Network effects and regulatory competition

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AN INTRODUCTION TO THE EXPECTATIONS AND CHALLENGES OF PARTNERSHIP LAW REFORM

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ABSTRACT

This article examines the theoretical arguments for and against the importance of new partnership-type business forms. Section 1 briefly reviews the history of partnership law and reform in Europe. The review of traditional partnership law reveals that the absence of new business forms may be due to status quo bias and network effects. Section 2 turns to the importance of partnership law reform and the introduction of new business forms to a robust economy. Section 3 evaluates whether we can project a pattern of regulatory competition in the business organization law context that could prompt lawmakers to innovate by introducing new partnership-type business forms.

INTRODUCTION

Until recently national legislatures within the European Union (EU) had few incentives to introduce legal innovations in the context of closely held business firms, despite potential benefits for governments, such as tax revenue and economic growth. In many European jurisdictions, the provisions of the dominant closely held business form, the close corporation, are somehow linked to its publicly held counterpart. This may account for a 'lock-in' to the existing legal framework and mandatory provisions.[1] Some take it for granted that when network or learning benefits are present, the value of legal products such as

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[1] See generally Erik P.M. Vermeulen, The Evolution of Legal Business Forms in Europe and the United States, Venture Capital, Joint Venture and Partnership Structures (Kluwer Law International, The Hague, 2003).

business forms increases.[2] The effect of these benefits is to create standard provisions in corporation and partnership law. For example, the fact that the majority of closely held business firms select the domestic close corporation law to govern their rights and duties may actually lead to a network benefit for the firms using this particular business form. As a result, domestic close corporation forms maintain and strengthen their leading position.

Indeed, newly formed firms will likely migrate to those business forms that confer large network and learning 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 standards rather than customized terms that benefit a variety of closely held firms. Because standardized terms offer certainty, when advising clients about choice-of-business-form decisions, domestic lawyers will contribute to the unwillingness of firms to substitute the standard form for new structures.[3] The upshot is that lawmakers are arguably reluctant to innovate.

A number of other reasons limit legal innovation in business organization law. The involvement of the European legislature in developing a harmonization programme designed to create a degree of uniformity in the law regarding creditor and investor protection throughout the European Union has tended to restrict innovation in business organization law in general. This harmonization process, which introduces essential minimum standards and tolerates a degree of diversity at a national level, applies mainly to the public corporation. Even though the EU directives initially focused on public corporations, both national and EU lawmakers tend to extend their reach to the close corporation when introducing policy reforms. Given the network and learning effects, imposing mandatory rules could be thought to encourage the

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2 Kahan, M. and Klausner, M., *Path Depenedence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, Eashington University Law Quaterly 74 (1996), pp. 347-366; Kahan, M. and Klausner, M., *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, Virginia Law Review 83 (1997), pp. 713-770; Klausner, M., *Corporations, Corporate Law, and Network of Contracts*, Virginia Law Review 81 (1995), pp. 757-852.

3 Lawyers and other professional advisors can indeed play a significant role in the 'lock-in' to adopted contracts. If a particular lawyer spends time and money on customizing an alternative term that will benefit other lawyers and their clients generally, that lawyer may face a potential free-rider problem. As a result, the drafting and designing of innovative contract terms is not in itself always cost-effective. Efforts to enhance change will not live up to expectations. The possible failure of the new term, which might damage the lawyer's professional reputation and even ruin his career, also tends to confine lawyers to a more passive role by encouraging them to follow the herd and to some extent to ignore their own information and judgments regarding the merits of their decisions. *See*, e.g., Kahan, M. and Klausner, M., *Path Dependence in Corporate Contracting: Increasing returns, Herd Behavior and Cognitive Biases*, Washington University Law Quaterly 74, (1996), pp. 353-358.

standardization effect, hence decreasing the prospects for changing European business organization laws.

The evolution of European business organization law may well turn on the prospect of national lawmakers finding compelling reasons to abandon the defence of well-entrenched legal forms and the mandatory rules that reinforce their position and so block the diffusion of new innovative legal rules. Yet given the way in which lawmakers have responded to date, the emergence of new separate legal business forms responsive to the needs of closely held firms would appear improbable, particularly in absence of the conditions necessary for competitive lawmaking. For several reasons, in most European jurisdictions, the small and medium-sized business community is not likely to play an important part in the development of business organization legislation. Except for the United Kingdom, where accountants have already played a central role in the adoption of a 'limited liability partnership' statute, the national lawmaking process in Europe is led by lawmakers and civil servants who give priority to the preferences of large firms. Thus, unless small and medium-sized enterprises and affiliated interest groups are able to influence the pattern of lawmaking, any statutory changes made will not be particularly beneficial to closely held firms.

Yet the modernization of business organization laws is now high on the policy agenda in Europe. The European Court of Justice's (ECJ) decisions in the *Centros*, *Überseering* and *Inspire Art* cases have led to more and more jurisdictions taking actions.[4] Indeed, the ECJ's decisions appear to trigger the development of competitive lawmaking in Europe, which could give member states incentives to adopt, for example, modern corporation and partnership law statutes that are in line with the requirements of modern businesses. Further support for this is evidenced by the interest of legislatures in supplying new business forms in response to the threat of competition posed by offshore jurisdictions. Even though there is considerable pent-up demand across Europe for firms to organize under the laws of low-regulation jurisdictions, it is nevertheless difficult to predict with certitude the circumstances that would lead to the development of regulatory competition in the context of partnership forms.

This article attempts to demonstrate the breadth and variety of the challenges for partnership law reform. As will be discussed, the law is being

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[4] Case C-212/97, *Centros Ltd*. v. *Erthvers-og Selskabbsstyrelsen*, [1999] *ECR* I-1459, [1999] 2 *CMLR* 551 (*Centros*); Case C-208/00, *Überseering BV* v. *Nordic Construction Company Baumanagement GmbH (NCC)*, [2002] *ECR* I-9919 (*Überseering*); and Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam* v. *Inspire Art Ltd (NL)*, [2003] *ECR* 1 (*Inspire Art*).

challenged substantively, not only by fundamental changes in the nature of commerce, but also by competitive pressures on lawmakers. Section 1 discusses several factors that play a crucial role in the lawmaking process and prevent lawmakers from adopting modern partnership forms that would benefit closely held firms more. In section 2, we then turn to the importance of new business forms to a robust economy. Section 3 attempts to determine the probability of national legislatures adopting new business forms by discussing which incentives may create adequate demand for the introduction of such legislation. The last section concludes.

1 THE STASIS OF 'TRADITIONAL PARTNERSHIP LAW'

It is a common refrain that partnership law has an ancestry that can be traced back to the Roman *societas*, the mediaeval *commenda* and the *lex mercatoria* or Law Merchant.[5] The main features of these historic institutions are preserved and encapsulated in various ways in the traditional partnership laws in Europe and the United States. Although the way business is conducted has altered dramatically over the past century, becoming more competitive and internationally orientated, partnership laws have essentially been in stasis since the codifications in the nineteenth and the early twentieth century.[6] Except for a

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5 See Story, J., Commentaries on the Law of Partnership, (Boston: Little, Brown and Company, 1859), p. ix; Zimmermann, R., The Law of Obligations; Roman Foundations of the Civilian Tradition, (Oxford: Clarendon Press, 1996), pp. 451-476; See also Blackett-Ord, M., Partnership, The modern law of trade, business and professional partnership in England and Wales, (London: Butterworths, 1997), pp. 4-7; Bromberg, A.R. and Ribstein, L.E., Bromberg and Ribstein on Partnership, (New York: Aspen Law and Business, 1999), §1.02; Callison, J.W., Partnership Law and Practice, General and Limited Partnerships, (St. Paul: West Group, 2001), §1.02; Henning, J.J., *The Origins of the Distinction between Loan and Partnership Enshrined in Partnership Act 1890*, Company Lawyer 22, 2001, p. 75; Raaijmakers, M.J.G.C. (2000), Vennootschaps- en Rechtspersonenrecht, (Deventer: Gouda Quint, 2000a), §1.30-§1.38; Schücking, Ch., *Einführung: Entwicklung und Bedeutung der BGB-Gesellschaft*, in B. Riegger and L. Weipert (eds.), Münchener Handbuch des Gesellschaftsrecht, Band 1, (München: C.H. Beck'sche Verlagsbuchhandlung, 1995), p. 13.

6 In this article, 'traditional partnership law' refers to the first codifications of the general partnership and its variations, such as the limited partnership and, in civil law jurisdictions, the civil partnership. *See* Heenen, J., *Partnership and Other Personal Associations for Profit*, in A. Conrad (ed.), Business and Private Organizations, International Encyclopedia of Comparative Law Vol. XIII Chapter 1, (Tübingen: Mohr Siebeck,1975), p. 3. Although the analytical framework used in this book is also helpful in understanding the 'participation association' and 'internal' civil partnerships, which are nothing more than a simple contract between parties and do not affect third parties, these business forms are outside the scope of the book.

few statutory and judicial 'patching-up' amendments, principally to solve problems with respect to the rights and obligations of a partnership as an entity distinct from its members,[7] the core principles remain practically unchanged. Lawmakers, who have traditionally abdicated their task of partnership law reform in favour of satisfying the needs of large multinational enterprises organized predominantly as corporations, have only recently acknowledged the effects of delayed attention to partnership-type business forms and their economic importance.

Consequently, small and medium-sized enterprises (SMEs), which are often formed informally without carefully considering and clarifying their business relationship in an agreement, continue to suffer the detrimental effects of sub-optimal legal rules in many respects. These firms usually lack the organization and resources necessary to lobby for the required legislative overhaul.[8] In addition, despite the dynamic environment in which SMEs operate, traditional partnership law has attracted relatively little critical scrutiny from academics. Legal scholars have generally shied away from partnership law analysis, treating its longstanding principles, such as the general partners' personal liability for a firm's debts and obligations and broad fiduciary duties, as revealed natural law.[9] These circumstances lend credence to the perception that partnership-type business forms have been a rather dull and unattractive topic of study, which, in turn, may explain the discontinuity in the evolution of partnership law.

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7 These amendments attempt to solve the so-called entity-aggregate dispute, which is often viewed as the central problem of partnership law in legal doctrine.

8 In seeking to design and implement more optimal arrangements for their clients, lawyer associations could be powerful interest groups with regard to partnership law reform. *See* Ribstein, L.E., *Lawyer Licensing and State Law Efficiency*, Working Paper, Draft of March, (2002). However, since most users of traditional partnership forms are not significant consumers of legal services, lawyers have no high-powered incentive to lobby for reform; Romano, R., The Genius of American Corporate Law, (Washington: The AEI Press, 1993), p. 27 offers an economic explanation for the lack of interest in partnership law reform. Since many disputes in partnerships occur in 'endgame' situations (the parties will not be continuing in a long-term relation of repeated play), there will be no gains from future relations. She argues that the benefits from the costs of lobbying for a statutory change are therefore scant: the change will be used only once in the parties' mutual dealings. Furthermore, the flexibility of partnership law has offered large sophisticated law and accounting firms sufficient leeway to contract around inefficient default rules; this partly explains why, before extensive malpractice claims were common, these large professional firms routinely used the partnership form.

9 *See* Hillman, R.W., *Private Ordering Within Partnerships*, University of Miami Law Review 41, (1987), p. 425-432 (enumerating possible explanations as to why academics in the United States shunned a profound analysis of partnership law in the 1980s).

With the corporation being the dominant and most important business form in the industrial sectors of the economy, it is hardly surprising that corporate law has captured the legal imagination. Scholars usually prefer to research glamorous corporate issues such as insider trading, hostile takeovers and the corporate governance of publicly held corporations with shares traded through an organized exchange. Furthermore, those convinced of the importance of SMEs to the robustness of the economy have directed their attention to the close corporation rather than to partnership-type business forms.[10] Courses in business organization law understandably seek to keep pace with the scholarly work devoted to certain issues, and therefore focus primarily on corporate law issues, while either ignoring partnerships and their variations or addressing them only briefly by way of comparison.

Of course, in the light of the related reputational and professional gain, it is much more attractive for law professors and their peers to write academic articles bearing on the more dynamic problems arising from the regulation of the public corporation. Similarly, in order to prepare students for business practice, law academics address issues that are most relevant to their future clients' pressing interests. Nevertheless, as the impact of SMEs on the economy is significant, the lack of partnership law analysis can be argued to be detrimental. Partnerships are common in the agricultural and service sectors, especially in the wholesale and retail trade, the tourist sector, construction and professional services. In fact, partnership-type business forms play a key role in the knowledge-driven economy. The limited partnership, widely used by venture capitalists and investors, dominates the venture capital industry.

At first sight, it might be argued that the lasting prominence of traditional partnership forms in many sectors of the economy serves as compelling evidence of the capacity of these forms to satisfy the wide-ranging needs of many types of firms. Traditional partnership forms are allegedly very popular with a broad range of businesses, from small family firms to large law and accounting firms, which could explain the lack of attention by scholars and practitioners alike.[11] That traditional partnership forms have stood the test of

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[10] This article uses US terminology. For instance, the word 'close corporation' is used as the equivalent of the modern English 'private company' and German *Gesellschaft mit beschränkter Haftung* (*GmbH*).

[11] The alleged efficiency of traditional partnership law could be an explanation for the absence of academic attention. After all, it is not really challenging to promote the *status quo* of partnership law. *See* Gillette, C.P., Lock-In Effects In Law and Norms, Boston University Law Review 78, (1998), p. 824 (arguing that law professors who write articles urging the rejection of existing doctrines or who draft amicus briefs typically derive significant reputational and professional benefits from those activities).

time evinces their straightforwardness. However, the view that the longstanding partnership law statutes are in fact efficient is naïve.[12] It is submitted that even though the survival value may provide superficial evidence of efficiency, traditional partnership law may very well depend on the history of problems that had to be solved in the past but may be irrelevant today (i.e., path dependence).[13] Upon closer examination, it appears that traditional partnership forms are only attractive marginally due to their informality and tax advantages in comparison to corporations.

Here, it is worth identifying the main reasons that currently underlie the choice of traditional partnership forms. First, partnerships are considered to be the default form of business associations in most countries. They may arise informally and even inadvertently,[14] can often be created by oral agreement and operate with considerable informality. In fact, the formation of a partnership may be the only possible way of organizing a firm.[15] The necessity of compliance with various complex, cumbersome, time-consuming and expensive formation and operation requirements, calling for considerable legal advice and other expert assistance, may act as a serious disincentive to forming a corporation. This is especially true in continental Europe, where entrepreneurs sometimes view the requirements to obtain the broad corporate liability shield (i.e., the formal use of lawyers, the minimum capital requirements and the statutory audit and mandatory publication of annual accounts) as draconian.[16]

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12 Cf. Sheikh, S., *Partnership Reform: Legal and Practical Implications*, International Company and Commercial Law Review 12, (2001), p. 89 (noting that the absence of any discussion in legal journals or government reports may be evidence of partnerships in the United Kingdom functioning well in practice, but also pointing to evidence suggesting that the traditional law has not kept in mind the needs of small businesses); Law Commission (Law Commission for England and Wales and the Scottish Law Commission), *Limited Partnerships Act 1907*, A Joint Consultation Paper, (London: The Stationery Office, 2001), p. 2 (arguing that even though the venture capital industry in the United Kingdom is the largest and most developed in Europe, accounting for almost half of total European venture capital investment, there is no room for complacency).

13 Cf. Roe, M., *Chaos and Evolution in Law and Economics*, Harvard Law Review 109, (1996), p. 641.

14 In most jurisdictions, the existence of a partnership relationship can be proven by looking to all the facts and circumstances.

15 In many jurisdictions, professionals used to be prohibited by ethical considerations from practicing with limited liability. Today, professionals are increasingly permitted to conduct their business with some sort of liability protection (provided that they meet several conditions). *See* Godfrey, E., Law Without Frontiers, A Comparative Survey of the Rules of Professional Ethics Applicable to the Cross-Border Practice of Law, (London: Kluwer Law International, 1995).

16 *See*, e.g., Chan, C.W. *et al*, Administratieve lasten – Meningen van ondernemers, Commissie Administratieve Lasten, (1999), I-III and 10 (observing that in the

Similarly, the organizational structure of corporations is perceived as particularly troublesome and inflexible, due to the contravention in the corporate statutes of lengthy, mandatory provisions designed to solve problems encountered in amassing substantial amounts of capital from a large number of passive investors or, in more technical terms, when there is a significant separation of ownership and control.[17] Where the costs of formation and

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Netherlands, entrepreneurs perceive the preparation and disclosure of annual accounts as one of the greatest administrative burdens); Nielsen, B., *Statistics on New Enterprise, Entrepreneurs and Survival of Start-ups: The Danish Enterprise*, STI Working Paper 2002/7, p. 19 (noting that accounting procedures are the most important barriers to establishing a new business in Denmark). *See* also Centre for Law and Business, Faculty of Law, University of Manchester, *Company Law in Europe: Recent Developments, A survey of recent developments in core principles of companies regulation in selected national systems* (produced for the Department of Trade and Industry), (1999), pp. 4-5; European Commission, Green Paper on Innovation, (1995), pp. 36-37; European Commission, Risk Capital: A Key to Job Creation in the European Union, (1998b), pp. 17-19. The recent decision of the European Court of Justice (Case 212/97 *Centros Ltd v Erhvervs- og Selskabsstryelsen* [1999] ECR I-1459) illustrates that the draconian capital requirements could persuade potential entrepreneurs to incorporate in a more favorable jurisdiction. *See* Wymeersch, E., Centros: A Landmark Decision in European Company Law, in Th. Baums, K.J. Hopt, and N. Horn, Corporations, Capital Markets and Business in the Law, Liber Amicorum Richard M. Buxbaum, (London: Kluwer Law International, 2000). *See* also Case 79/85 *Segers v Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen* [1986] ECR 2375. Even in the United Kingdom, which does not impose minimum capital requirements for closely held firms, DTI's Company Law Steering Group acknowledges that the capital maintenance provisions under the Companies Act are complex and often of little practical relevance for small firms. *See* Sheikh, S., *Company Law for the 21st Century – Part 3: Financial Aspects*, International Company and Commercial Law Review, (2002), pp. 108-109.

17 For an overview of the perceived disadvantages of UK corporation law as a template for the regulation of SMEs, *see* Freedman, J. and Godwin, M., *Incorporating the micro business: perceptions and misperceptions*, in A. Hughes and D.J. Storey (eds.), Finance and the Small Firm, (London: Routledge, 1994); Freedman, J., *The Quest for an Ideal Form for Small Businesses – A Misconceived Enterprise?*, in B.A.K. Rider and M. Andenas (eds.), Developments in European Company Law Volume 2/1997: The Quest for an Ideal Legal Form for Small Businesses, (London: Kluwer Law International, 1999); Hicks, A. *et al*, Alternative Company Structures for the Small Business, commissioned and published by The Chartered Association of Certified Accountants, (London: Certified Accountants Educational Trust, 1995); Hicks, A., *Legislation for the Needs of the Small Business*, in B.A.K. Rider and M. Andenas (eds.), Developments in European Company Law Volume 2/1997: The Quest for an Ideal Legal Form for Small Businesses, (London: Kluwer Law International, 1999). An overview of the complex provisions and recent developments in the close corporation statutes of several European countries can be found in De Kluiver, H.J. and Van Gerven, W (eds.), The European Private Company?, (Antwerpen: MAKLU, 1995). *See* also Centre for Law and Business, Faculty of Law, University of Manchester, *Company Law in Europe: Recent Developments, A survey of recent developments in core principles of companies regulation in selected national systems* (produced for the Department of Trade and Industry), (1999); Lutter, M., *Limited Liability Companies and Private Companies*, in D. Vagts (ed.), Business and Private

operation would exhaust the resources of SMEs entrepreneurs are left with the second-best choice of either forming a partnership or not starting up a business at all. As a result, even if traditional partnership law is considered ill-equipped to meet the contracting needs of entrepreneurs, some firms will nevertheless contract into this form due to over-optimism and overconfidence on behalf of the founders.[18]

Tax-enhancing qualities offer another explanation for the extensive use of traditional partnership forms. Some argue that tax considerations are the most important factor in choice-of-business-form decisions.[19] The key feature of partnership tax treatment, often referred to as pass-through taxation or fiscal transparency, appears to play a pivotal role. In partnerships, income is generally treated as if it is the personal income of the partners, and is taxed accordingly.[20] In comparison to a corporation, in which income is first taxed to the corporation, and later, if the corporation's after-tax income is paid as dividend, again to the shareholders as part of their income, partnership taxation could have two

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Organizations, International Encyclopedia of Comparative Law, (Tübingen: Mohr Siebeck, 1998), vol. XIII chapter 2. For a representative survey regarding the US situation, *see* Wortman, T.J. (1995), *Unlocking Lock-in: Limited Liability Companies and the Key to Underutilization of Close Corporation Statutes*, New York University Law Review 70, (1995).

18 *See* Cheffins, B.R. , Company Law: Theory, Structure, and Operation, (Oxford: Clarendon Press, 1997), p. 66 (noting that individuals often start a small business in an atmosphere of heady optimism and mutual good-will, in part because the participants are often related or friends). See also Klein, W.A. and Coffee. J.C. Jr. (1996), Business Organization and Finance, Legal and Economic Principles, (Westbury: The Foundation Press, 1996), p. 64.

19 *See* Erle, B., *Besteuerung der Personengesellschaft Gewinnermittlung und laufende Besteuerung*, in W. Müller and W-D Hoffmann (eds.), Beck'sches Handbuch der Personengesellschaften, (München: C.H. Beck'sche Verlagsbuchhandlung, 1999), §6; Blackett-Ord, M., Partnership, The modern law of trade, business and professional partnership in England and Wales, (London: Butterworths, 1997), pp. 526-527; Raaijmakers, M.J.G.C., *Persoonsgebonden Samenwerkingsvormen en de 'Onderneming' in het Privaatrecht*, in M.J.G.C. Raaijmakers (ed.), Personenvennootschap en "onderneming", (Deventer: W.E.J. Tjeenk Willink, 1999), p. 1; Schmidt, K., Gesellschaftsrecht, (Köln: Carl Heymanns Verlag, 1997), pp. 21-24. *See* also Endres, D., *The New Tax Law and Corporate Structure Choices*, EuroWatch 13, (2001) (arguing that the recent changes in German tax law have reversed the choice of business organization forms in favour of the partnership form).

20 Although partnership taxation is generally based on the assumption that a partnership is merely an aggregate of the individual partners, who reflect their share in the partnership in their own returns, jurisdictions use different bases for determining the partner's income from the partnership. For instance, the taxable income may be determined at the partnership or partner level. *See* Daniels, A.H.M., Issues in International Partnership Taxation: with special reference to the United States, Germany, and the Netherlands, (Deventer: Kluwer Law and Taxation Publishers, 1991), p. 46 (comparing the taxation of partnerships in the United States, Germany and the Netherlands).

advantages. First, it allows the partners to offset deductible tax losses against other sources of income at the partners' level. Second, the 'double taxation' effect could be avoided.[21] In fact, most spousal and other family-owned firms are often formed as partnerships for these and other fringe tax benefits, such as tax-qualified pension and retirement provisions.[22] Allegedly, the tax-shelter capabilities of partnerships are also largely responsible for the use of the form for joint ventures and the relative success of limited partnerships as financing devices.

It follows from the above discussion that the use of traditional partnership forms is attributable mainly to their flexibility and informality, and, most importantly, to their tax benefits. Traditional partnership forms have always covered informal and temporary ventures of the smallest scope, as well as very complicated tax-driven operations. However, as soon as the tax benefits dissipate and legal advisors are involved, firms are urged to organize or re-organize in the corporate form.

Given the importance of tax considerations in choosing a business form, the possible uncertainty about the tax authorities' reaction to revisions to partnership law and the introduction of new partnership-type forms is yet another important source of legal stasis. The fact that both commentators and practitioners tend to characterize partnership forms as artifacts of tax law could very well impede the evolution of partnership law.[23] Apparently, amendments in business form statutes are often suggested to reflect changes created by tax regulations.[24] In the main, lawmakers are inclined to take for granted rigid and

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21 It must be noted, however, that whilst it is clear that partnerships in the United States have major tax advantages, the tax position in other jurisdictions is to some extent different. Due to the availability of tax credits for shareholders on dividends and more favourable corporate tax rates, double taxation on corporate profits is not experienced to the same extent in Europe. *See*, e.g., Freedman, J., *Limited Liability Partnerships in the UK – Do They Have a Role for Small Firms?*, Journal of Corporation Law 26, (2001),p. 914 (comparing the United Kingdom with the United States).

22 *See* Blackett-Ord, M., Partnership, The modern law of trade, business and professional partnership in England and Wales, (London: Butterworths, 1997), p. 532; Bromberg, A.R. and Ribstein, L.E., Bromberg and Ribstein on Partnership, (New York: Aspen Law and Business, 1999), §2.10; Freedman J. and Ward, J., *Taxation of Small and Medium-Sized Enterprises*, European Taxation 40, (2000), pp. 159 and 172-173; Mohr, A.L. (1998), Van Maatschap, Vennootschap Onder Firma en Commanditaire Vennootschap, (Deventer: Gouda Quint, 1998), pp. 198-207.

23 Cf. Ribstein, L.E., *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, Washington University Law Quaterly 73, (1995), p. 371 (noting that lawyers tend to assume that statutory business forms are artifacts of tax law, and often fail to acknowledge transaction cost justifications for statutory business forms).

24 *See*, e.g., Stara, N.J., *Has The Uniform Partnership Act Been Superseded by Subchapter K*?, Drake Law Review 41, (1992) (arguing that the US Uniform Partnership Act should be amended to reflect changes in the federal income tax laws).

awkward rules that are unsuited to the operation of small and medium-sized firms. In their tax-influenced view, they assume that legal rules are trivial, in the sense that business partners could easily neutralize sub-optimal statutory provisions by making contractual adjustments. Nevertheless, this assumption of triviality may not hold.[25] As we will see in the next section, closely held business forms are likely to enter into a period of rapid and substantial change in Europe, as recently experienced in the United States.[26] Arguably, if the law were trivial, reform-minded lawmakers and interest groups would not encourage its reform. More importantly, current law and finance scholarship suggests that legal rules such as disclosure requirements and investor protection have a significant impact on firms' growth.[27] While the literature mainly focuses on publicly held firms, it also lends support to the view that the legal environment may have important influences on the development of closely held firms.

In the United States, taxation of partnership-type business forms was governed by the 'Kintner regulations' for many years. The Internal Revenue Service (IRS) used to look to four factors in determining when an entity should be deemed 'an association taxable as a corporation': (1) freedom from personal liability, (2) centralized management, (3) free transferability of interests, and (4) continuity of life. If a firm had more than two of these characteristics, it was taxed as a corporation. *See* Treas. Reg. §301.7701-2(a)(1). The 'Kintner regulations' resulted in so-called 'bullet-proof' business form statutes, which contained mandatory rules so as to ascertain partnership tax treatment. *See* Hamilton, R.W., Business Organizations, Unincorporated Businesses and Closely Held Corporations Essential Terms and Concepts, (New York: Aspen Law and Business, 1996), p. 124; Humphreys, Th.A, Limited Liability Companies, (New York: Law Journal Seminars-Press, 1998), §1.03; Hynes, J.D., Agency, Partnership, and the LLC, The Law of Unincorporated Business Enterprises, Cases, Materials, Problems, (Charlottesville: Lexis Law Publishing, 1998), p. 439. For another US example regarding estate and gift tax rules, *see* Miller, S.K., *What Buy-out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company?*, Harvard Journal on Legislation 38, (2001), pp. 413-415 (arguing that changes in fundamental rights should not be driven by purely tax considerations).

25 Cf. Black, B., *Is Corporate Law Trivial?: A Political and Economic Analysis*, Northwestern University Law Review 84, (1990) (arguing that mandatory rules in corporate law may be trivial to the extent that they are market-mimicking, avoidable, changeable or unimportant).

26 Cf. West, M.D., *The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States*, University of Pennsylvania Law Review 150, (2001), p. 531 (suggesting that legal change presents a great challenge to the triviality thesis).

27 *See* La Porta, R. *et al*, *Legal Detrminants of External Finance*, Journal of Finance 52, (1997); La Porta, R. *et al*, *Law and Finance*, Journal of Political Economy 106, (1998); La Porta, R. *et al*, *Corporate Ownership Around the World*, Journal of Finance 54, (1999); Gonzáles, N.U., *Legal Environment, Capital Structure and Firm Growth: International Evidence from Industry Data*, Working Paper February 2002. Cf. Coase, R.H., *The Institutional Structure of Production*, American Economic Review 82, (1992), pp. 717-718 (noting that the legal system has a profound effect on the working of the economic system).

2 THE GENESIS OF 'NEW PARTNERSHIP LAW'

2.1 The 'Partnership Analogy' in Corporate Law

The economic role of SMEs has given a fresh impetus to business organization law reforms.[28] Over the past decade, SMEs, and particularly high-tech firms, have attracted increased attention in recognition of their major employment-generating abilities and their contribution to innovation and economic growth. Since they are regarded as the backbone of a robust economy, bolstering a regulatory and business environment conducive to their development is at the top of the political agendas of industrialized countries.[29] Policymakers have become aware that neglecting the organizational needs of these firms will stunt productivity growth and job creation. The rapid pace of technological change and the decreasing international barriers to trade over the past decade have not only created new strategic and organizational opportunities for SMEs, but have also made these enterprises more vulnerable to risks.[30] Hence, it is submitted that in order to help SMEs fully exploit these new opportunities and adjust more

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28 According to the OECD, Small and Medium Enterprise Outlook, Enterprise, Industry and Services, (2000), small and medium-sized enterprises (SMEs) are non-subsidiary, independent firms that employ fewer than a given number of employees. In the European Union, this number is 250, while the United States considers SMEs to include firms with fewer than 500 workers. Small firms employ fewer than 50 employees. Micro-enterprises have at most 10 employees. In Europe, 93% of the businesses are micro-enterprises. In the United States, this percentage is 50. The OECD report indicates that the average firm size in OECD countries is in fact declining.

29 *See* OECD , Small and Medium Enterprise Outlook, Enterprise, Industry and Services, (2000); OECD, The New Economy: Beyond the Hype, Final Report on the OECD Growth Project, (2001). *See* also European Commission, Green Paper on Innovation, (1995); European Commission, Risk Capital: A Key to Job Creation in the European Union European Commission, (1998); European Commission , The Competitiveness of European Enterprises in the Face of Globalisation – How it can be encouraged, COM(98) 718 final, Brussels, 20.01.1999; European Commission, Challenges for enterprise policy in the knowledge-driven economy, Proposal for a Council Decision on a Multiannual Programme for Enterprise and Entrepreneurship (2001-2005), COM(2000) 256 final/2, Brussels, 11.5.2000.

30 Cf. Sakai, K., *Global Industrial Restructuring: Implications for Small Firms, OECD Directorate for Science, Technology and Industry*, STI Working Papers 2002/4, p. 5 ('[t]he degree of globalization of SMEs differs significantly by sector, reflecting the fact that they consist of a diverse and heterogeneous set of firms. While small firms in traditional services still predominantly serve local markets, some, especially knowledge-based small firms, have been particularly active in cross-border strategic alliances in the 1990s.').

easily to immediate uncertainty, policymakers at both a national and international level should endeavour to devise the most competitive and efficient legal business forms as part of the 'intangible infrastructure' intended to foster investment, innovation and entrepreneurship.[31] Of course, business organization law is only one of the determinants of start-up decisions. There is little doubt that the main considerations affecting these decisions are operational and macro-economic.[32] Nevertheless, in the age of globalization, the pattern of business start-ups is likely to be increasingly sensitive to business organization law. Competitive legal business forms must allow SMEs to ideally match their legal status with their organizational needs, giving them the opportunity to start, grow and develop in the context of a highly competitive business environment.[33]

While scholars have debated the advantages of the corporate form for small and medium-sized businesses, the discussion of competition-based lawmaking for this type of business form represents a new departure. Given the presence of market-driven pressures, monopolistic regulators are being forced to make changes to their legal regimes. In their quest for ideal business organization law, the lawmaking elite focuses predominantly on close corporation law. The main thrust of these reform efforts has been to break down the traditional rigidities and formalities inherited from the publicly held corporation.[34] Regardless of whether they are governed by a separate statute (the

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31 Rapid technological change and increased global competition put pressure on governments to make their intangible and physical infrastructures more efficient so as to stimulate entrepreneurship. In this context, 'intangible infrastructure' means the regulatory system that fosters the development of SMEs. 'Physical infrastructure' alludes to (among other things) the communication and transportation systems available, such as roads, cables, and so on. The urge to reform regulations that could discourage the creation and expansion of SMEs could not only be ascribed to indigenous exigencies, but also to the desire to attract foreign investment and business activity. *See* Wilf, S., *Creating the Next Silicon Valley*, Hartford Courant, 2 February 2001; Cf. Ferran, E., *Company Law Reform in the UK*, Working Paper Ferran (2001), p. 1.

32 Cf. DTI, the UK Consultation Document from the Company Law Review Steering Group, Modern Company Law for a Competitive Economy, The Strategic Framework , (1999), p. 96.

33 Cf. Ferran, E., *Company Law Reform in the UK*, Working Paper, (2001), p. 2 ('whilst company law on its own may be relatively insignificant, it is appropriate to look at the reform of company law in the context of a bigger package of regulatory reform initiatives in the UK. This package is intended to provide incentives for business activity and investment that will, in the government's view, have a significant cumulative impact on productivity and economic growth.').

34 *See*, e.g., DTI, the UK Consultation Document from the Company Law Review Steering Group, Modern Company Law for a Competitive Economy, The Strategic Framework, (1999), pp. 56-69. Cf. Bachmann, G., *Grundtendenzen der Reform geschlossener Gesellschaften in Europa*, Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR) 30, (2001) (arguing that the recent decision of the European

'free standing approach') or viewed as factual variations on or sub-type of the general corporation (the 'integrated approach'),[35] close corporations have developed in the image of the large publicly held corporation with its capital-oriented structure.[36]

Court of Justice (Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstryelsen* [1999] ECR I-1459) could give an important impetus to close corporation law reform in Germany); Ferran, E., *Company Law Reform in the UK*, Working Paper, (2001), pp. 9 and 11 (observing that even though the United Kingdom has low barriers to entrepreneurship in comparison with other European countries, encouraging the creation and expansion of small firms and innovative start-ups is high on the political agenda in the UK); Freedman, J., *The Quest for an Ideal Form for Small Businesses – A Misconceived Enterprise?*, in B.A.K. Rider and M. Andenas (eds.), Developments in European Company Law Volume 2/1997: The Quest for an Ideal Legal Form for Small Businesses, (London: Kluwer Law International, 1999), p. 29 (discussing the story of statutory audit exemption for SMEs in the United Kingdom); Sinha, A, *A Modern Corporate Revolution for Small Private Companies*, International Company and Commercial Law Review, (2002) (noting that the DTI's Company Law Steering Group core proposals aim to simplify and modernize the law for small businesses).

35 In the United Kingdom and the United States, the closely held and publicly held corporation have a single legislative base. However, it is argued that the distinction between these two business organization forms is becoming clearer. *See* Bachmann, G., *Grundtendenzen der Reform geschlossener Gesellschaften in Europa*, Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR) 30, (2001). *See* also Centre for Law and Business, Faculty of Law, University of Manchester, *Company Law in Europe: Recent Developments, A survey of recent developments in core principles of companies regulation in selected national systems* (produced for the Department of Trade and Industry), p. 3 (enumerating the European countries that have a single legislative base and countries that follow the pattern of formal and distinct regulatory regimes). Many European jurisdictions have a separate close corporation statute. For instance, the German Limited Liability Company (*Gesellschaft mit beschränkter Haftung*) is governed by a separate statute. *See* Volhard, R. and Stengel, A., German Limited Liability Company, (West Sussex: John Wiley & Sons, 1997), pp. 6-8. Because most national legislatures in Europe voluntarily apply the EU directives on publicly held corporations to their closely held counterpart ('implicit linkage'), it might nevertheless be argued that an integrated approach prevails.

36 *See* Carney, W.J., *Limited Liability Companies: Origins and Antecedents*, University of Colorado Law Review 66, (1995), pp. 863-867; Lutter, M, *Limited Liability Companies and Private Companies*, in D. Vagts (ed.), Business and Private Organizations, International Encyclopedia of Comparative Law, (Tübingen: Mohr Siebeck, 1998), Vol. XIII Chapter 2, pp. 3-12; Wymeersch, E., *Company Law in Europe and European Company Law*, Gent Working Paper Series, (2001), p. 6. *See* also Wouters, J., *European Company Law: Quo Vadis?*, Common Market Law Review 37, (2000), pp. 263-265 (noting that most national legislatures in Europe have voluntarily applied the EU directives on publicly held corporations to the closely held corporate form). Under EU law, mandatory rules are designed to protect third parties from externalities. They are also intended to protect contracting parties that face strategic or information problems that would prevent them from reaching optimal contracts. There has been a fear that the mandatory rules ensuing from centralized efforts to unify publicly held corporations ('top-down harmonization') would lead to a loss of coherence in national corporate law. However, according to Wouters, this fear seems to be partly compensated by the directives' spillover effects, i.e., by the extent to which these directives affect close corporations.

To the extent that jurisdictions have had few revenue-based incentives to research and design the optimal rules for SMEs, they have attempted to apply the governance structure and mandatory provisions designed for publicly held corporations to their closely held counterparts.[37] Since this governance structure is designed to attract substantial amounts of capital into the firm from passive investors and, consequently, to regulate a rich and intricate set of agency relationships, corporation law is poorly tailored to fit the governance needs of smaller firms, in which ownership and control are typically not completely severed.[38] Despite the inappropriateness of the corporate law governance rules, the corporation has nevertheless become the preferred vehicle for business organization among SMEs wishing to take advantage of several corporate features, such as limited liability and continuity of life.[39] Naturally, the impetus

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37 It is argued that European policymakers and legislatures underestimated the importance of small businesses in the growth period of the after-war years. *See* Moussis, N., *Small and Medium Enterprises in the Internal Market*, European Law Review 17, (1992), p. 484. In the United States, the legislature's focus on attracting large corporate charters has left the law governing closely held business forms as somewhat of a backwater. *See* Ayres, I., *Judging Close Corporations in the Age of Statutes*, Washington University Law Quaterly 70, (1992), pp. 372-373.

38 In the context of publicly held corporations, a set of legal rules is intended to align the interests of the managers with those of the passive investors. In this respect, legal rules and corporate governance structures are important as a means of reducing the agency costs imposed by managers acting in their own interests to the detriment of shareholders, mainly in firms owned by dispersed ownership. *See* Scott, K.E., *Agency Costs and Corporate Governance*, in P. Newman (ed.), The New Palgrave Dictionary of Economics and the Law, (London: Macmillan Reference Limited, 1998), Vol. 1, pp. 26-27. Please note that the economic theory of agency, to which the corporate governance issue refers, should be distinguished from the legal concept of agency. *See* Cheffins, B.R., Company Law: Theory, Structure, and Operation, (Oxford: Clarendon Press, 1997), p. 45.

39 *See* Lutter, M, *Limited Liability Companies and Private Companies*, in D. Vagts (ed.), Business and Private Organizations, International Encyclopedia of Comparative Law, (Tübingen: Mohr Siebeck, 1998), Vol. XIII Chapter 2, p. 182 (calling the close corporation the most successful business form in the world). In 2001 approximately 850,000 firms were organized as close corporations in Germany. *See* Hansen, H., *Die GmbH als weiterhin umsatzstärkste Rechtsform, Anzahl der GmbH beträgt Ende 2001 ca. 850 000*, GmbHRundschau 93, (2002); Meyer, J., *Die GmbH und andere Handelsgesellschaften im Spiegel empirischer Forschung (I) and (II)*, GmbHRundschau 93, (2002), p. 188 (arguing that popularity of the close corporation is still increasing in Germany). In the United Kingdom, this number was more than 1 million. Several empirical projects show that limited liability and tax considerations are the most important reasons to incorporate in the United Kingdom. *See*, e.g., Freedman, J. and Godwin, M., *Incorporating the micro business: perceptions and misperceptions*, in A. Hughes and D.J. Storey (eds.), Finance and the Small Firm, (London: Routledge, 1994), pp. 245-247; Hicks, A. *et al*, Alternative Company Structures for the Small Business, commissioned and published by The Chartered Association of Certified Accountants, (London: Certified Accountants Educational Trust, 1995), pp. 16-18.

to incorporate increases when becoming a corporation provides tax benefits. Moreover, incorporation is often prompted by lawyers and accountants who tend to shy away from the task of drafting a partnership agreement. Even though they usually have standard contractual forms at their disposal, they seem to feel more comfortable forming a corporation. In view of learning effects, this is understandable, but may be inefficient since it involves more formality and higher costs.[40]

The current debate on the regulation of close corporations can be explained in terms of a trade-off between the need for creditor and minority shareholder protection,[41] in case of firm failure, and the commitment to supply legal rules, which gives firm participants the ability to maximize wealth. In order to meet the needs of the specialized and idiosyncratic relationships in close corporations, legislative and (more importantly) judicial adaptations and additions to the analogy of partnership law have been made in a piecemeal fashion across jurisdictions through the years. For instance, in the United States and Germany, the judiciary has recognized that shareholders in a close corporation setting may owe each other a strict fiduciary duty of good faith and loyalty.[42] In the Netherlands, the Dutch Supreme Court articulated strict restrictions on interest transfer for shareholders of close corporations, based on enhanced good faith and fiduciary duties, where the articles of incorporation did not explicitly address these matters.[43] Finally, in *Ebrahami v Westbourne*

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40 It might be argued that corporate law statutes have generated learning and network benefits, such as judicial precedents, customs and practices which tend to confine lawyers to a more passive role. There appears to be a prevailing belief that corporations are simpler and less expensive to organize than partnership-type business forms. *See* Keatinge, R.R., *Corporations, Unincorporated Organizations, and Unincorporations: Check the Box and the Balkanization of Business Organizations*, Journal of Small and Emerging Business Law 1, (1997), p. 203.

41 The principle of centralized control and majority rule in combination with the lack of a public market for shares in a close corporation leave a minority shareholder vulnerable in a way that is distinct from the risk faced by shareholders of a public corporation.

42 *See Donahue v Rodd Electrotype Co.*, 328 N.E.2d 505 (Mass. 1975) and, to a lesser extent, *Wilkes v Springside Nursing Home, Inc.*, 353 N.E.2d 657, 663 (Mass. 1976). In Germany, the German Supreme Court imposed a broad fiduciary duty on controlling shareholders of the German close corporation – *Gesellschaft mit beschränkter Haftung (GmbH)* – in the ITT case (BGH 5 June 1975, BGHZ 65, 15 (ITT). For an analysis on the development of case law regarding fiduciary duties, *see* Pistor, K. and Xu C., *Fiduciary Duty in Transitional Civil Law Jurisdictions, Lessons from the Incomplete Law Theory, European Corporate Governance Institute (ECGI)* Law Working Paper No. 01/2002, pp. 28-32.

43 *See* Hoge Raad, 31 December 1993, (1994) NJ, 436. *See* also Raaijmakers, M.J.G.C., Vennootschaps- en Rechtspersonenrecht, (Deventer: Gouda Quint, 2000), §1.93-§1.96.

Galleries,[44] the House of Lords decided that circumstances in which a UK private company is in essence a quasi-partnership (formed and continued by individuals who were essentially partners but who had chosen the legal mechanism of a corporate structure for its obvious advantages) justify the application of partnership just and equitable winding-up principles.[45] In short, the application of automatic dissolution and buy-out rights, strict precepts of fiduciary duty and good faith to protect shareholders, the authorization of strict share transfer restrictions, and contractual flexibility to modify and sidestep rigid rules characterize the close corporation form as a 'quasi-partnership', 'incorporated partnership', or 'partnership corporation'.[46]

While many commentators view the 'mom and pop' firm as being the archetypical close corporation, others point to a wider range of closely held firms that employ the corporate form, such as high-tech operations backed by sophisticated outside investors.[47] They argue that although the traditional close

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44 [1973] AC 360 (HL).

45 *See* Cheffins, B.R., Company Law: Theory, Structure, and Operation, (Oxford: Clarendon Press, 1997), pp. 292-293; Rider, B.A.K., *Partnership Law and Its Impact on "Domestic Companies"*, Cambridge Law Journal 38, (1979), pp. 161-176. *See* also Acton, S., *Just and equitable winding up: the strange case of the disappearing jurisdiction*, Company Lawyer 22, (2001), pp. 135-136 (arguing that the decision in *Re Guidezone Ltd.*, [2000] 2 B.C.L.C. 321, Ch D., which held that the just and equitable winding-up jurisdiction was no wider than the jurisdiction under section 459 of the Companies Act 1985, is wrong).

46 *See*, e.g., Thompson, R.B., *The Shareholder's Cause of Action for Oppression*, Business Lawyer 48, (1993), pp. 704-706 (explaining that legislatures and courts in the United States have modified close corporation law in at least five areas: governance structure, share transfer restrictions, contractual flexibility, the use of involuntary dissolution statutes, and enhanced fiduciary duties). In other jurisdictions, these strategies have not been developed to same extent as in the United States. *See* Lutter, M, *Limited Liability Companies and Private Companies*, in D. Vagts (ed.), Business and Private Organizations, International Encyclopedia of Comparative Law, (Tübingen: Mohr Siebeck, 1998), Vol. XIII Chapter 2, pp. 94-99 (recognizing the importance of the partnership analogy, but admitting that solutions appear to be haphazard and *ad hoc* rather than systematic). That the majority of close corporations usually have less than four shareholders tends to support the partnership metaphor. *See*, e.g., Gomes, A. and Novaes, W., *Sharing Control as a Corporate Governance Mechanism*, University of Pennsylvania Law School, Institute for Law and Economics Research Paper No. 01-12, (2001), pp. 25-27 (referring to empirical data in the US, which shows that, even though the average number of shareholders was 74.4 in 1992, the median was only 3.0); Meyer (2002: 180 and 243) (noting that approximately 80% of the closely held firms that use the *GmbH* form have one or two shareholders).

47 Certainly, the members of small firms are usually part of the management team. *See*, e.g., Hicks, A. *et al*, Alternative Company Structures for the Small Business, commissioned and published by The Chartered Association of Certified Accountants, (London: Certified Accountants Educational Trust, 1995), pp. 13-14 (showing that small companies are not being used as a vehicle to attract outside capital from passive investors). However, many closely held firms are financed by debt and venture capital, separating ownership from risk-bearing at least to some extent. *See*, e.g.,

corporation does not meet the needs of the typical small firm, its structure is especially well-suited to high-tech firms, which are characterized by a high proportion of 'match-specific assets'.[48] In their view, it is more efficient to expand the menu of business forms so as to allow the close corporation to maintain its distinctive qualities.

There is something to the expansion of business forms. Because it is not yet clear when and to what extent the partnership principles should be applied to close corporations, the 'partnership law' analogy is full of perils and pitfalls.[49] For instance, it is not always possible to effectively draft around the statutory provisions of corporate statutes, in that the contractual variations may not always be fully enforced.[50] This is especially true when a contract between shareholders

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Easterbrook, F.H. and Fischel D.R., The Economic Structure of Corporate Law, (Cambridge: Harvard University Press Easterbrook and Fischel, 1991), p. 228; Rock,, E.B. and Wachter, M.L., *Waiting for the Omelet to Set: Match-specific Assets and Minority Oppression in Close Corporations*, Journal of Corporation Law 24, (1999), pp. 913-914.

48 *See* Rock,, E.B. and Wachter, M.L., *Waiting for the Omelet to Set: Match-specific Assets and Minority Oppression in Close Corporations*, Journal of Corporation Law 24, (1999) (explaining that the closely held structure encourages the investment of 'match-specific assets', i.e., assets that have a value to the parties to the venture but little value to outsiders); Stevenson, S.W. , *The Venture Capital Solution to the Problem of Close Corporation Shareholder Fiduciary Duties*, Duke Law Journal 51, (2001) (arguing that experiments in the laboratory of venture capital contracting show that courts should be reluctant to impose broad fiduciary duties on minority shareholders). The survival capacity of high-tech close corporations lends empirical support to Rock and Wachters' thesis. Cf. Hampe, J. and Steininger, M., *Survival, Growth, and Interfirm Collaboration of Start-Up Companies in High-Technology Industries: A Case Study of Upper Bavaria.* Institute for the Study of Labor (IZA) Discussion Paper No. 345, (2001), pp. 9, 13, and 22 (noting that empirical research indicates 'a clearly higher probability of survival of the legal form limited liability company (GmbH) in comparison to companies of all other legal forms').

49 Cf. DTI, the UK Consultation Document from the Company Law Review Steering Group, Modern Company Law For a Competitive Economy, Final Report DTI (2001), pp. 33 and 163-164 (arguing that limiting the unfair prejudice claim under section 459 of the Companies Act 1985 (*see O'Neill v Phillips* [1999] 1 W.L.R. 1092) will discourage the practice of making all manner of allegations which might conceivably sustain a case of unfairness). *See* also Blaiklock, A.R.M., *Fiduciary Duties Owed by Frozen-out Minority Shareholders in Close Corporations*, Indiana Law Review 30, (1997), pp. 766-767 (noting that criticism has arisen in the United States as to the scope and applicability of the partnership analogy).

50 *See*, e.g., Hochstetler, W.S. and Svejda, M.D., *Statutory Needs of Close Corporations – An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law?*, Journal of Corporation Law 10, (1985), pp. 918-919 ('[o]rganizing the close corporation as a partnership, however, runs counter to the idea expressed in some judicial opinions that a close corporation must be run like a publicly held corporation – not as a partnership. Corporations cannot revert to partnership practices in the management of the business whenever they so desire. Thus, courts' decisions have invalidated partnership arrangements in close corporations for being contrary to public policy. Specifically, courts have held that the

conflicts with the close corporation's articles of association and bylaws. The fact that many closely held firms are unlikely to adjust statutory corporate rules,[51] leaving dispute resolution to rest solely on judicial discretion in applying vague legal standards of good faith and fiduciary duties, reinforces critics' view of the partnership metaphor. The judicial discretion to meddle in the internal affairs of close corporations might entail deficiencies and inconsistencies, in that the firm's participants (e.g., the investors and creditors) might no longer be able to rely on the business form they deal with.[52] Judicial interpretation, especially when it stands apart from the statute itself, could limit the statute's certainty and its value for both public and closely held firms.[53] Furthermore, it appears that, once partnership-type doctrines are accepted in the close corporation context, these doctrines are difficult to opt out of.[54] Finally, because these doctrines are vague and open-ended, they may create confusion, thereby preventing the formation of firms, international joint ventures in particular.[55] There is therefore

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parties cannot be partners as between themselves, and a corporation as to the rest of the world. A corporation cannot serve as the mere instrumentality of a partnership because a corporation is a distinct type of business organization and its characteristics cannot be mingled with those of a partnership.'). *See* also Lutter, M, *Limited Liability Companies and Private Companies*, in D. Vagts (ed.), Business and Private Organizations, International Encyclopedia of Comparative Law, (Tübingen: Mohr Siebeck, 1998), Vol. XIII Chapter 2, pp. 94-99.

51 It appears that departures from statutory rules raise procedural and psychological barriers. *See* DTI, the UK Consultation Document from the Company Law Review Steering Group, Modern Company Law for a Competitive Economy, The Strategic Framework DTI, (1999), pp. 56-57.

52 *See*, e.g., O'Kelley, Ch. R. Jr., *Opting in and out of Fiduciary Duties in Cooperative Ventures: Refining the So-called Coasean Contract Theory*, Washington University Law Quaterly 70, (1992), pp: 357 fn 16 (arguing that efficiency-minded judges must weigh the potential gains from correcting for irrational form selection against the costs in form devaluation resulting from such erroneous second guessing). Cf. Cheffins, B.R., Company Law: Theory, Structure, and Operation, (Oxford: Clarendon Press Cheffins, 1997), p. 333 (explaining that despite the approach English courts take to precedent and despite the division of labour within the High Court, the predictability of company law is undermined in some measures).

53 *See*, e.g., Ayres, I., *Judging Close Corporations in the Age of Statutes*, Washington University Law Quaterly 70, (1992), pp. 387-388.

54 *See* Oesterle, D.A., *Subcurrents in LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Business*, University of Colorado Law Review 66, (1995), p. 888 (discussing three doctrines that courts in the United States have used so as to protect the minority shareholder in close corporations).

55 *See* Miller, S.K., *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem"*, Cornell International Law Journal 30, (1997), p. 427 (arguing that vague legal concepts regarding shareholder misconduct may increase rather than reduce the international shareholder's confusion regarding the scope of acceptable conduct).

a prima facie case for partnership law reform and the development of new partnership-type business forms. In order to enhance certainty and efficiency, new business forms should recognize the diversity of closely held firms.

2.2 The Need for New Partnership-type Business Forms

Notwithstanding the increased popularity of the partnership analogy, lawmakers acknowledge that the corporate form alone is not equal to the task of serving all types of closely held firms.[56] Converting the close corporation into an incorporated partnership by codifying numerous judicial opinions would certainly better meet the needs of the vast majority of small firms. However, to some extent it could act as a barrier to growth for firms wishing to expand and to attract outside capital.

2.2.1 SMEs

In an era in which the average firm size is decreasing,[57] some are therefore pointing to the importance of partnership law reform.[58] In this view,

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56 *See*, e.g., Faber, D., *Foreword*, in B.A.K. Rider and M. Andenas (eds.), Developments in European Company Law Volume 2/1997: The Quest for an Ideal Legal Form for Small Businesses, London: Kluwer Law International, (1999), p. v (arguing that there is no ideal legal form for small businesses); Freedman, J., *Small Businesses and the Corporate Form: Burden or Privilege?*, Modern Law Review 57, (1994), p. 580 (using the Australian experience to illustrate the impossibility of formulating a simple statute that would cater for small business generally).

57 *See* OECD, Small and Medium Enterprise Outlook, Enterprise, Industry and Services OECD, (2000) p. 8.

58 Recently, partnership law has increasingly attracted attention across jurisdictions. The United Kingdom: DTI, Company Law Review: The Law Applicable to Private Companies (URN 94/529), (1994); Law Commission (Law Commission for England and Wales and the Scottish Law Commission), *Partnership Law*, A Joint Consultation Paper (2000); Deards, E., *Partnership Law in the Twenty-first Century*, Journal of Business Law 2001. Germany: Gustavus, E., *Die Neuregelungen im Gesellschaftsrecht nach dem Regierungsentwurf eines Handelsrechtsreformgesetzes*, GmbHRundschau 89, (1998); Kögel, S., *Entwurf eines Handelsrechtsreformgesetzes*, Betriebs-Berater 52, (1997); Krebs, P., *Reform oder Revolution? – Zum Referentenentwurf eines Handelsrechtsreformgesetzes*, Der Betrieb 1996; Schmidt, K., *HGB-Reform und gesellschaftsrechtliche Gestaltungspraxis*, Der Betrieb 1998. The Netherlands: Maeijer, J.M.M., Memorandum with respect to the bill regarding the (personal) partnership (*(persoonlijke) vennootschap*): title 7.13 of the New Civil Code (NBW), (1998). The United States: NCCUSL, *Uniform Limited Partnership Act*), NCCUSL, (2001); UPA Revision Subcommittee of the ABA Partnership Committee, Corporate Banking and Business Law Section, *Should the Uniform Partnership Act be Revised?*, Business Lawyer 43, (1987); Weidner, D.J., *The Revised Uniform*

traditional partnership laws are inappropriate in the current business climate, characterized by closer economic integration and consumerism. The reform debates, which are heralded as providing the essential conditions for innovative change, focus primarily on the nature of the partnership as a separate legal personality, thereby encouraging the stability and continuity of the partnership form. Paradoxically, reformers are moving partnership law further in the direction of corporate law.

More significant than straightforward partnership law reform, traditional partnership forms have been reworked and mutated into successful new partnership-type business forms in the United States.[59] The creation of these new business forms, ironically often carried out independent of traditional partnership law reform, appears to be based on a compelling logic. Expanding the menu of business forms is essential to meet the complex needs of a variety of modern closely held firms. For instance, the introduction of the Limited Liability Company (LLC), the Limited Liability Partnership (LLP) and the Limited Liability Limited Partnership (LLLP) in the United States allows closely held firms to access limited liability by means of a perfunctory filing, reduce complexity and limit transaction costs, resulting in more capital being available for the actual operations of the business. Evidence from the United States also shows that the introduction of new business forms provides the necessary impetus to help erode antiquated tax and burdensome mandatory legal rules.[60]

In Europe, the introduction of new partnership-type business forms is also on the policy agenda. The policy debate in the United Kingdom, for instance, has centered on the problems of easy availability of limited liability for

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Partnership Act Midstream: Major Policy Decisions, University of Toledo Law Review 21, (1990); Weidner, D.J. and Larson, J.W., *The Revised Uniform Partnership Act: The Reporters' Overview*, Business Lawyer 49, (1993); ULA, Business and Nonprofit Organizations and Associations Laws, (St. Paul: West Publishing Co, 1995), Volume 6. Europe: European Commission . White Paper on growth, competitiveness, and employment: The challenges and ways forward into the 21st century, COM(1993) 700 final; European Commission , Recommendation 94/1069 on the transfer of small and medium-sized enterprises, OJ 1994 L.384; European Commission, Communication from the Commission on The transfer of small and medium-sized enterprises, OJ 1998 C 93.

59 *See*, e.g., Callison, J.W. and Vestal, A.W., *"They've Created A Lamb With Mandibles of Death": Secrecy, Disclosure, and Fiduciary Duties in Limited Liability Firms*, Indiana Law Journal 76, (2001), pp. 271-273; Vestal, A.W., *"… Drawing Near the Fastness?" The Failed United States Experiment in Unincorporated Business Entity Reform*, Journal of Corporation Law 26, (2001), p. 1019.

60 *See*, e.g., Ribstein, L.E., *The Evolving Partnership*, Journal of Corporation Law 26, (2001), pp. 828-830 (arguing that horizontal competition among states and vertical competition among forms erode traditional restrictions to the internal structure of business associations).

small businesses.[61] Given the apparent success of the new vehicles in the United States, UK lawmakers have recently introduced legislation allowing firms to organize as an LLP. By making the best of both worlds available cheaply to SMEs, policymakers help to level the playing field between large multinational businesses and their small and informal counterparts. Arguably, business forms which offer a favourable tax treatment, partnership-type ease of operation and flexibility, and limited liability with a minimum of 'red tape' are most important at a time when SMEs are facing increased risks to starting and operating a venture.[62] This is especially true of high-growth small firms, which play a pivotal role in both innovation and economic growth. Obviously, the combination of partnership and corporate benefits, which make cheaply available separation of personal assets and life from the business venture are important to facilitate the often-necessary private equity financing.[63] Due to high asset input and uncertain valuations, the risks can be substantial in high-growth start-ups. For instance, venture capitalists invest large stakes in entrepreneurs, whose abilities are often difficult to evaluate. Accordingly, given the high probability of conflict between the venture capitalist and the entrepreneur, the former finds it necessary to both monitor and bond the entrepreneur so as to reduce the agency costs that occur throughout the venture capital cycle. The absence of complete risk diversification and an active market for control holds out the potential for greater risk and reinforces the demand for high-level

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61 *See* Freedman, J., *Limited Liability: Large Company Theory and Small Firms*, Modern Law Review 63, (2000), p. 317.

62 Obviously, numerous legal requirements for starting to operate a business, combined with the time it takes to meet them, can act as a disincentive for entrepreneurs to take up the risk of creating a new business. *See*, e.g., European Commission, Risk Capital: A Key to Job Creation in the European Union, (1998), pp. 17-19. A study of the regulation of entry in 75 countries of the world shows that, even aside from the costs associated with corruption and bureaucratic delay, legal entry is extremely expensive in the vast majority of countries around the world. Since heavier regulation of entry does not appear to be associated with measures of better quality of private or public goods, the principal beneficiaries, if any, appear to be the politicians and the bureaucrats themselves. *See* Djankov, S. *et al*, *The Regulation of Entry*, Harvard Institute of Economic Research Discussion Paper No. 1904, (2000).

63 Venture capital is often the only source of investment for entrepreneurs. *See* Keuschnigg, C. and Nielsen, S.B., *Public Policy for Venture Capital*, Center for Economic Studies & Ifo Institute for Economic Research (CESifo) Working Paper No. 486, (2001), p. 2 ('Lacking the required financial resources, entrepreneurs must usually rely on outside finance to start up a company. Unfortunately, outside financiers find it difficult to evaluate projects with acceptable reliability since the technological feasibility and commercial potential of new ventures are largely unknown. While many essential features of the project are known to the entrepreneur, he cannot credibly communicate them to outside financiers. Loans cannot be secured due to lack of collateral. Neither is their any past record that might help to gauge the future business potential.').

contractual mechanisms. Since changed economic conditions often entail the need for new contractual regimes,[64] a business form which offers a staggering degree of freedom to design the relationship between entrepreneurs and venture capitalists seems necessary to facilitate the negotiations and renegotiations without being held back by antiquated mandatory rules.[65]

2.2.2 Joint Ventures

Unsuitable and rigid rules also present problems for joint ventures and strategic alliances,[66] which, under the pressure of ongoing globalization, have become an important means of limiting risks, decreasing costs, and increasing economies of scale and scope.[67] Many large firms enter into worldwide alliances and joint

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64 *See* Goetz, Ch.J, and Scott, R.E., *Principles of Relational Contracts*, Virginia Law Review 67, (1985), p. 296.

65 Cf. Goldman, M.D. and Filliben, E.M., *Corporate Governance: Current Trends and Likely Developments for the Twenty-First Century*, Delaware Journal of Corporate Law 25, (2000) (arguing that the need to raise capital quickly and efficiently in different global capital markets will lead to the emergence of a universal entity, affording its creators maximum flexibility). Again, one should recognize that efficient business organization laws are only one ingredient in a robust economy. The supply of a menu of business forms alone is not sufficient for an entrepreneurial environment. For instance, even though the Chinese legislature promulgated a corporate form in the early 20th century, outside finance remained marginal. *See* Berkowitz, D. *et al*, *Economic Development, Legality, and the Transplant Effect*, Working Paper, (2001), p. 6 (referring to Gary Hamilton and Robert Feenstra, *Varieties of Hierarchies and Markets*, in M. Orru *et al*., The Economic Organization of East Asian Capitalism, (London: Thousand Oaks, 1997)).

66 Strategic alliances and joint ventures can both be described as contractual relationships between distinct organizations that provide for sharing the costs and benefits of a mutually beneficial activity. Johnson, S.A. and Houston, M.B., *A Reexamination of the Motives and Gains in Joint Ventures*, Journal of Financial and Quantitative Analysis 35, (2000), p. 70 note that strategic alliances are similar to joint ventures, but do not involve equity investments or the creation of a third party. *See* also Lewis, J.D., Trusted Partners; How Companies Build Mutual Trust and Win Together, (New York: The Free Press Lewis, 1999), pp. 4-5. This book speaks of joint ventures when partners create a separate 'firm' they jointly own and control. Alliances are viewed as long-term firm-like contracts.

67 *See*. e.g., Kogut, B., *Joint Ventures and The Option To Expand and Acquire*, Management Science 37, (1991), pp. 19-20; Milgrom, P.R. and Roberts, J., Economics, Organization & Management, (Upper Saddle River: Prentice Hall, 1992), p. 586; Raaijmakers, M.J.G.C., Joint Ventures, (Deventer: Kluwer, 1976); Raaijmakers, M.J.G.C. , Enkele rechtsvergelijkende beschouwingen over joint ventures, Preadvies uitgebracht voor de Nederlandse Vereniging voor Rechtsvergelijking, (Deventer: Kluwer, 1992); Ribstein, *Limited Liability Unlimited*, Delaware Journal of Corporate Law 24, (1999), p. 9; Rosenkranz, S. and Schmitz, P., *Joint Ownership and Incomplete Contracts: The Case of Perfectly Substitutable Investments*, Centre for Economic Policy Research (CEPR) Discussion Paper No. 2679, (2001), pp. 13-15; Shishido, Z., *Conflicts of Interests and Fiduciary Duties in the Operation of a Joint Venture*, Hastings Law Journal 39, (1987), p. 63; Conaway

ventures to obtain technological know-how. In addition, globalization and consumerism increasingly push SMEs to get involved in international joint ventures, both among themselves and together with larger multinationals, when access to manufacturing, distribution and other assets is too difficult or costly to create internally.[68] At the same time, these joint ventures and alliances encourage the further development of new technologies and the reduction of international barriers.[69]

Although the benefits of joint ventures are relatively straightforward, they are highly sensitive to conflict-of-interest situations.[70] The partners are acutely conscious of these situations, and so pay careful attention to them in the joint venture agreement. The resulting relational contracts encompass dealings between the joint venture, venturers and third parties. A wide variety of

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Stilson, A.E., *The Agile Virtual Corporation*, Delaware Journal of Corporate Law 22, (1997), pp. 498-502; Vestal, A.W.,*"Ask Me No Questions and I'll Tell You No Lies": Statutory and Common-Law Disclosure Requirements Within High-Tech Joint Ventures*, Tulane Law Review 65, (1991), pp. 706-707. It is argued that these alliances and joint ventures will increasingly be the building blocks of the 'next society'. *See* Drucker, P., *The next society, A survey of the near future*, Economist 361, 3 November 2001, pp. 5 and 21 (arguing that although the next society has not quite arrived yet, firms should start experimenting with new corporate forms and conducting a few pilot studies, especially in working with alliances, partners and joint ventures); Pisano, G.P., *R&D Performance, Collaborative Arrangements, and the Market-for-Know-How: A Test of the "Lemons" Hypothesis in Biotechnology*, Harvard Business School Working Paper No. 97, (1997), p. 1 (observing that some commentators suggest that the vertically integrated enterprise has become outmoded in industries where technology changes rapidly and predict a future dominated by smaller, specialized enterprises that acquire and sell technologies through networks of inter-firm relationships and outsourcing arrangements).

68 See OECD, Small and Medium Enterprise Outlook, Enterprise, Industry and Services, (2000), p. 13; European Commission, Report from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions, Creating an entrepreneurial Europe, the activities of the European Union for small and medium-sized enterprises (SMEs), COM(2001) 98 final, p. 75 (the Joint European Venture programme, with a guideline of €84 million for the period 1997-2000, aimed at stimulating cooperation between SMEs by fostering the creation of transnational joint ventures between European Union SMEs). See also Sakai, K., Global Industrial Restructuring: Implications for Small Firms, OECD Directorate for Science, Technology and Industry, STI Working Papers 2002/4; Shapiro, C., Competition Policy and Innovation, OECD Directorate for Science, Technology and Industry, STI Working Papers 2002/11, p. 21.

69 See Milgrom, P.R. and Roberts, J., Economics, Organization & Management, (Upper Saddle River: Prentice Hall, 1992), p. 586.

70 See Raaijmakers, M.J.G.C., Joint Ventures, (Deventer: Kluwer, 1976); Raaijmakers, M.J.G.C., Enkele rechtsvergelijkende beschouwingen over joint ventures, Preadvies uitgebracht voor de Nederlandse Vereniging voor Rechtsvergelijking, (Deventer: Kluwer, 1992). *See* also Shishido, Z., *Conflicts of Interests and Fiduciary Duties in the Operation of a Joint Venture*, Hastings Law Journal 39, (1988), p. 64 (dividing the conflict-of-interest situations into three categories: self-dealing conflicts, corporate opportunity conflicts and disclosure conflicts).

protection and incentive provisions are included so as to protect relation-specific investments, such as exclusive selling rights, long-term delivery agreements, rights to veto important decisions and explicit exit rights. However, it is submitted that the joint venture agreement cannot solve all conflict of interest problems. Indeed, joint venture agreements are often incomplete, in that they are vague or silent on a number of key issues.[71] This raises the question of which default rules can be used to complete the relational contract.[72] In order to answer this question, it is important to know whether the partners have formed the joint venture as any particular type of business form, as the default rules of the applicable statute will fill the gaps in the agreement. Even if the parties have not explicitly made a choice-of-business-form decision,[73] the joint venture could be

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71 Lawyer-economists usually invoke transaction costs to explain this incompleteness. Three such costs are most frequently mentioned: (1) unforeseen contingencies; (2) costs of writing contracts; and (3) costs of enforcing contracts. *See* Tirole, J., *Incomplete Contracts: Where Do We Stand?*, Econometrica 67, (1999), pp. 743-744. Parties sometimes deliberately choose not to draft all encompassing contracts, 'because they cannot observe relevant economic variables, because they cannot verify those variables to courts, or because they prefer not to disclose relevant information about themselves.' *See* Schwartz, A., *Incomplete Contracts*, in P. Newman (ed.), The New Palgrave Dictionary of Economics and the Law, (London: Macmillan Reference Limited, 1998), Vol. 2, p. 282. *See* also Goetz, Ch.J, and Scott, R.E., *Principles of Relational Contracts*, Virginia Law Review 6, (1981) ('Parties enter into relational contracts because such agreements present an opportunity to exploit certain economies. Each party wants a share of the benefits resulting from these economies and consequently seeks to structure the relationship so as to induce the other party to share the benefits of the exchange.'); Lewis, J.D., *Trusted Partners*; How Companies Build Mutual Trust and Win Together, (New York: The Free Press, 1999), pp. 263-264 (illustrating how large firms in joint ventures often deliberately choose to draft only simple and incomplete contracts, because extensive contracts limit the flexibility, imply an understanding will not be implemented fairly, and affect the tone of the relationship).

72 *See* Ribstein, L.E. and Kobayashi, B.H., *Joint ventures*, in P. Newman (ed.), The New Palgrave Dictionary of Economics and the Law, (London: Macmillan Reference Limited, 1998) Vol. 2, p. 377.

73 The literature distinguishes between equity and non-equity joint ventures. Equity joint ventures arise whenever two or more venturers contribute assets to a firm and are paid for some or all of their contributions from the profits earned by the firm. The term 'non-equity joint ventures' describes a wide array of long-term relational contract arrangements, such as licensing, distribution and supply arrangements, or technical assistance and management contracts. *See* Hennart, J-F, *A Transaction Costs Theory of Equity Joint Ventures*, Strategic Management Journal 9, (1988), pp. 361-362. These non-equity joint ventures have several shortcomings: they are extremely lawyer-intensive; they do not create an independent equity interest which is transferable; and they are largely dependent on the other parts of the venturers' business. *See* Klein, A.M., *Structuring the International Joint Venture*, Practising Law Institute 835, (2002), pp. 27-29. Equity joint ventures are often explicitly structured as a legal business form, e.g., a partnership or corporation. *See* Urban, S. *et al*, *Wirtschaftliche Vorgaben: Analyse der Zusammenarbeit der Unternehmen in Europa*, in J. Boucourechliev and P. Hommelhoff (eds.), Vorschläge für eine Europäische Privatgesellschaft, Strukturelemente einer kapitalmarktfernen europäischen

treated as a partnership.[74] In that case, partnership law default rules are used as gap-fillers in the joint venture relationship. Although this treatment has many advantages over corporations, such as tax benefits, flexibility and privacy, the partners usually avoid vicarious liability for the venture's debts by incorporating the joint venture.

An incorporated joint venture is governed mainly by statute and articles of incorporation. Corporation law does not have partnership-like flexibility, and generally does not provide shareholders with the same kind of freedom to vary from statutory provisions. In fact, it appears that the joint venture agreement cannot always be easily imitated under the corporation laws of many jurisdictions, especially in continental Europe.[75] In practice, lawyers often struggle to translate the shareholders' wishes into a comprehensive set of articles of incorporation. In the case of a conflict between partners, provisions of the statute and the articles are likely to override the terms set forth in the joint venture agreement.[76] The upshot is that such conflicts may dilute the value of a

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Gesellschaftsform, (Köln: Verlag Dr. Otto Schmidt, 1999), p. 19. Besides contractual and equity joint ventures, a third form of joint ventures could be distinguished: an asymmetric joint venture, where the joint venture partners acquire minority stakes in each other's subsidiaries.

74 *See* Ribstein, L.E. and Kobayashi, B.H., *Joint ventures*, in P. Newman (ed.), The New Palgrave Dictionary of Economics and the Law, (London: Macmillan Reference Limited, 1998), Vol. 2, p. 377 (arguing that a contract that the parties designate as a joint venture or that has the characteristics of a joint venture and is not incorporated or formed as any particular type of business association is generally treated as a partnership in many countries. *See* also Heenen, J., *Partnership and Other Personal Associations for Profit*, in A. Conrad (ed.), Business and Private Organizations, International Encyclopedia of Comparative Law, (Tübingen: Mohr Siebeck Heenen , 1975), Vol. XIII Chapter, pp. 188-190; Stengel, A., *Joint Ventures*, in W. Müller and W-D Hoffmann (eds.), Beck'sches Handbuch der Personengesellschaft, (München: C.H. Beck'sche Verlagsbuchhandlung , 1999), §21; Volhard, R. and Stengel, A., German Limited Liability Company, (West Sussex: John Wiley & Sons, 1997), pp. 9-10.

75 *See*, e.g., Volhard, R. and Stengel, A., German Limited Liability Company, (West Sussex: John Wiley & Sons, 1997), pp. 8-10 ('The joint venture agreement can be treated as confidential, but the articles of association are open to public inspection. It is thus sometimes difficult to decide whether clear enforceability or confidentiality should prevail.'). For instance, a joint venture agreement which is typically incorporated in the articles in the United States is not easily folded into the Dutch articles of incorporation due to the restrictive quality of the Dutch code. Cf. Raaijmakers, M.J.G.C., Joint Ventures, (Deventer: Kluwer, 1976); Raaijmakers, M.J.G.C., Enkele rechtsvergelijkende beschouwingen over joint ventures, Preadvies uitgebracht voor de Nederlandse Vereniging voor Rechtsvergelijking, (Deventer: Kluwer, 1992).

76 Cf. Karalis, J.P., International Joint Ventures, A Practical Guide, (St. Paul: West Publishing Co, 1992), pp. 100-121. Many hold that a joint venture agreement that predates incorporation dominates the relationship. However, in order to avoid confusion, it is advisable that the venturers specify the rules governing the joint venture in their corporate documents. *See* Bromberg, A.R. and Ribstein, L.E.,

joint venture agreement upon incorporation. It is therefore argued that a limited liability vehicle that is truly flexible in formation, organization and control of the venture holds out the potential to provide cost-saving benefits and to encourage joint ventures.[77]

2.2.3 Professional Service Firms

The evolution of legal forms does not only benefit commercial business firms like SMEs and joint ventures.[78] Until recently, the typical partnership, in which the partners are unlimitedly liable for the debts of the partnerships, was the dominant mode of organization for professional firms – sometimes because these firms were prohibited by ethical rules to employ a limited liability vehicle, but mostly because professionals simply preferred the traditional partnership form. However, in light of the progressive move towards commerce and finance, professional firms are frequently choosing limited liability vehicles to better protect themselves against the recent increase in malpractice claims and the threat of litigation.[79]

It is submitted that the liability concerns of professionals are often the instigator of new partnership-type limited liability vehicles.[80] The partners of the

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Bromberg and Ribstein on Partnership, (New York: Aspen Law and Business, 1999), §7.21; Ribstein, L.E. and Kobayashi, B.H. (1998), *Joint ventures*, in P. Newman (ed.), The New Palgrave Dictionary of Economics and the Law, (London: Macmillan Reference Limited, 1998), Vol. 2, p. 377.

77 *See*, e.g., Ribstein, *Limited Liability Unlimited*, Delaware Journal of Corporate Law 24, (1999) (arguing that joint venture partners may prefer a business form that is governed by their specific contract rather than by the default rules of a standard type of business form, such as a partnership or corporation). In this respect, it is worth pointing to the 1994 introduction of the *SAS* in France, and its subsequent modification in 1999, creating the opportunity for partners in a joint venture to adopt a legal structure that is truly flexible in the organization and control of the firm. *See* Lazarski, H. and Lagarrigue, A., *The "New" SAS, Legal and Tax Considerations*, European Taxation 40, (2000); Omar, P.J., *France: Company Law Reform: Innovation and Renovation*, Company Lawyer 22 (2001), pp. 192-193.

78 The distinction between professional and commercial firms has become more illusory than real in the past decades.

79 *See* Economist, When partnerships unravel, 9 July 1994, pp. 13-14 (noting that liability law, particularly in America, has developed in a way that is damaging to all kinds of businesses); Economist, Partners in pain, 9 July 1994, pp. 63-64 (noting that mounting liability claims are threatening to kill off partnerships in professional service firms). *See* also Goforth, C.R., *Limiting the Liability of General Partners in LLPs: An Analysis of Statutory Alternatives*, Oregon Law Review 75, (1996), pp. 1140-1142 (describing the liability crisis in the United States).

80 In the United States, the LLP was originally restrictive in allowing only professionals to use the new form. However, during the legislation process or shortly after promulgation, the scope of the LLPs is expanded to other users. Like the German

big professional service firms (particularly, but not exclusively) feel the need for protection against liability for the malpractice or negligence of co-partners.[81] When their partners have become virtual strangers due to the growth and internationalization of the firm, they have less reason to trust them, let alone to put all their worldly belongings at the mercy of their mistakes.[82] The

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Partnerschaftgesellschaft legislation, which was enacted in 1995 and which allows only professionals listed in §1 of the statute (*Partnerschaftsgesellschaftsgesetz*) to limit their personal liability, the UK LLP was initially designed to address the liability concerns of professional service firms. However, unlike the German form, the LLP statute, as enacted in April 2001, covers all types of businesses. *See* Bärwaldt, R., *Partnerschaftgesellschaft*, in W. Müller and W-D Hoffmann (eds.), Beck'sches Handbuch der Personengesellschaft, (München: C.H. Beck'sche Verlagsbuchhandlung, 1999); Freedman, J., *Limited Liability Partnerships in the UK – Do They Have a Role for Small Firms?*, Journal of Corporation Law 26, (2001); Raaijmakers, M.J.G.C., *The European Reform Agenda for Company and Securities Law, Perspectives on Business Enterprises in Light of the EU-US Comparison*, in G.J. Niezen *et al* (eds.), Nederlands Genootschap van Bedrijfsjuristen, Ongebonden Recht Bedrijven, Bedrijfsjuridische opstellen op de grens van het derde millennium, (Deventer: Kluwer, 2000); Seibert, U. (1995), *Einführung, Entwicklung, Begriff und Bedeutung der Partnerschaft*, in B. Riegger and L. Weipert (eds.), Münchener Handbuch des Gesellschaftsrecht, Band 1, (München: C.H. Beck'sche Verlagsbuchhandlung, 1995); Young, S., *Limited Liability Partnerships – A Chance for Peace of Mind*, Business Law Review 21, (2000).

81 In the United States, accounting, law, consulting and architectural firms are using these new partnership-type limited liability vehicles. *See*, e.g., Hamilton, R.W., *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, University of Colorado Law Review 66, (1995), pp. 1065-1066. The fact that British LLP regulations, unlike their US namesake, demand high levels of financial disclosure in exchange for a degree of protection against liabilities arising from negligence claims could partly explain the reluctance of the professions to convert into a UK LLP. It might also be argued that professional firms prefer unlimited liability to signal to the market for professional services that the partners stand behind the quality of their work. 'It is, in effect, a bonding mechanism in a lemons market.' *See* Banoff, B.A., *Company Governance Under Florida's New Limited Liability Company Act*, Florida State University College of Law Public Law and Legal Theory Working Paper No. 43, (2001), pp. 5 fn 14. In order to maintain the spirit of partnership in a time of increasing liability claims, each partner could set up his or her own 'professional corporation'. The firm then becomes a partnership of the 'professional corporations' and the individuals who elected not to incorporate.

82 After the Enron debacle, the Andersen accounting firm, which provided accounting and other services to Enron, hoped that the limited liability partnership structure would limit exposure to Enron-related fines and legal bills to the American business. It seems inconceivable, however, that the partners could remain free from the claims arising out of the malfeasance of the Houston office. Cf Economist, For Better, for worse, 16 March 2002, p. 18. *See* Ribstein, L.E., *Aftermath of Enron May Test Limits on Professionals' Liability*, Legal Opinion Letter (Washington Legal Foundation) 12, 16 March 2002 ('Texas adopted the first LLP statute in 1991, in response to the savings and loan liabilities threatening large law firms. These statutes, born in the last big professional liability crisis, now have been adopted in every US jurisdiction. The current crisis may determine how well the statutes work.'). *See* also Finch, V. and Freedman, J., *The Limited Liability Partnership: Pick and Mix or Mix-Up?*, Journal of Business Law 2002, p. 512 (Postscript); Fortney, S.S., *Seeking Shelter in the*

combination of limited liability protection and flexibility of organizing the firm in such a manner, as they seem fit, is a very attractive feature of a partnership-type limited liability vehicle.

3 THE PROSPECT OF NEW PARTNERSHIP-TYPE BUSINESS FORMS IN EUROPE

The potential introduction of new business forms holds out the prospect of overcoming the negative effects of lock-in. We now turn to regulatory competition theory, and ask whether there are sufficient incentives to create adequate demand for the introduction and diffusion of new partnership-type business forms.

In Europe, the pressures of competitive lawmaking have induced domestic lawmakers to take action and initiate law reform projects with respect to business organization law. To the extent that these lawmakers had few revenue-based incentives for researching and designing the optimal rules for all types of firms, they have attempted – for the most part – to apply the legal provisions designed for typical small partnerships or large publicly held enterprises to a wide range of closely held firms. The issue here is whether, in the context of regulatory competition, the 'integrated framework' that seems to prevail across Europe will dominate, or whether, as a result of increased competition, the 'free-standing' approach, which involves creating separate business forms, can emerge. Because most national legislatures in Europe voluntarily apply the EU Directives on publicly held corporations to the closely held corporate form (implicit linkage), it might be argued that the integrated approach prevails. This suggests that a major source of lock-in for most jurisdictions appears to be the implicit linkage of close and public corporation structures.

This article proposes, in contrast, that in a competitive legal environment, where the signalling function of business forms becomes more important, business forms for firm organization provided for by law should be adapted to prevailing forms of ownership and incentive structures. Given the significant role of a specialized judiciary and related case law in conferring large benefits to firms, a 'de-linked' legal form that has distinctive statutory qualities for a certain group of business firms is arguably better equipped to commit courts and arbitrators to future responsiveness.

Minefield of Unintended Consequences – The Traps of Limited Liability Law Firms, Washington and Lee Law Review 54, (1997), pp. 762-763.

It seems clear that as Europe enters the competitive lawmaking environment, lawmakers will mainly focus on the needs of business firms that are most likely to engage in forum shopping. Since the Directives regarding publicly held corporations have reduced the feasibility of competition in the context of large corporations, European lawmakers will begin to turn their attention to 'closely held firms', such as large professional firms, venture capital funds, joint ventures, and start-ups generally. Although jurisdictional competition in Europe is still in a developmental stage, the empirical evidence lends support to this view. We can already foresee a pattern of regulatory competition in the context of business organization law that prompts competitive lawmakers to innovate by initiating law reforms and introducing new legal entities that are better equipped than the traditional partnership and corporate forms to meet the (changed) needs of these firms.

CONCLUSION

It follows from the above discussion that the evolution of partnership-type business forms presents clear benefits for a wide range of business and professional firms. Empirical studies tend to confirm that the modernized and new business forms have advantages over traditional partnership and close corporation forms.[83] For instance, the US LLC and LLP, which combine a menu of limited liability, flexibility-respecting governance terms and a choice of tax treatments, allow firms to select legal forms that are compatible with their organizational features. Consequently, it is often claimed that the development of a menu of 'off-the-rack' business forms will eventually provide an efficient, low-cost solution to the governance problems of closely held firms.

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[83] For instance, the LLC is becoming a very attractive and widely accepted vehicle in the United States. *See* Goldman, M.D. and Filliben, E.M., *Corporate Governance: Current Trends and Likely Developments for the Twenty-First Century*, Delaware Journal of Corporate Law 25, (2000), p. 707 (citing the Delaware Supreme Court: 'The phenomenon of business arrangements using "alternative entities" has been developing rapidly over the past several years. Long gone are the days when business planners were confined to corporate or partnership structures.'); Ribstein, L.E. and Kobayashi, B.H., *Choice of Form and Network Externalities*, William and Mary Law Review 43, (2001) (supplying empirical evidence of the popularity of the US LLC). The earliest empirical evidence on registrations of UK LLPs, compiled by company registration agents Jordans, shows that a wide variety of small and medium-sized enterprises are most attracted to this new limited liability vehicle. Astonishingly, more than 75% of the LLPs registered in the first few months after 6 April 2001 have been drawn from the wider business community. This pattern of registration is important because it reverses the assumption that LLPs are appealing only to professionals seeking limited liability protection from large claims.

A closer look at the recent developments of closely held business forms within the European Union and the United States shows that competitive pressures have driven the rapid evolution of 'new partnership law'. It turns out that regulatory competition creates a dynamic law that is responsive to the varied needs of modern firms.[84] In sharp contrast to the US evolution story, however, the recent expansion of business forms within the European Union has arguably been disadvantaged by a legal framework that includes mandatory rules derived from public corporation law, which has been greatly influenced by European directives.[85] Apparently, there are a number of interest group barriers that prevent member states from adopting more cost-effective legal business structures for closely held firms. The legal regimes used by European closely held firms to organize their businesses are likely to lead to high costs, and do not meet the full range of their contracting needs.

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

The advent of competitive pressures from offshore jurisdictions, however, has created some incentives for national policymakers to generate new statutory measures. The recent enactment of the LLP statute in the United Kingdom in order to stem the outflow of professional firms to Jersey, which created an LLP statute in 1996, is an example of competitive lawmaking in Europe. Hence, if Europe succeeds in creating conditions more conducive to regulatory competition, one could expect more member states to be involved in, as in the United States, creating a variety of legal rules that are beneficial to different types of closely held firms.

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84 *See* Ribstein, L.E., *The Evolving Partnership*, Journal of Corporation Law 26, (2001).

85 For instance, the imposition of minimum capital requirements and disclosure rules. Cf. Wouters, J., *European Company Law: Quo Vadis?*, Common Market Law Review 37, (2000), p. 301 (arguing that the French *SAS* should be recalled if the new business form was introduced partly to avoid the capital protection rules of the Second Directive).