaking elites compete for hegemony than a system of checks and balances (Bourdieu 1987).

What are the factors that tend to reinforce legal rules and institutions that are in place? Generally, there are two factors which operate to make law conservative. First, the lawmaking elite treats the law as existing in its own right. In this view, the law is largely autonomous and operates in its own sphere (Kelsen 1967). As one commentator puts it: 'the means of creating law, the sources of law, come to be regarded as a given, almost as something sacrosanct, and change in these even when they are obviously deeply flawed is extremely difficult to achieve' (Watson 1985). Second, the law is justified in its own terms. Lawmakers, i.e., persons trained in law and nothing else, search for the legitimacy of legal change, which makes the law typically backward-looking. To a large extent, this insulates legal evolution from social and economic change and it therefore displays a serious degree of path dependence.

To what extent does the evolution of the legal rules and institutions reflect social and economic change? Lawmakers, who genuinely disagree as to which rules and institutions are 'best' (Bebchuk and Roe 1999), could be viewed as legal elites that produce competing legal formants. It is possible to distinguish between conservative and reform-minded legal elites. Because the law is viewed as autonomous, lawmakers historically employ two strategies when entering the competitive arena of legal reform. On the one hand, conservative lawmakers deploy the existing legal doctrines, principles and culture to protect the *status quo* and thwart reform. On the other hand, reform-minded lawmakers traditionally make reference to foreign rules and institutions to propose legal change and to induce the controlling elite of the receiving system to believe that the offered model meets their expectations (Watson 1974).

16 The theory of legal formants, as suggested by Rodolfo Sacco, views the law as a social activity in which lawmaking elites compete to provide legal doctrines.

If we take this a step further, it could be argued that the development of the law takes place mainly by transplantation of legal rules. Yet in order to be effective, a borrowed legal rule or institution must be understood and appreciated by the dominant, and usually conservative, lawmaking elite. Indeed, it is submitted that a legal transplant increases its own receptivity when adaptations to the domestic formal and informal legal order are made or the borrower is already familiar with basic legal principles of the donor jurisdiction (Berkowitz, et al 2001).

It is in the legal actors' nature to attach considerable importance to authority in the transplanting process. It is often very difficult for a law reformer to 'sell' his ideas without the support of some kind of authority whose expertise is widely recognized by the legal community (Sacco 1991).[17] That authority could be inherent in a foreign legal system or institution due to its prestige, common legal tradition or high accessibility. Reform-minded lawmakers attempt to convince the controlling elite that borrowing should occur by juxtaposing black-letter law reports, and consulting intuition and any available facts to show the foreign legal system's supremacy (Ogus 1998, Fanto 2002).[18] Yet, the results of comparative legal studies often lack a clear theoretical or empirical explanation of why a particular foreign system or institution is the most suitable model, given the needs of the social and economic environment. When legal parochialism is strong and jurisdictions are largely resistant to transplants (which is often the case where jurisdictions are convinced of the effectiveness of their own legal system), reform-minded elites adopt a different strategy. They deny the fact that a model is borrowed, and use local authority to bolster their opinion (Mattei 1994). In this view, legal change could be explained largely by 'hidden' transplants, which are a mixture of foreign and indigenous doctrines and principles (Horowitz 1994).

However, it might be argued that if a jurisdiction becomes part of a common market like the United States or the European Union, convergence of important principles of company law is likely to become greater, as the number of firms that not only do business in more than one state, but have among their members residents of different states, increases. In this context, national level company law reforms in the European Union (EU) have been encouraged by changes in European Court of Justice case law, which have encouraged firm mobility for start-ups, giving reform-minded lawmakers an incentive to intensify their efforts

17 Sacco (1991: 400) argues that a legal innovation that does not originate from an authority is often viewed as an 'error'.

18 Prestige seems to be the key word. As a consequence, 'it is unlikely that a European country will imitate an African model, that the United States will imitate a Venezuelan model, that the Scandinavian countries will imitate an Italian model, and so forth' (Sacco 1991, 399). Fanto (2002) gives an analysis of psychological factors used by reform-minded lawmakers to make a persuasive case for reform.

to modernize their domestic company laws.[19] But, as noted earlier, the dominant reform strategy of most national level policymakers is still influenced by a 'patching up' approach designed to ensure prevalence of the *status quo* (McCahery and Vermeulen 2005).

For instance, the elimination of the capital maintenance rules for private companies appears relatively easy. These rules, where the content is less important than their uniformity (Charny 1991), had already been applied to public corporations and subsequently were harmonized by the European Commission to reduce costs for third parties transacting with the firm.[20] Having served simply as an authoritive focal point rule for legislators engaged in company law reform, the decision to eliminate the rule for private companies – in light of the ECJ's triad of judgments on free mobility – is hardly surprising as it could be accomplished without causing too much disturbance of existing expectations of the controlling and conservative lawmaking elite. In this view, the array of mandatory legal capital rules only seems to benefit several interest groups (Carney 1997). In fact, incumbent management may have influenced the EU legislature to supply provisions that limit dividend payments and share repurchases so as to obtain more leeway to reinvest firm's profits. Accountants, who play a pivotal role in the required valuation, also have a substantial interest in exerting influence on the legislative outcome.

But also members of the lawmaking elite, such as lawyers and other legal practitioners, seem to benefit from guiding their clients through the complicated harmonized rules (Enriques and Macey 2001). Thus, since legal elites that benefit from the existing legal rules arguably have incentives to block innovative measures, reform-minded groups are confronted with the daunting task of replacing the existing legal rules with new measures and techniques.[21] Still, it is not surprising that bringing about change can be more troublesome than merely having to protect the incumbent interests. This partly explains the inherent shortcomings of this legal reform strategy.

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19 Case C-212/97 Centros Ltd v Erhvervs- og Selskabsstryelsen [1999] ECR I-1459; Case C-208/00 Überseering BV v Nordic Construction Co Baumanagement GmbH; Case C-167/01 Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd.

20 For the most part, harmonized rules for legal capital tended to benefit publicly-listed firms engaged in cross-border transactions (Leleux 1968).

21 As discussed, the blocking power of the conservative lawmaking elite differs from country to country. For instance, the French legislature reacted immediately to the possibility of losing new incorporations to England by reducing the mininum capital requirement to € 1. On the other hand, the German legislature, as we will see, which experiences a much higher number of businesses opting for the English limited, seems only to be able to agree on a compromise which lowers the capital requirement from €25,000 to €10,000.

3.1.2 Increasing Returns

This subsection surveys another factor of path dependence that is responsible for creating barriers that hinder reform-minded lawmakers from persuading the legislature to adopt effective company law forms. This factor of path dependence, which is generally labelled as increasing returns, can explain the survival of particular institutions and traditions that were once effective in solving serious problems in the business environment, but no longer provide strong support of lawmakers given changing economic and social circumstances.

It is now commonplace that if firms use a particular business form more frequently, its value increases, thereby decreasing incentives to introduce legal reform. Increasing returns engender the standardization of rules and institutions over time (Kahan and Klausner 1996). Standardization, in turn, accounts for the lock-in to a sub-optimal framework.[22] The increasing returns approach corroborates the hypothesis that lawmakers are prone to inertia and inflexibility. The models pertaining to the appearance of increasing returns are often used to explain why the widespread adoption of products and technologies that become more valuable as their use (or the use of compatible products) increases could lead to a sub-optimal outcome (Arthur 1994; 1996). When increasing returns are associated with competing products, inferior products may prevail over products that are inherently better. More importantly, they may stand in the way of innovations.

The literature points to the success of the QWERTY keyboard, VHS video recorder and DOS operating system over allegedly superior alternatives (Arthur 1994; Katz and Shapiro 1986).[23] Three related but conceptually different mechanisms are responsible for the possible dominance of increasing returns over inherent benefits: (1) sunk costs, (2) learning effects and (3) network effects. The end result is that if new adopters of a product or technology are only interested in their own benefits without any consideration of the effect of their decision on other 'network users', the development of new products and technologies will be impeded, thereby fostering lock-in to the inferior standard.

Unsurprisingly, law and economics scholars have asserted that similar increasing return mechanisms help to explain inertia and momentum in the evolution of legal rules and institutions (Klausner 1995; Kahan and Klausner

22 Bebchuk and Roe (1999: 155) state that 'rules might be path-dependent because the identity of the locally efficient legal rule – the rule efficient for a given country – might depend on the rules and structures that the country had at earlier times.'

23 These allegedly superior products are the Dvorak Simplified Keyboard (DSK), Sony's Beta format and Philips V2000 format for VCRs and Apple's Macintosh system respectively. But Liebowitz and Margolis (1995); (1998) demonstrate that the evidence for the superiority of a particular product is weak and, hence, the extent of network effects may be much more limited than is commonly assumed.

1996).[24] Comparable increasing return effects appear to play a pivotal role, especially in the field of business forms, which, as we have seen, should be viewed as legal products traded in a market (Posner 1982).[25] Consider, for example, statutory provisions and cases under company laws. In most western jurisdictions, the majority of firms are organized under the provisions of a corporate statute. Such statutes not only confer substantial network effects to users of those statutes, but firms also expect to obtain further benefits as new enterprises incorporate. The use of the corporate statute could be valuable to a particular firm, regardless whether other firms have incorporated under the same statute. All the same, widespread use of the corporate form could have network effects analogous to those of the QWERTY keyboard. As more firms adopt the corporate form, networks of legal actors specializing in this particular business form (e.g., lawyers and legal scholars) will develop, thereby offering legal services of a higher quality and lower cost. Furthermore, firms may choose the corporate form to attract and accommodate investors who expect firms to use it.[26]

Learning effects further reinforce the application of increasing returns processes to business forms, including legal doctrines, statutory provisions and case law (Bratton and McCahery 1995).[27] These effects, which come from the use of the corporate law statute, for instance, also explain why most of the parties that originally opted into the corporate form have an incentive to continue to use the regime. Factors that arguably add to the value of the traditional corporate form include avoidance of formulation errors, ease in drafting relational agreements, availability of case law on the interpretation of the statute, and the familiarity to legal actors (Clark 1989). If these benefits are taken into account, newly formed businesses are likely to migrate to the business corporation statutes that confer these benefits to the user. This will mean that demand will be higher than it otherwise might be, which in turn will lead to the supply of standardized statutory terms, rather than customized ones that benefit a particular firm in a particular situation. Because standardized terms offer

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24 But see Gillette (1998); Lemley and McGowan (1998); Ribstein and Kobayashi (2001).

25 Banoff (2001) gives an overview of the literature that uses the product metaphor.

26 Klausner (1995: 785-786) argues that where information asymmetries exist and signalling is costly, marketing network externalities may exist. Network effects provide a purely academic explanation for the fact that US high-tech start-ups are structured predominantly as public corporations, despite tax disadvantages. Venture capitalists would rather avail themselves of the predictable corporate form, for which many contractual mechanisms have been developed and standardized, than rely on new customized governance and organizational structures.

27 If, for instance, case law creates a legal rule that goes beyond the statute, such as enhanced fiduciary duties for close corporations, increasing returns derive directly from precedent and the doctrine of *stare decisis* (Hathaway 2001; Rasmussen 1994; Stone Sweet and McCown 2001).

certainty (Goetz and Scott 1985), when advising their clients about incorporation decisions, business lawyers will recommend a standardized term – even if it is sub-optimal – rather than draft a customized term that could lead to a higher expected value for a client.

The result of network and learning effects is that continuous use of the dominant business form, even if it is not ideally suited to some firms, will reduce the incentives for lawmakers to innovate. As in other areas of law reform, the reluctance to diverge from the existing framework means that even if new business forms were created, parties might be unwilling to substitute the standard form for non-standard terms. In short, the benefits that accrue to a standardized regime may be sufficient to outweigh the benefits that firms could gain by shifting to a new or modernized statute. Also, because potential first-users of new business forms do not have the advantage of future network benefits, such new forms may only emerge if the inherent benefits are of paramount importance.

These 'switching costs, i.e., the costs of switching from a standardized form to a new or innovative business form, constitute yet another reason for conservative lawmakers to defend the *status quo* or only engage in patching-up reforms.[28] The uncertainty about the future benefits of the introduction of new legal business forms leads to the persistence of traditional rules and governance structures, and delays genuine legal innovation (Parisi et al 2001).[29] Like R&D investments into high-tech products and technologies, initial lawmaking costs are partially sunk costs. In this respect, legal intervention is costly, not only due to the research, legislative and publication costs of new law, but also because various legal actors must invest substantial amounts in human capital and modes of operation that 'fit' the new rules and institutions. If the new legal regime proves to be undesirable over time, these costs cannot easily be recovered.

3.1.3 GmbH Reform: An Example of 'Patching-up' Provisions

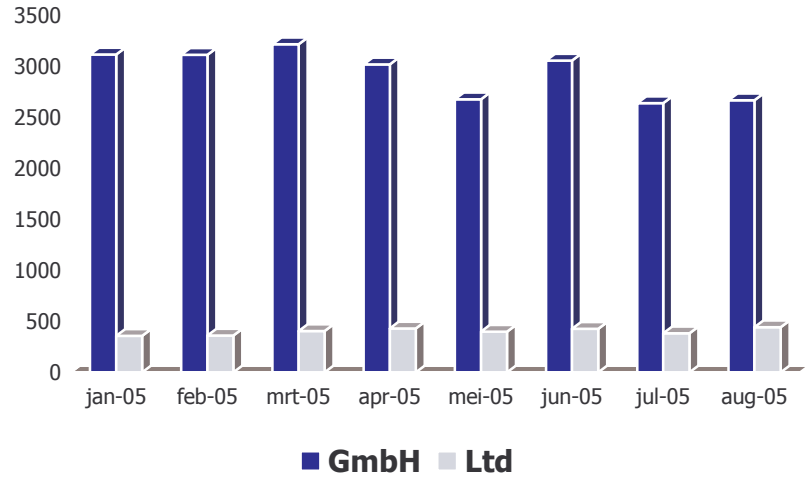
In the context of company law, the ingredients of strong path dependence may involve externalities that lock firms into an inferior business form and make it very difficult for the reform-minded to convince the controlling elite of the merits of offering a new menu of legal business forms. To explain this, let us

28 Research in behavioural psychology has indicated that people in general show a natural bias toward the *status quo*, in that, they have a tendency to prefer to leave things as they are. Moreover, evidence from laboratory experiments shows that people exhibit a so-called endowment effect: people often demand significantly more to give up an object than they would be willing to pay to acquire it, even when the transaction costs associated with reacquiring a similar object are very low (Arlen 1998).

29 DTI (1999: 64-65) argues that in light of the opposition from special interests, professional advisers and network externalities, introducing a new statute is of no value unless it will be widely used.

look at the current reform situation in Germany to see how resilient these mechanisms have been in facing off challenges to reforms that might have allowed firms more organizational choice. For example, despite competitive and interest group pressures to reform the German close corporation, the *GmbH,* along the line of the British Ltd., German legislators have largely resisted taking actions that would challenge the *status quo*. To be sure, proposals have been advanced to reform the *GmbH* in order to stem the flow of German firms using the British Limited. *Figure 3* shows that in the first eight months of 2005 23,496 new GmbHs were formed against 3,195 Ltds, which counts for fourteen percent of the newly incorporated firms.

Figure 3: Comparison Newly Incorporated GmbHs versus Ltds



Source: Adapted from Deutscher Bundestag (BT) – Drucksache 16/283 – 16.12.2005 – Auswerkungen und Probleme der Private Limited Companies in Deutschland.

However, economic and political pressures have not built up sufficiently to force through German legislative action that would involve substantial costs to incumbent groups. For example, it has been proposed that changes involving the reduction of minimum capital requirement (involving a reduction from EUR 25,000 to EUR 1), the transplant of the British *wrongful trading rule,*[30] and the option allowing firms to choose a single layer member-managed *GmbH*, would

30 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.

lead to a more flexible and lower cost structure and thereby overcoming the path dependence forces which have successfully blocked the introduction of a more market friendly structure so far.[31] The German legislature had a two-phased reform in mind, first, a compromise proposal should have lowered the capital requirement from EUR 25,000 to EUR 10,000. Subsequently, a more fundamental reform should have further adjusted the GmbH legislation to the social and economic changes. However, due to the change in government after the federal election in September 2005, the proposed reform path has not seen the light of day. The point here is that not only have reform groups failed to overcome the system's barriers, but they have also failed to effectively alter society's perceptions about the need for legislative change in this field. Major reforms that involve deviations from the current rules on the preservation of the share capital and the notarial deed requirement for the transfer of the shares are unlikely to find support in the near future. Indeed, in order to limit the increasing popularity of the limited, a new proposal to introduce a modernized *GmbH* was published on 29 May 2006.[32] The proposed act – *Gesetzes zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG)* is built on three main functions of the GmbH law: (1) The incorporation of a *GmbH* should be fast, cheap and simple, (2) the new *GmbH* should offer a transparent shareholder structure, and (3) creditors should be better protected against illicit exploitation and rent seeking strategies of the owners of a *GmbH*.

The reform measures serve to simplify the registration system, making a fast and electronic registration with the Chamber of Commerce possible for *GmbHs*. The availability of a public shareholders' list at the Chamber of Commerce emphasizes the importance of the electronic registration as such an up-to-date list should help prevent the acquisition of the company from non-shareholders. It is the intention of the new Act to consider only registered persons as shareholders. In order to make the *GmbH* an attractive export product, the new Act proposes to abolish the requirement that the registered office of a firm is located in the same country as its corporate seat. Surprisingly, however, the upgraded GmbH would still require a minimum capital of €10,000 (see *Table 3*). Moreover, as a trade-off for the reduction of the minimum capital requirement, the legislature proposes to increase the managing director's liability in the event of the firm's insolvency. It seems that Germany's lawmaking elite endeavours to

31 To be sure, the German legislature introduced a professional limited liability partnership. (*Partnerschaftgesellschaft)* in 1995 and updated the legislation in 1998. However, the procedures involving the formation and operation of this partnership form appear too costly and cumbersome to economic actors. For instance, the *Partnerschaftgesellschaft* statute is linked awkwardly to both the civil and commercial partnership rules

32 See http://www.bmj.bund.de/files/36cadac97153e8f45c30973556948656/1236/RefE%20MoMiG.pdf

secure the popularity of the *GmbH* by enacting a compromise legislation that mainly focuses on the relations of shareholders and managers to persons dealing with the *GmbH*.

Table 3: Legal Characteristics 'new' GmbH (Germany)

Characteristic	GmbH (revised)
Legal Personality	Yes
Management	At least one managing director
Formation	Articles of Incorporation + notarial deed + registration at the Registry of Commerce + audit by the Local Court + publishing in a legal gazette
Autonomy of Articles of Incorporation	Some provisions are only valid if they are included in the Articles. Agreements and resolutions with effect for the future or that lack the agreement of all shareholders are null and void or voidable
Notarization of Articles of Incorporation	The Articles must be recorded in a notarial deed, otherwise the Articles are null and void
Fiduciary Duties	Statutory shareholder's right to information/case law duty of good faith and loyalty
Financial Rights	Shareholders have a right to share profits in proportion of their investment
Transferable Interests	No public offerings allowed; a transfer of shares requires a notarial deed in order for the transfer to be valid
Continuity of Life	Yes
Limited Liability	Yes, minimum capital requirement of EUR 10,000
Financial Statements	Mandatory disclosure
Taxation	Corporate taxation
Linkage	Management structure of public corporation (*Aktiengesellschaft, AG*)

The above example shows that the legislative inertia resulting from both elite and traditional rule-making as well as the standardization-effect arguably leads to strong-form path dependence in Germany, which hampers innovation despite serious competitive pressures from the English limited. The next section, however, will discuss how competitive pressures could instigate reforms despite the presences of considerable path dependence effects. It seems that the influence of high-powered, reform-minded interest groups is pivotal to the direction of change in company law reform.

3.2 The Second Strategy: Responding to Reform-minded Interest Group Pressures

The evolution of company law may well generate a new transformation if national lawmakers find a compelling reason to abandon the defence of well-entrenched legal forms and increasing returns that reinforce their position and block the diffusion of new innovative legal rules and institutions. Studies on the political determinants of legislative change have examined the connection between public welfare and legislative outcomes, calling into question the motivation of lawmakers to undertake reforms on this basis. Given this, the introduction of new company law forms in response to social and economic concerns would seem unlikely. Nevertheless, the recent emergence of new

business forms strongly suggests the presence of some kind of incentive to innovate.

A general implication for a broad theory of legal evolution is that lawmakers do not always dominate the lawmaking process. This is especially true of company law, which is influenced not only by lawmakers, but also by politicians and – more importantly – interest groups (Becker 1983; Grossman and Helpman 2001). To fully explore this phenomenon, this section discusses the incentives for the introduction of new legal forms. This analysis builds on the economic theory of legislation, which assumes that legal rules are demanded and supplied in much the same way as other products. Legislation ensues from the jointly maximizing relationship between interest groups and political actors. Promising political or personal support,[33] interest groups persuade political members of the legislature, and specifically those who run the supply and demand process of legal products, to pass or veto legislation (Tollison 1988).

A key question concerns the identification of which groups of firms are able to lobby successfully for business organization law reform and the prospect of success. Within the economic theory of legislation, legislatures have no incentive to adopt efficient provisions for firms that lack sufficient resources to lobby for laws (McCubbins and Schwartz 1984). Generally, the legislature, consisting of risk-averse politicians and conservative lawmakers, tries to avoid innovations. Yet if powerful interest groups demanded that provisions of business forms be changed, political pressures within the legislature would attempt to satisfy the demand with beneficial legislation (Bratton and McCahery 1995).

In terms of assessing the likelihood of the enactment of modernized or new business forms into national law, there are several classes of firms that might be directly attracted by the cost-saving benefits. The first class is made up of prospective firms that will only come into existence if modern, flexible and responsive business vehicles are available. For instance, it is expected that simplicity and low formation costs will not only appeal to firms, but will also encourage the formation of joint ventures and other combinations. The second class consists of future start-ups which would use either the traditional partnership or close corporation form. For the most part, these start-ups are small, closely held firms that would not consider the law *ex ante*, but may

33 Interest groups have several means of influencing the so-called *brokers* of legislation. For instance, they can offer hoped-for future employment. Another pervasive means is political support, i.e., monetary contributions to political campaigns and votes. In addition, personal relationships make members of the legislature particularly responsive to interest groups (Laffont and Tirole 1993; McCormick and Tollison 1981). Because politicians care about their re-election, they seek information on how their position on a particular issue will affect the outcome of the next election. As a result, it is submitted that 'lobbying and information provision by interest groups to politicians is the most important factor in explaining governmental policy outcomes' (De Figueiredo 2002).

unwittingly fall foul of unexpected and disruptive rules *ex post*. The third class is made up of potential portfolio firms that will convert into the newer business form in order to have a chance of attracting outside capital. A fourth and related class consists of existing firms for which cost savings will accrue in the event of reorganization to a new business form, with the savings exceeding the cost of reorganization. This class includes professional service firms which, but for a limited liability partnership form, would continue to use a traditional partnership form.

A wide array of business firms may deviate from the *status quo* to demand a new company law form. Economic evidence shows that only certain firms will have sufficient influence to achieve positive legislative results, either because they are more powerful than others or because they perform collective lobbying through a common body which gives them an advantage over other firms in the procurement of favourable legislation (Macey 1998). Small and medium-sized enterprises (SMEs), for instance, are not likely to play a featured role in the development of business organization legislation. While this type of firm could derive much benefit from legal changes that dispose of the cumbersome formation and operation requirements, information and organization costs arguably inhibit its efficacy in attaining its preferred legislative goals (McCormick and Tollison 1981). In the event of SMEs making the lobbying effort independently, they must first incur information costs in discovering the effects of the choice of business forms on their own welfare.[34] Consequently, since SMEs may be severely budget-constrained in their ability to influence the legislature (De Figueiredo and Tiller 2001), they have incentives to join up with firms with whom they share common interests so as to lobby for legislation. The organization costs (i.e., the costs of identifying other similarly situated firms) must not exceed the overall benefits from lobbying. This is especially true if firms encounter collective action problems. Rational firms have incentives to free-ride on the costly lobbying efforts of others. Attempts to engage in collective lobbying will therefore fail if a few firms bear the entire cost, but receive only a portion of the benefits (Olsen 1965). Additionally, even if small and medium-sized firms can overcome these problems and have adequate resources to lobby legislatures, they are likely to expend their efforts on more pressing operational and special considerations relating to a particular industry.

It can therefore be predicted that company laws will not adequately reflect the needs of SMEs. But even if this class of firms has high-powered incentives

34 As small firms are unlikely to consider business organization laws, except in major relational crises, it is costly to ascertain the effects of different rules and provisions in advance.

to lobby for innovative business forms (Bernardo and Welch 2001),[35] their efforts might not be successful. In terms of assessing the prospect of success, two factors may play a crucial role. First, legislative procedures and political processes reduce the stakes interest groups have in regulation. Legislatures have developed administrative structures and mechanisms (i.e., the political and regulatory institutions, voting rules, rules of order) to control the opportunistic conduct of politicians and legislators who are sensitive to lobbying (McCubbins et al 1989; Schwarz and Scott 1995). As a result, the supply side plays a decisive role with respect to company law reform (Laffont and Tirole 1993). Second, although amendments to the menu of business forms would arguably make smaller firms more efficient, it may not be in the interests of other more powerful lobby groups to modify the law to allow new legal forms to emerge. Consequently, legislatures are likely to respond by failing to adopt value-increasing legislation.

Consider, for instance, the notaries (lawyers who specialize in incorporations and are qualified to issue a notarial deed) who could organize themselves as a significant interest group, blocking innovative measures and frustrating attempts to effectively implement the easy availability of limited liability for small businesses.[36] In continental Europe, a notarial deed is usually required for all incorporations (see also *Table 3*). Given the importance that firms attach to the regulation and cost of market entry (Djankov et al 2001), the extension of limited liability protection to partnership forms would preferably not require the issuance of such a deed. Yet, if a limited liability partnership were to gain adherence amongst investors and popularity with entrepreneurs,[37] the notaries' fee revenues might drop substantially. If their losses are more acute than the possible gains of business lawyers who would be involved in the formation process of a new limited liability vehicle, the notaries will have a particularly high-powered incentive to block such a new form.

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35 Bernardo and Welch (2001) argue that overconfident entrepreneurs are relatively less likely to imitate their peers and more likely to explore the environment leading them to adopting new innovations.

36 It might be argued that the persistence of the system of notaries is an example of the path dependence role of interest groups as a serious source of path dependence. In the 12th and 13th century, the function of notaries was to register long-term contracts, including relational contracts – such as partnerships. Apparently, the merchants used notaries when 'reputation via word of mouth alone was insufficient to support honest behaviour and that a third party without any binding authority to enforce obligations was nonetheless quite valuable for promoting honest exchange' (Milgrom *et al.* 1990, 6). In continental European jurisdictions, the formal use of lawyers as notaries evolved into a requirement to obtain legal personality.

37 It is submitted that the developments with respect to the 'quasi-partnership' close corporation demonstrate the demand for business forms that combine the combination of partnership and corporate features (Ribstein 1995).

That is not to say that legal professionals will not lobby for modernized company law legislation. Indeed the US experience points in the opposite direction. As experts in law with a well-entrenched position and proximity to the lawmaking process, they have a strong ability to influence the legislature (Ribstein 2002). As noted, the increase in recent years of the number of hybrid entities offering limited liability can be attributed to the legislatures' responsiveness to the interest group activities of professional services actors. Well-organized professional firms may lack enough choice to shield their liability, giving them adequate incentives to exercise political influence over legislatures to enact an LLP-type form.[38] In addition, innovative legal professionals who seek to design and implement new arrangements for their clients may have a financial incentive to persuade the legislature to enact a new business form.[39] If the existing menu of business forms does not satisfy a pent-up demand for firms to employ new and improved frameworks,[40] 'innovative form entrepreneurs' will endeavour to capture the market, thereby increasing their fee revenues (Banoff 2001). In the event of these professionals strongly favouring reform, given both types of incentives, the legislature is likely to respond by referring back to, and evolving from, existing doctrines and rules. For instance, they will bear in mind the key role of the notaries in the formation and operation of business forms. In fact, the current role of the notaries in business formations makes it likely that they will be able to defend the *status quo*, or expand their power in the future.

The upshot is that the political economy of new company law statutes tends to reflect the compromise between the legislature and powerful organizations of professional lawyers. It is by no means certain that a new framework that meets the perceived interests of professionals is efficient and equally beneficial to other business firms, SMEs in particular. Nevertheless, legislatures are likely to allow these other firms to use such a framework without the value of corresponding advantages for these firms.

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38 The professional lobbies could be very powerful if they are in fact the by-products of organizations that obtain their strength and support because they perform some functions in addition to lobbying for collective goods. Because membership is in fact mandatory, the organization can overcome information, organization and collective action problems (Olsen 1965).

39 The role of business lawyers as interest groups is of course closely related to their role as lawmakers in the arena of legal formants.

40 Since there is a prevailing view that tax issues play a crucial role in choice-of-business-form decisions, innovative lawyers are inclined to design statutes or combinations of statutes with a view to helping firms obtain favourable tax treatment. Section 4 of this paper shows that there are other choice of business form drivers, such as contractual flexibility and the autonomy of firm participants in structuring, free from court interference, the internal affairs of the firm (Oesterle 1995).

To illustrate these points, let us consider the introduction of the LLP in the United Kingdom. While the decision to introduce an LLP was motivated by diverse 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. The DTI, which was motivated by the threat of regulatory competition from offshore LLP statutes, particularly that of Jersey,[41] promulgated the Limited Liability Partnership Act in 2001.[42] The legislation introduced a new limited liability vehicle that has legal personality, a partnership governance structure, and partnership tax treatment.[43] In drafting this legislation, DTI responded to the pent-up demand from multinational professional service firms wishing to transfer to LLP status.[44] Importantly, the reform-minded lawmaking elite, side-stepping traditional elites, exploited the lobby groups' pressures to extend the scope of the UK LLP to other non-professional firm. In this view, the linkage of the UK LLP to the corporate law provisions, such as the requirement to comply with many of the provisions of the Companies Act and Insolvency Act, constituted a trade-off for gaining access to limited liability. Equally, conservative lawmakers made it mandatory that accounts must be audited to show a 'true and fair' view under UK GAAP.[45] The Consultative Committee of Accountancy Bodies published its Statement of Recommended Practice (SORP) on accounting by Limited Liability Partnerships (LLPs).[46] SORP confirms that UK LLPs must disclose their financial statements in line with those of limited companies.[47] *Table 4* gives an overview of the most important legal features of the UK LLP.

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41 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.

42 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.

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

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

45 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.

46 See SORP Accounting by limited liability partnerships at: http://www.ccab.org.uk.

47 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

Table 4 : Legal Characteristics UK LLP

Characteristic	UK LLP
Legal Personality	Yes
Management	Decentralized; in absence of agreement every partner may take part in management, however designated members have particular responsibility for certain statutory requirements
Formation	Registration at Companies House on a prescribed form LLP2 together with a statutory fee – two or more partners
Autonomy of Articles of Incorporation	N/A
Notarization of Articles of Incorporation	No
Fiduciary Duties	No general duty of good faith; specific duties in the regulations to account for competing activities and use of partnership property
Financial Rights	In absence of agreement equal sharing rights
Transferable Interests	No public offerings allowed
Continuity of Life	Change in membership of partners does not lead to dissolution
Limited Liability	Yes
Financial Statements	An annual return and annual statutory accounts must be filed
Taxation	Pass-through taxation
Linkage	Linked to corporate law provisions

It follows that innovative change differs across systems depending on the organization of reform-minded interest groups, and the accessibility and responsiveness of legislative bodies. In fact, these features help explain the capacity of the US and UK legal systems to establish hybrid legal vehicles for different forms of business relationships and professional firms. The next section suggests that legal evolution is also not immune to exogenous shocks, such as social and economic changes, international competition and foreign pressures, which may be sufficient to trigger a new company law statutes.

3.3 The Third Strategy: Responding to Exogenous Pressures

In this section, we discuss how existing institutional arrangements may be called into question by economic shocks, increasing global competition or war (Roe 2006; Rajan and Zingales 2003). The large scale effects of these events can lead to reversals of expectations and consequently supply incentives and opportunities for reform-minded groups to create new legal rules and institutions. Even though there are few genuine exogenous shocks in history, it

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.

is generally recognized that the Asian economies experienced a major financial crisis in 1997 which, combined with earlier underlying weaknesses, prompted policymakers to consider altering the taken-for-granted institutional arrangements. A most conspicuous example of external-shock induced organizational changes is the corporate governance and securities law reforms in Japan, which were introduced by governmental regulators in response to the so-called lost decade of the 1990s.

Japan has a long history of responding to external threats. Consider the period before the Meiji reforms when Japan was essentially a closed country and carried out only limited commercial and cultural exchanges with the Hollanders.[48] At the end of the Edo period (1603-1867), the Japanese government responded to the external shock of confronting new social and economic pressures of the Russians, and later Europeans and Americans, which attempted to establish trade contracts with Japan. Yet, it was only in 1854 that Japan ratified the Japan-US treaty of peace and amity forced by Commodore Perry of the US Navy. But, it took some time for the trade, which remained very limited until the beginning of the Meiji period (1868-1912), to develop. Foreign nations demanded the ratification of treaties, which provided for immunity for foreigners from Japan's existing penal system. At the same time, these treaties granted foreign traders economical and legal advantages over domestic business people. In order to regain independence and dignity in their own country, Japan reacted, among other things, by adopting legal reforms, including a legislative regime to govern the internal affairs of companies, inspired by German law. The transplantation of a civilized, Western-style legal system was viewed as the only rapid and effective solution to force the foreign powers to abrogate the treaties.

Thus, company law in Japan could be viewed as a German transplant (Milhaupt 2005). Despite the 1950-amendments introduced during the American occupation, the general corporate form (*Kabushiki Kaisha*) remained relatively formal and later reforms continue to show a tendency to transplant German legal rules.[49] For instance, the enactment of the *Yugen Kaisha*, a closely held business form based on the German *GmbH* in 1938, reflects the German legacy.

Subsequently, radical attempts to change Japan's company law system emerged in the late 1990s. In general this period is considered to be a 'lost decade' as Japan experienced a long-lasting severe recession followed by the burst of the preceding bubble economy. The Japanese economy was hit hard as large corporations defaulted and banks suffered under an increasing weight of non-performing loans. The 'shock' not only hit the financial economy but also destroyed Japan's self-esteem as a 'technopower'. The weakening of domestic

48 The Meiji period (1868-1912) is known for bringing about the modernization of Japanese economic, political and social institutions.

49 Such as strengthening the statutory auditors' powers.

confidence, manifested in the involvement of the Japanese bullet train, *Shinkansen* – once a symbol of the reliability of Japan's technological superiority – in multiple accidents in 2000, has become increasingly important for Japan. Moreover, large firm confidence was further weakened by the successful commercial strategies of European and American high-tech companies, collaborating through US hybrid entities, that have eroded the position of many Japanese technology-oriented firms.

All of this raised concerns about the rigidities and shortcomings of Japanese law. The growing emphasis on institutional reform and change, in response to globalization and the corresponding competitive pressures, has been stimulated by a new constellation of interest groups which have significant political clout to bring about a variety of reforms, including the facilitating of stock options, to spur the knowledge-based sector and encourage investment.

Besides traditional governance measures, policymakers have focused on creating hybrid business forms, similar to those developed earlier in the US and UK, that offer more flexibility in the decision making structure and governance framework as well as resource management mechanisms needed to support the efforts of firms working in the human capital intensive sector. Moreover, there are numerous indications that policymakers have devoted considerable attention to the concerns of the largest and most established companies seeking to develop new technology, spin-off new opportunities and intellectual property, and which can form the basis of joint ventures and alliances.[50] Thus, by 2003, the Ministry of Justice had established a number of priorities involving the amendment of the Commercial Code. The end result was a package of legislative reform measures, comprised in The New Company Law, which were submitted to the Diet in March 2005.

Generally, the New Company Law (*Kaisha Ho*) abolishes the *Yugen Kaisha* (YK), the close corporation, and leaves a modernized *Kabushiki Kaisha* (KK) in place (grandfathering the existing YKs). The KK regulation is 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

50 In 2002, realizing this adverse change in the competitive situation, Japan used its prior and existing 'Research Association for Mining and Manufacturing Technology Law' (koukougyo gijutsu kenkyuu kumiai hou), and established "EUVA" (EUV association, 2002-2008) aiming at catching up to the EUV-LLC, but so far, this effort has not born fruit. To worsen the situation, the US-European group has just initiated their stage by starting the INVENT partnership (2005-2012) to which IBM, AMD, Infineon, and Micron Technology have contributed roughly JPY 70 billion (about USD 700 million) which is also a closely held firm aimed at carrying out similar R&D activities (similar to EUV-LLC) on technologies to form a super-fine semiconductor integrated circuit by using extreme ultra violet (EUV) light.

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 legislature acknowledged that the amendments introduced will not be sufficiently attractive to those individuals or established companies that are interested in selecting a more flexible business form.

It is therefore not surprising that the New Company Law provides for the introduction of a new company law form, the Limited Liability Company (LLC) or *Godo Kaisha*. 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 audit and disclose 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 receive corporate, but not pass-through, tax treatment.

It may be that the adoption of a US-style LLC can be seen as the effect of a strong triggering event, which is the determinative force of domestic institutional change. It is difficult at this juncture, however, to be certain that these changes are only the result of such an exogenous trigger. Moreover, it is hard to distinguish between endogenous and exogenous pressures as the determinative force of institutional change. In any event, it could be argued that the sequence of institutional changes marked by the new hybrid entities is ultimately the result of both pressures. On the one hand, the effects of decreasing returns on key actors within commercial system, notably through the growth and internationalization of the financial system and the integration of product markets as a whole, actually influences the course of legal and institutional development, undermining complementary institutions and policies. Further, pronounced disruptions to the existing path not only altered intrinsically the interests of key pressure groups, but also modified their incentives to invest in the development of new types of legal institutions and rules. That said, the scope for both exogenous and endogenous pressures to bring about major structural reforms in Japan is evidently great.

On the other hand, controlling legal elites and incumbent interest groups were initially strongly resistant, regardless of the pressures, to adopt a business form that combines important attributes of the corporate form and the partnership form, such as limited liability, flexibility and pass-through taxation. In order to overcome resistance to change, the Ministry of Economy, Trade and Industry (METI) stepped in and submitted, subsequent to the introduction of the *Godo Kaisha*, the Limited Liability Partnership Bill to the Diet in February 2005. As a consequence, the LLP or *Yugen Sekinin Jigyou Kumiai* came into

effect on 1 August 2005 to encourage the creation of new business ventures, 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) disclosure of financial information including the profit and loss statements and the balance sheet upon the request of creditors; 3) the mandatory obligation of partners to participate in LLP management and its operation; and 4) the right of partners to exit at will. Notwithstanding these arguable shortcomings, which reflect political compromises, the LLP may, as will be discussed in the next section, provide significant cost advantages to firms.

Viewed from the perspective of an entrepreneurially government faced with exogenous pressures, such as global competition (Bratton and McCahery 1997), rapid changes in technologies and evolving market conditions, it is more likely to promote the competitiveness of indigenous industries through adoption of a cost-effective, reliable and flexible legal regime. If the future brings a substantial increase in business activity, a shift in interest group pressures for efficiency-based lawmaking could well be expected. Such a jurisdiction may consider entering the competitive lawmaking environment for the supply of law as product. In the company law context, a jurisdiction could reap the benefits by coming forward with a set of contractual-based rules ideally suited to closely held firms. If this jurisdiction would engage in a law reform process along such lines, it could very well create a focal point leading to a significant number of domestic and even foreign firms to select this legal innovation.

Singapore is an example of an entrepreneurial jurisdiction. As a result of increased competition in Asia and the rapid development of China and the increase of Chinese firms being engaged in cross-border activities, the Singapore legislature enacted, among other things, an LLP (which came into effect on 11 April 2005). This evolution reflects 'the acute awareness of the need to recognize and accommodate current international business and commercial practices'.[51] The Singapore LLP (S-LLP) is a new type of business vehicle in Singapore based on the Delaware LLP and to a less extent the UK LLP. An S-LLP is a legal entity that can sue and be sued and acquire and hold property. Like the Japanese counterpart, it offers a flexible management structure and pass-through taxation. The LLP is a stand-alone business form explicitly de-linked from the existing partnership law.[52] The partners are not

51 See www.singaporelaw.sg.

52 See Section 6 of the Limited Liability Partnerships Act 2005.

personally liable for the firm's debts and obligations.[53] This protection shall not effect the personal liability of a partner in tort for his own wrongful act or omission. The internal relationship between the partners is governed by the limited liability partnership agreement. In the absence of an agreement or when the agreement is silent, the First Schedule, which acts as a model agreement, will apply. Although the S-LLP is required to keep accounts and other records, it is not necessary to prepare profit and loss accounts or balance sheets or to have them audited and disclosed. *Table 5* provides a comparative overview of the revised and introduced business forms in Japan and Singapore.

Table 5: Comparison – New Company Law in Japan and Singapore

Characteristic	**KK (new)**	**J-LLC**	**J-LLP**	**S-Private Company**	**S-LLP**
Legal Personality	Yes	Yes	No	Yes	Yes
Management	Corporate structure (shareholders-board of directors)	Flexible – no restriction	Flexible – mandatory participation of all partners	Corporate structure (shareholders-board of directors)	Flexible – default: partnership like management structure
Formation	Registration of the articles of incorporation with the Legal Affairs Bureau (*hômukyoku)* – registration fee = JPY 150,000	Formed by articles of incorporation signed between members – registration of operating agreement and corporate seal with the Legal Affairs Bureau (*hômukyoku)* – registration fee = JPY 60,000	Registration and disclosure of the LLP agreement with the Legal Affairs Bureau (*hômukyoku)* – registration fee = JPY 60,000	Registration of the Memorandum (subscribed by at least 1 person) and the articles of association	Online Registration at www.bizfile.gov.sg / Registration Fee is S$ 165 / Registration takes 15 minutes
Autonomy of Articles of Incorporation	Yes	Operating agreement	LLP agreement	Yes	LLP agreement
Notarization of Articles of Incorporation	Yes – notarization fee = JPY 50,000	No	No	No	No
Fiduciary Duties	Directors must act in good faith	Managers have similar duties to legal duties of KK directors	Defined by LLP agreement (Incomplete law)	Duties of directors: (1) to act honestly; (2) duty to disclose shareholdings; (3) duty to convene general	Defined in LLP agreement or, if the agreement is silent, the provisions in the First Schedule (full disclosure of relevant

53 The LLP may recover distributions from partners that know or ought to have known that the LLP was insolvent or the distributions caused insolvency of the LLP.

				meetings	information and non-compete clause)
Financial Rights	Distribution of profits and losses allocated according to equity participation ratio (however, distributions of profits require net assets of at least JPY 3 million)	Profits and losses may be allocated at a different rate from equity participation rate if specified in operating agreement	Profits and losses may be freely allocated with the unanimous approval of partners	Dividends shall be apportioned and paid proportionately to the amounts paid or credited as paid on the shares during any portion or portions of the period in respect of which the dividend is paid;	Defined in LLP agreement or, if the agreement is silent, the provisions in the First Schedule (equal sharing rule)
Transferable Interests	Shares are freely transferable. Restrictions (by making transfer subject to board approval) in the articles possible	Members' unanimous approval required	Partners' unanimous approval required (mandatory rule)	A private company restricts the right to transfer its shares	LLP agreement – default: assignment of financial rights
Continuity of Life	Yes	Yes – even with one member	Yes, but minimum of two partners	Yes	Yes – the Court may order the winding up if the LLP carries on business with less than two partners for more than two years
Limited Liability	Yes, no minimum capital requirement, but in practice some paid-in capital is necessary	Yes	Yes	Yes	Yes (claw-back provision for distributions made three years before insolvency)
Financial Statements	Disclosure of annual balance sheet	No disclosure of annual balance sheet – financial statements must be made available to members and creditors	LLP must disclose its balance sheet and profit and loss statement to creditors (upon request)	Submission of an audited profit and loss account and balance sheet at a general meeting	Accounts and other records should be kept and retained for seven years. No mandatory audit and disclosure requirements
Taxation	Corporate	Corporate	Pass-through	Corporate	Pass-through
Linkage	Company Law	Company Law	Law Concerning Limited Liability	Companies Act	Non-applicability of partnership law clause

			Partnership Agreements		

Source: Adapted from www.singaporelaw.sg and www.jetro.go.jp

The transformation described above provides a framework to evaluate the economic role of new hybrid business forms. On this basis, the next section will evaluate the new legal entities that emerged in the US, UK and Asia and are attracting more and more businesses to their relatively new network. It is suggested that these hybrid business forms, compared to the traditional menu, can provide effective choices for controlling opportunism while limiting transaction costs. Three fundamental questions will be asked: (1) whether closely held firms would prefer to select a new, redesigned hybrid legal entity, which sets forth the joint ownership structure and provides important contractual provisions in advance; (2) whether new business forms ideally suited to particular businesses are better positioned to offset the inefficiencies resulting from the lock-in effects and path dependence factors; and (3) how many products a menu of legal business forms should contain.

4. NEW PRODUCT SELECTION

The three reform strategies roughly lead to the emergence of three distinct statutory products. First, a legal up-grade arguably provides an easy-to-use vehicle that supplies lawyers and firms with familiar provisions that are 'tried and tested' and consequently offer learning and network benefits to users of the form. Second, a linked, but new, legal business form similarly holds out continued network and learning benefits along with the prospect of superior cost advantages due to better suited statutory provisions. Third, in contrast, a non-networked product holds out greater costs for adopting firms as switching costs effect prospective users negatively, and the absence of an established set of precedents – which are needed to fill the gaps in the inherently incomplete law – provide few incentives for parties to adopt an entirely new type of legal product.

It would not be surprising that, given the relative cost advantages of up-grading, that the first approach is the obvious alternative. A modified statute could be attractive as there are no new learning costs involved. Because there are usually few alterations needed, it is easier for practitioners and business parties to adjust to the new round of changes. Given that the changes are unlikely to touch the core components of the legal tradition and its legitimating features, parties will have an incentive to learn the new rules. Nevertheless, the up-grade model has been criticized for not only making innocuous, albeit necessary, changes but for being out of step with innovative social and economic change. Although the up-grade approach seems attractive, particularly

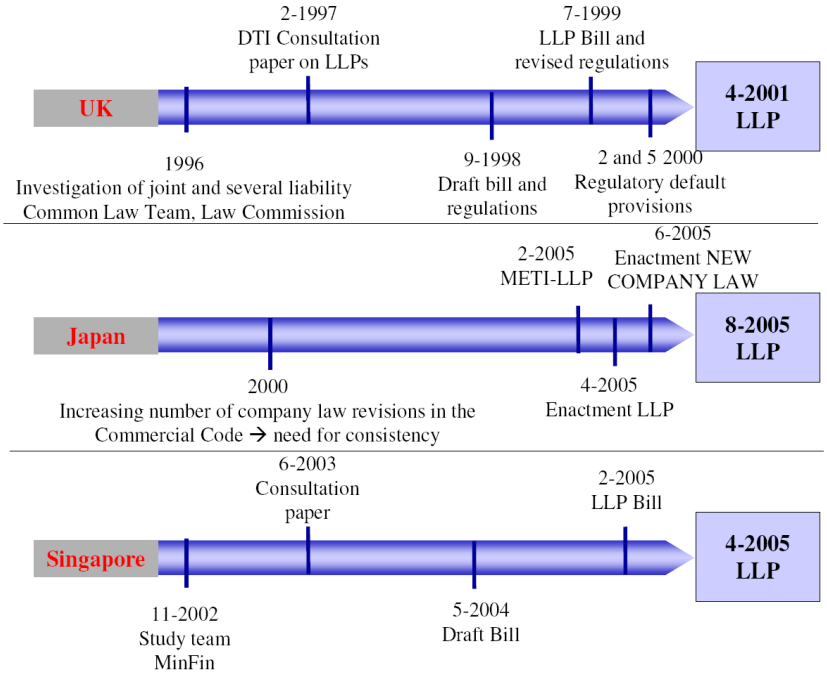
if the existing statutory framework is functionally obsolete, it is unlikely to benefit users unless accompanied by genuine cost saving changes.

Despite the apparent ease for jurisdictions to engage in producing statutory upgrades, this phenomenon has proved more costly and time-consuming than anticipated. This is evidenced by: (1) the difficulty in the design of acceptable upgrades; and (2) the reluctance of lawmakers to agree and quickly implement the proposed changes. Apparently, lawmakers when committed to incremental reform are less concerned with the pace and practical consequence of legislative change.

Even though most jurisdictions still employ the up-grade strategy to reform, an increasing number of countries embrace a new product approach by following either the second or third reform strategies as described in the previous section. This can be seen in the cases of the UK, Japan, and Singapore which moved quickly into un-chartered territory when embarking on a new legal reform strategy that complemented their existing up-grade legislative reform approach. Surprisingly, this development seems better able to ensure speedy and effective legislative action. The length of time to develop and reform new company statutes is reflected in *Figure 4*.

It follows from *Figure 4*, that it is probably easier for lawmakers to understand and appreciate the alleged benefits of the new forms across political systems. The complex tax and doctrinal issues that can hamper and delay law reform projects are more effectively avoided when a new vehicle is proposed which leaves untouched the existing company law framework. Reforms along these lines, moreover, are supported by interests groups due to the measurable benefits they yield, including a new business form's (1) greater flexibility, (2) response to specific market problems and pressures, (3) ability to resolve conflicts between agents, and (4) value-added features in the structuring of transactions and business planning. Thus seen, the introduction of new legal products results in inherent benefits for businesses leading to major changes in the bargaining environment in which firms operate.

Figure 4: The time needed to introduce the LLP

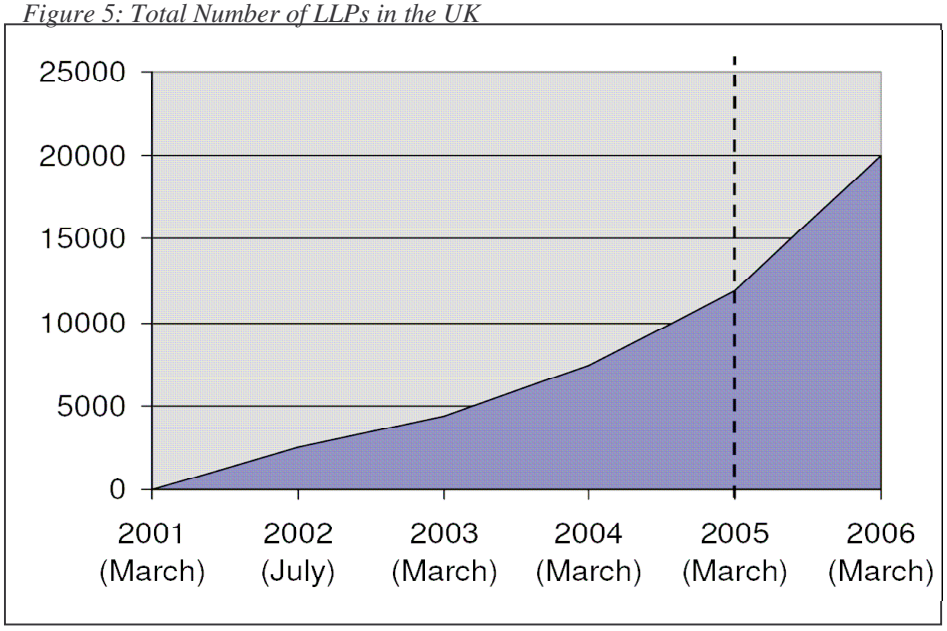


4.1 Inherent Benefits of New Statutory Products

4.1.1 Limited Liability and Pass-Through Taxation

New statutory products often involve an optimal mix of legal and fiscal attributes (Thompson 1995). Empirical research supports the view that a new legal product eventually outweighs the benefits that arise due to learning and network effects (Ribstein and Kobayashi 2001). While there is great appeal to the utilization of existing frameworks, firms are now more inclined to structure their business in a framework that is largely free from legal oversight and allows experimentation. *Figure 5* shows the number of LLP formations in the United Kingdom for the period 2001-2005.

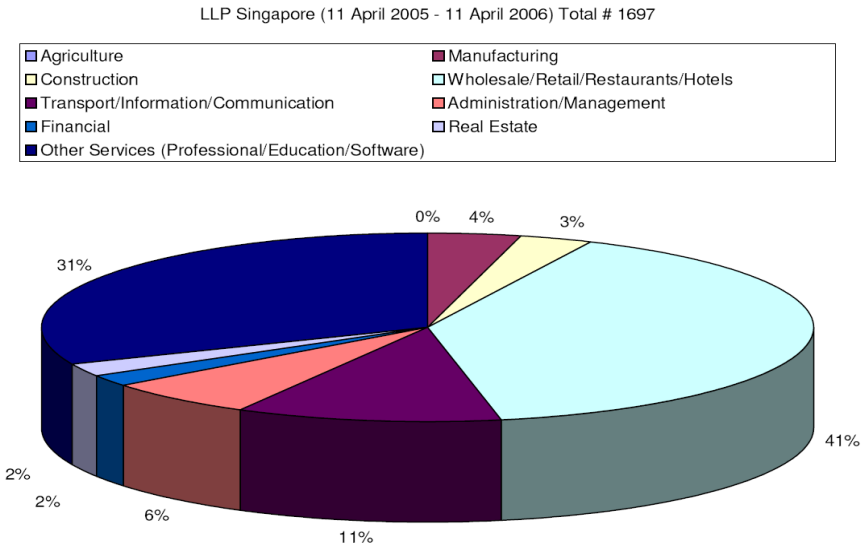
Figure 5: Total Number of LLPs in the UK



Source: Companies House (20,000 LLPs on March 2006 is an estimated figure)

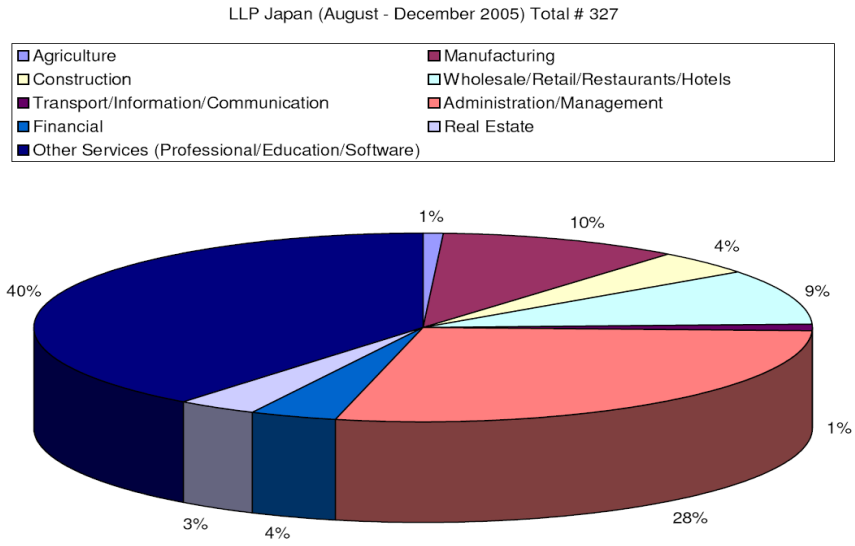
Figure 6 and *Figure 7* below show respectively the categories of businesses that have adopted the S-LLP and J-LLP.

Figure 6: LLPs in Singapore



Source: BizFile Singapore

Figure 7: LLPs in Japan



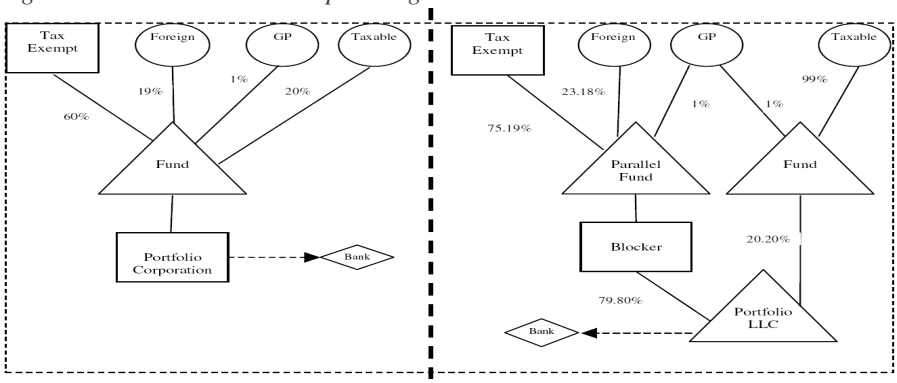
Rather than the professional firms that the LLP form was initially designed for, there are numerous other categories of businesses which, due to a variety of drivers, have selected this new form. There are a number of common factors that induce firms to choose hybrid forms (e.g., limited liability and tax advantages). Limited liability is the most important attractor of businesses to the hybrid entities. Surprisingly, empirical research shows that, despite tax benefits, the emergence of the LLC did not affect the total number of new incorporations. It appears that the first LLC-statutes were not able to attract firms that typically incorporated (Ribstein and Kobayashi 2001). Observers questioned, for example, why high-tech start-up firms chose to forgo tax savings by selecting the public corporation.

Naturally, it is difficult to give a clear-cut answer, as the factors prompting start-ups to prefer the corporate legal form to other vehicles, is the subject of considerable controversy. Commentators have argued that the network effects and conversion costs, rather than the pass-through tax treatment and its lower tax rate, is the main considerations for selecting the corporate form (Bankman 1994, Klausner 1995). The reluctance on the part of venture-capital backed start-ups to choose the LLC is explained in terms of a preference to save on transaction costs and time in the course of the venture capital cycle. By forming a public corporation, for instance, they would avoid the costs of converting the

LLC into the corporate form before an initial public offering (IPO).[54] Indeed, conversion to a corporation remains necessary as long as underwriters in the United States are loath to support hybrid business forms that issue equity interests.[55] To be sure, it is only to be expected that the popularity of the US LLC will increase when it becomes a more accepted instrument for initial public offerings. Even though the US LLC allows for publicly traded 'units' – that are nothing more than depository receipts for the owners' property interest – the efficiency of selling units is called into question because underwriters are probably unwilling to employ 'units' on a large scale.

Nevertheless, the popularity of the LLC in the fastest growing business segment of the market in the United States is increasing. Approximately 30% of the 100 fastest growing firms in the United States are structured as LLCs. These companies are less than five years old, but their annual sales exceed US$ 1 million.[56] This trend is to some extent driven by the recent tendency of venture capital and private equity funds, faced with an ever-growing fierce and global competition, to embrace complex structures that help optimize the financial results for each group of investors. The illustration below shows, for instance, how the pass-through feature of the LLC, in combination with a corporate blocker, could increase the options for fund managers to better tailor the tax structure to the needs of their investors.

Figure 8: Tax-driven business planning



Source: Blashek and McLean (2006)

54 Although the laws regarding the conversion of LLCs to corporations are usually very flexible in the United States, such a conversion could nevertheless, depending on the number of investors, be surrounded by cumbersome barriers in terms of finances and resources.

55 See Bankman (1994: 1749-1750). Issuing interests to the public dissipates the tax advantage because most publicly traded business forms are taxed as corporations under section 7704 of the Internal Revenue Code.

56 See http://www.entrepreneur.com/hot100. These 100 firms had a total sales of US$ 1.7 billion in 2005 and employed a total number of 6,920 people.

Certainly, there is some evidence that similar flow-through vehicles, such as the Canadian Business Income Trust, Energy Trusts and Real Estate Investment Trust, are associated with tangible tax benefits that attract a significant number of firms.[57]

Table 6: Comparison of the Taxes Paid Under Different Structures

	Corporate Structure	Income Trust	Limited Partnership
Entity Level	$35.00	NIL	N/A
Investor Level			
Taxable Canadian	$5.70	$14.82	$14.82
Non-Resident	$2.15	$3.30	$8.36
Tax-exempt	N/A	N/A	N/A
Total Tax	**$42.85**	**$18.12**	**$23.28**

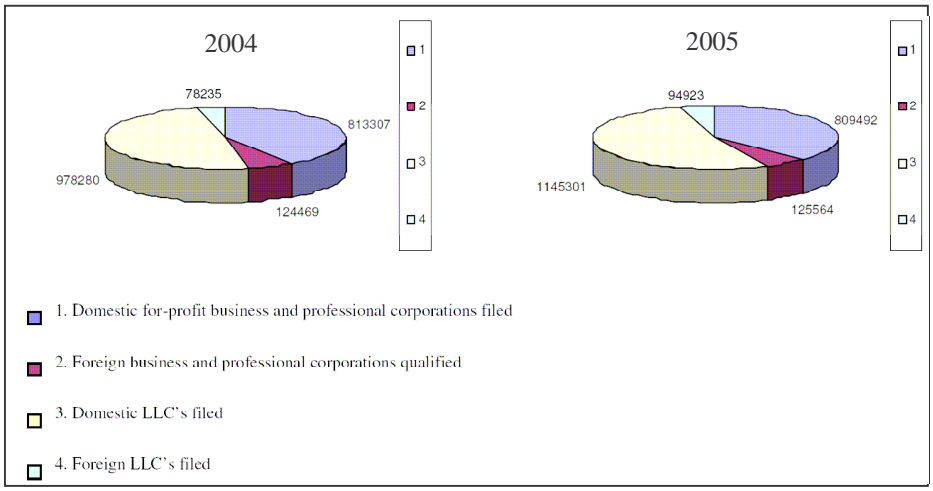
Source: Department of Finance Canada (2005)

While the Canadian vehicles, for example, can be employed more widely than in other jurisdiction, their enhanced popularity, compared to similar vehicles in the US, seems mainly related to the fact that an IPO does not effect their tax treatment. In contrast, US listed entities are by definition taxed as a corporation. A similar pattern would likely emerge if US tax authorities were to adopt the same fiscal measures. Such a development would naturally tip the balance in favour of the LLC since the possible benefits of incorporation, like network effects, would not weigh-up against the advantages of hybrid forms.

There is already a trend which shows a high number of firms selecting the LLC over the corporate form in the US. The decrease in new incorporations is not only attributed to tax advantages, but also to the flexibility surrounding the formation and operation of an LLC as well as the higher costs associated with satisfying corporate governance mandates arising from the Sarbanes Oxley Act (Ribstein 2004). *Figure 9* shows that the number of new corporations in the US declined while the LLC continues to gain in popularity.

57 Consultation Paper by the Department of Finance Canada – Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships).

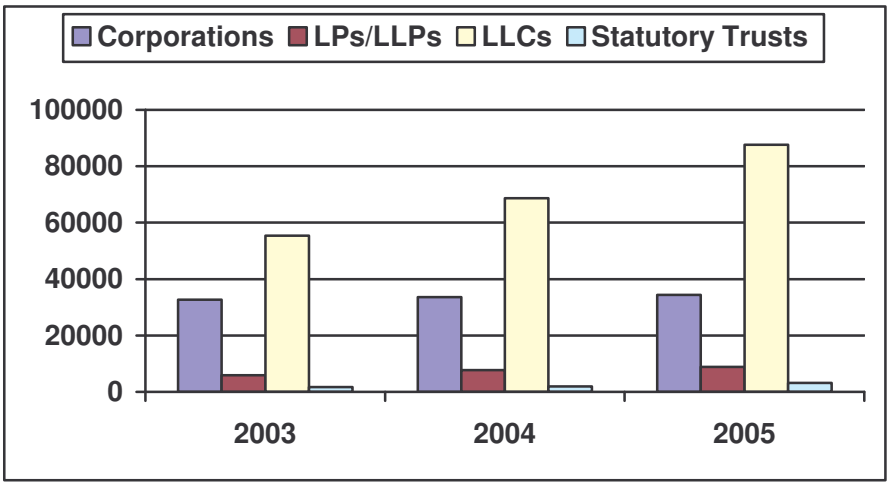
Figure 9: New Filings of Corporations and LLCs in the United States



Source: 2006 IACA Annual Report of Jurisdictions

LLCs are now widely employed for real estate and energy ventures, the exploitation of patents, corporate joint ventures, acquisition vehicles, and venture capital and private equity funds as well as high tech start-ups. As a matter of fact, the 2005 increase of revenues collected by the Delaware Division of Corporations – from US$ 612,8 million to US$ 626,1 million – is mainly due to the increase in LLC tax collections and filing fees (see *Figure 10*).

Figure 10: New Business Formation in Delaware (2003-2005)



Source: 2005 Annual Report, Delaware Department of State, Division of Corporations

4.1.2 Limited Liability and Private Ordering

It is a common refrain in the evolution of the corporate form that firms, in exchange for certain privileges, go through a number of formalities to incorporate their businesses, varying from, at first, the governmental approval of a corporate charter to the obligation to abide by the terms and provisions of the corporate statute, particularly the rules surrounding the separation of ownership and control. Before the Industrial Revolution the privileges consisted mostly of a monopoly over trade or the exclusive right to act on behalf of the government in developing a country's infrastructure. With the growth of commercial and industrial activity, the pressures from politically influential industrialists to abandon the specific governmental approval of a corporate charter grew steadily. By 1890, the statutes providing for incorporation by simple registration prevailed throughout the United States. The introduction of a relatively simple incorporation procedure in France in 1867 had already resulted in the rapid proliferation of general incorporation statutes in continental Europe.

In its developed form with fully-fledged limited liability protection, the corporation was the choice-of-business form for large-scale firms which were compelled to amass substantial sums of equity capital in order to give effect to capital-intensive industrial and technological innovations. The principle of limited liability was widely acclaimed as an industrial breakthrough and it took only until the late 19th century that the corporate limited liability feature became available to smaller, closely held firms. In this respect, two legal developments could be distinguished. First, a separate close corporation form, the *Gesellschaft mit beschränkter Haftung (GmbH)*, was enacted in Germany in 1892. Another, second, development demonstrates the importance of case law in furnishing smaller firms with the much-coveted limited liability feature. A decision of the House of Lords in *Solomon v. Solomon & Co. Ltd* overturned the assumption that only passive investors were granted limited liability under the Companies Act of 1862. These developments gained a widespread popularity across jurisdictions (McCahery and Vermeulen 2005). To date, most countries recognize a form of close corporation which, although they become increasingly flexible in terms of permissible deviations from the statutory provisions, are still modeled on the public corporations and its capital-oriented management structure (Lutter 1998).

This raises the question as to whether corporate-type business forms, without the pass-through tax treatment (as discussed in the previous section), but with the partnership-type feature to devise the most efficient management and governance structure, would gain a foothold in the modern business environment. The answer to this question can be found in France. Recent data concerning the use of the French société par actions simplifiée (SAS), a limited liability vehicle that is considered to be the most flexible company form in

France, which allows parties to freely contract into an optimal decision-making arrangement, indicates that not only tax, but also contractual flexibility is a main driver for business form selection.

Table 7: Comparison – French Business Forms

	Société Anonyme (SA)	**Société à Responsabilité Limitée (SARL)**	**Soiété par Actions Simplifiée (SAS**	***Most advantageous***
Minimum capital	€37,000	No	€37,000	SARL
Minimum number of shareholders	7	1	1	SARL - SAS
Management structure	3-18 board members (mandatory) – the president must be an individual person	One or more managing directors who must not be corporate entities	Flexible – at least one president	SAS
Tax	Corporate	Corporate	Corporate	SA – SARL - SAS
Transfer of shares	Free transferability	Restricted	Free, but Articles may restrict	SAS
Limited Liability	Yes	Yes	Yes	SA – SARL - SAS
Accountant	Mandatory	Exempted below a certain threshold	Mandatory	SARL

Source: No 222 April 2004 L'Entreprise

Table 7 shows the eschewal of tax as the driver for hybrid forms. Clearly, this runs against commentators' expectations that tax considerations predominately explain entity selection (Ribstein 1995). Obviously, the driving force behind SAS is the freedom of contract which enables firms, in an incomplete contracting world, to adapt to changing market circumstances and increased global competition.

That said, the key driver behind the success of the new hybrid business forms, such as the LLPs and LLCs, is the concept of maximum flexibility and autonomy of firm participants to structure the firm's internal affairs free from legal principles and doctrine (Oesterle 1995). It seems that, even though economic and path dependence factors prevent the emergence of complete law, the extended private ordering principles enhance the ability of business parties to experiment with these new forms. Businesses in need of debt and equity capital cannot therefore be expected to be tied up with corporate or partnership forms that only offer costly and burdensome statutory measures, such as mandatory management and decision-making structures (in the case of the corporation) or broad fiduciary duties (in the case of partnerships). This is especially true if these business forms – explicitly – fail to allow for the possibility to waive or contract around statutory rules and standards. For instance, the fact that parties may be subject to broad fiduciary duties, which

may require a party to forgo personal interests, appears to act as a deterrent to venture capitalists and joint venturers. If parties are allowed to bring an action based on a breach of fiduciary duty when their high-risk gamble does not pay off, thereby circumventing the contractual mechanisms put in place to overcome information problems, the transaction costs arising from legal uncertainty and statutory ambiguity will increase significantly (Stevenson 2001).

To be sure, a new hybrid business form has the potential drawback of being a relatively untested entity that has not yet generated a large body of case law and academic research. The fact that company law is inherently incomplete and the parties are boundedly rational inevitably necessitates the involvement of the judiciary in the resolution of intra-firm disputes (Bratton and McCahery 1995). Indeed, it might be argued that new legal products only survive because the judiciary plays an important role in *ex post* dispute resolution and the development of legal precedent. Empirical research indicates that new business forms create a new network of cases dealing with, among other things, the nature of new business forms, formation requirements, fiduciary duties, limited liability and veil piercing, transfer of interests, and dissolution (Miller et al 2003). However, given the spur for new company law products that offer the maximum contractual flexibility, courts should 'permit persons or entities to join together in an environment of private ordering'.[58] In order to enhance legal certainty, courts should first respect the contractual arrangements. Only if both the statute and agreement are silent courts should endeavour to fill the contractual gap by looking at the parties' intentions *ex ante*.

That is not to say that greater contractual flexibility will automatically lead to efficiency. It follows from the discussion in section 2 that an efficiency-minded legislature has the task to develop improved statutory default rules when enhanced certainty and guidance are needed. In order to increase the success of new business forms, legislators are advised not only to keep the statute up to date, but must also ensure it meets the coveted social and economic requirements over time. For instance, if the mandatory participation provision in the Japanese LLP entails problems for the internal stability of firms, the legislature may eventually offer new rules that are clearer and give better guidance on dealing with agency problems in a business environment. In this context it is worth noting that Delaware legislature strives to maintain legislative preeminence by periodically amending, among other things, the Delaware Limited Liability Company Act. *Table 8* highlights the amendments to the Act in 2003, 2004 and 2005.

58 See 727 A.2d 286 (Del. 1999) *Elf Atochem North America, Inc. v. Jaffari*.

Table 8: Amendments to the Delaware LLC-Act

	2004	2005	2006
Number of sections in the amendment	15	18	38
Amendment			
Freedom of Contract	7	-	-
Clarification of Default Rules	3	10	6
Domestication/Conversion	4	6	26
Effective Date of the Amendment	1	1	1
Other amendments	-	1	5

Source: General Assembly of the State of Delaware

The table above shows that Delaware frequently updates the LLC-Act to give maximum effect to the principle of freedom of contract and to the clarification of default rules. We should point out that interest group pressures mandate the introduction of amendments facilitating domestication of and conversion to Delaware law. If we take this point a step further, it is not difficult to explain the importance of the clarification of the default rules. Since the selection of business forms is a choice made ex ante, interest groups, e.g., business lawyers, have an interest to inform the legislature of shortcomings in existing provisions and provide technical support in devising amendments.

As we have seen, the freedom of contract is a priority of Delaware lawmakers and in this respect it could be argued that amending the LLC statute into an all-purpose 'contractual entity' is necessary to confront the technological advances and the internationalization of the economy. There is something to the introduction of a 'contractual entity' that can be tailored to the business needs and expectations of each type of firm. Parties in joint ventures, for instance, are likely to reduce agency problems and contract into the preferred structure of their particular relationship even if business form statutes do not contain any default rules. Still, the function of statutory company law – as a standard form contract – must not be underestimated. In the context of non-listed firms, company law should first offer a relatively small group of unsophisticated – and often unmotivated – business parties a ready-made business contract, which would reduce transaction costs and assist the parties with transaction planning.. Second, company law should give statutory guidance to mostly larger firms that do not fare well when ownership and control are integrated.

Table 8 reflects the Delaware's concern about emphasizing the importance of offering a coherent and consistent set of provisions. By continuously updating its legislation, Delaware signals to investors and creditors what they can expect in terms of the internal decision-making process and external representation model of a company. The foregoing discussion suggests that, given the importance of statutory guidance and the two types of governance structure –

integrated and differentiated – a menu of business forms should contain at least two closely held limited liability entities, a manager-managed entity and a member-managed business form.

5. CONCLUSION

In this paper, we have distinguished three different positions along the reform strategy spectrum of company law. The first position is located on the left side of the spectrum and closest to stasis - where virtually no effective legal changes can occur and where only the idea of reform clashes with legal tradition and standardization pressures. An example of a jurisdiction that takes this position is Germany. Along or near the mid-point of the spectrum, where company law changes are less impeded by tradition and standardization factors, but more influenced by interest group pressures. We see England occupying this position. Japan can be seen as a more adaptable jurisdictions located toward the right end of the spectrum and therefore better able to create and introduce more functional legal rules and institutions that turn the traditional view of company law around. It is submitted that Singapore is located on the right side of the spectrum as its legislature is aware of the need to adapt the legal system to international business practices in order to develop a distinct jurisprudence, acclaimed for its efficiency and integrity, which is set apart from the English legal system.

As we have seen in the case of the introduction of new hybrid business forms, traditional lawmaking elites are often out of step with the dominant vectors of economic and cultural change in society. As a consequence, this can open up opportunities for reform-minded lawmakers previously blocked in their efforts to undertake legislative reforms. This does not imply, however, that reform-minded legislators will create first-best measures that satisfy the demands of users. Yet, despite certain inefficiencies identified in this paper, there are some inherent benefits for firms in employing the new hybrid business forms. Besides pass-through taxation, the hybrid vehicles offer parties the freedom to contractually establish the rights and obligations within the organizational structure. They combine the corporate feature of fully-fledged limited liability with the partnership law principles of flexibility and informality. In this respect, the ‘new company law’ ushers in a new era in which the statement ‘when in doubt, don’t incorporate’ is increasingly applicable to innovative businesses. The introduction and popularity of ‘new company law’ as depicted in this paper is but a small step in that direction.

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