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A Primer on the Uncorporation

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Abstract

More and more companies appear with strange abbreviations behind their business name. Consider Chrysler Group LLC (instead of Inc.) or LVMH Montres & Joaillerie France SAS. Some even speak about the "endangered corporate form" and point to the rise of the uncorporation. This Primer examines how the uncorporation has evolved in the United States and, more recently, in other economies around the world. We find that the growth in non-listed business forms in Europe, Latin America and Asia have been shaped by a mixture of learning and professional advice arising from the company law review process, as well as the indirect influence of overseas business forms. We examine the main components of uncorporate business forms that are responsible for limiting transaction costs, curbing opportunism and creating organizational structures that are compatible with entrepreneurial expectations. We show the main differences between the partnership-type and corporate-type uncorporations, particularly the LLC in the United States (US-LLC), the SAS in France and Colombia, the LLP in United Kingdom (UK-LLP), Singapore (S-LLP), India (I-LLP) and Japan (Yugen Sekinin Jigyou Kumiai, J-LLP). We find that, given the pitfalls in the evolution of uncorporation laws, an international Model Act would be consistent with lower transaction and information costs and could help to encourage cooperation between firms situated in different jurisdictions.

Keywords: Beneficial Ownership, Business Courts, Conflict Resolution, Corporate Governance, FATF, Hybrid Business Forms, LLC, LLP, Model Laws, Non-Listed Companies, Uncorporation

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1. Introduction

The purpose of this Primer is to analyze and explain the evolution of the uncorporation. The term uncorporation includes business forms that combine the best of partnership and corporate law.[4] They have attracted a great deal of attention from policymakers, businesses and entrepreneurs.[5] Indeed, the increase in interest is both wide and deep. The focus on uncorporation law is not accidental, however. Especially in the United States, but increasingly in Europe, the expansion of activity in this area during the last two decades has been substantial. Several factors contribute to the growth of new and more efficient business structures. First, states have responded to the needs of a wide variety of firms for a more flexible set of forms, which has reduced reliance on or eliminated inefficient older forms. Second, the liberalization of corporate law has been accompanied by the virtual elimination of the distinctions between partnerships and corporations accompanied by a move toward the recognition of partnerships as entities. Third, the increase in the choice among business forms has resulted in the erosion of traditional restrictions of the internal structure of traditional legal business forms.[6]

The emergence of uncorporations in Europe has been influenced by both domestic and international factors. Importantly, the US reforms have stimulated policymakers' expectations that new business forms will create significant investment opportunities, increased employment and higher growth rates. At the same time, legal innovation in the European Union has been encouraged by changes in European Court of Justice case law, which has triggered jurisdictional competition in European business law and hence the introduction of various new entities designed to meet the needs of small and medium sized firms (SMEs) and professionals. Likewise, emerging economies have recently embarked on the reform of their company law framework. This has resulted in the development of new legal business forms, such as the Colombian Sociedad por Acciones Simplificada (C-SAS) and the Limited Liability Partnership (LLP) in India, as well as the modification of traditional corporate entities. This trend can be seen as a response to the dual demand for the reduction of regulation and improved legal vehicles that are better tailored to meet the needs of different types of firms. It would appear that the most recent developments are not the result of a competitive lawmaking process directly, but have been shaped by a mixture of learning and professional advice arising from the company law review process, as well as the indirect influence of overseas legal forms. But, of course, this is a first step in a process may eventually yield an interesting set of uncorporate type structures that supply efficient and flexible set of legal rules for most entrepreneurs, (small and medium-sized enterprises) SMEs, and professionals.

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[4] See Larry E. Ribstein, The Rise of the Uncorporation, Oxford University Press, 2010.
[5] See The Economist, The endangered public company. The big engine that couldn't, 19 May 2012. See also The Economist, Schumpeter: The eclipse of the public company, Traditional listed firms are facing competition, 19 August 2010.
[6] See Joseph A. McCahery and Erik P.M. Vermeulen, Corporate Governance of Non-Listed Companies, Oxford University Press, 2010.

In this Primer, which builds on our earlier work,[7] we argue that the design of uncorporate business forms is more likely to meet the needs of professional firms, SMEs, and entrepreneurs if the legislative process is shaped by market forces and evolutionary pressures that push in the direction of efficiency-enhancing outcomes. We also explain that separate reform projects for closely held firms would be more efficient in supplying these firms with distinct sets of rules and norms. Providing a diverse set of corporate governance frameworks and legal rules will allow firms to develop organizational structures that are suited to their particular preferences. It is argued, moreover, that various sets of legal arrangements could have substantial contracting benefits for the firm's participants by enabling them to define their expectations *ex ante* and, hence, assist judges in solving governance problems and other related conflicts *ex post*. Further, we develop a full account of how separate uncorporate business forms affect the market environment and provide an opportunity for regulatory arbitrage. Drawing on this learning, we argue that creation of a coherent and simplified set of 'delinked', stand-alone business forms may have clear economic benefits for business parties.

The primer proceeds as follows. The next section explains why we should care about uncorporate business forms. It will be shown that non-listed firms are largely closely held and hence specially tailored sets of measures are needed to prevent opportunism and encourage value-maximizing outcomes. We turn to discuss in section three the governance and features of uncorporations in Europe, the US, Asia and South America. We show how a set of new and more efficient structures could improve the governance of closely held companies, give investors and stakeholders more legal certainty, thereby creating new opportunities for both entrepreneurs and investors. In section four, we discuss the evolution of the uncorporate business forms and the drivers behind their success. In section five, we make clear that uncorporations can under special circumstances be used to undertake illicit and illegal activities. We will, however, argue that the pain associated with the illegal use of uncorporations must be regulated outside the realm of uncorporation law. The final section concludes.

2. Why Should One Care About Uncorporations?

2.1 Small and Medium-Sized Enterprises

In an era in which the average firm size is decreasing,[8] lawmakers are pointing to greater benefits of the uncorporation. Traditional partnership laws are inappropriate in the current business climate, characterized by closer economic integration and consumerism. A shift in traditional partnership law, beginning in the late 1980s, led to the introduction of successful uncorporate business forms throughout the United States.[9] The creation of these new business forms, ironically often carried out independent of traditional partnership and corporation law reforms, 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,

[7] See 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, 2003; Joseph A. McCahery, Erik P.M. Vermeulen, Masato Hisatake and Jun Saito, Traditional and Innovative Approaches to Legal Reform: 'the New Company Law', European Business Organization Law review, vol. 8, 2007; Joseph A. McCahery and Erik P. M. Vermeulen, Conflict Resolution and the Role of Courts: An Empirical Study in M. Neville and K. E. Sorensen (eds.), Company Law and SMEs, Thomson Reuters, 2010; and Francisco Reyes and Erik P.M. Vermeulen, Company Law, Lawyers and 'Legal' Innovation: Common Law versus Civil Law, Banking and Finance Law Review, forthcoming 2013.
[8] See OECD, Small and Medium Enterprise Outlook, Enterprise, Industry and Services, 2000.
[9] See Larry E. Ribstein, The Rise of the Uncorporation, Oxford University Press, 2010; Joseph A. McCahery and Erik P.M. Vermeulen, Corporate Governance of Non-Listed Companies, Oxford University Press, 2010.

reduce complexity and limit transaction costs, resulting in more capital being available for the actual operations of the business. The evidence shows that the introduction of new business forms provides the necessary impetus to help erode antiquated tax and burdensome mandatory legal rules.

In Europe, the introduction of new partnership-type business forms is also high 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 small businesses. Given the apparent success of the new vehicles in the United States, UK lawmakers have 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. When SMEs are facing increased risks to starting and operating a venture, access to business forms, that offer favorable tax treatment, partnership-type ease of operation and flexibility, and limited liability with a minimum of 'red tape,' is seen as beneficial. This is especially true of high-growth small firms, which play a pivotal role in both innovation and economic growth. Cruically, this implies that the combination of partnership and corporate benefits, which make cheaply available separation of personal assets and life from the business venture, could play a pivotal role in facilitating the necessary financing activities. Since changed economic conditions often entail the need for new contractual regimes, a business form which offers a staggering degree of freedom to design the relationship between entrepreneurs and investors seems necessary to facilitate the negotiations and renegotiations without being held back by antiquated mandatory rules.

2.2 Joint Ventures

Unsuitable and rigid rules also present problems for joint ventures and strategic alliances, which, under the pressure of ongoing globalization, have become an important means of limiting risks, decreasing costs, and increasing economies of scale and scope. Many large firms enter into worldwide alliances and joint 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. The strategy will encourage the further development of new technologies and the reduction of international barriers.

Although the benefits of joint ventures are relatively straightforward, they are highly sensitive to conflict-of-interest situations. 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 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. Of course, 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. This raises the question of which default rules can be used to complete the relational contract. 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. For example, even if the parties have not explicitly made a choice-of-business-form decision, the joint venture could be treated as a partnership.[10] 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.

[10] See Larry E. Ribstein and Bruce H. Kobayashi, Joint Ventures, in P. Newman (ed.), The New Palgrave Dictionary of Economics and the Law, Macmillan Reference Limited, 1998.

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. 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. The upshot is that such conflicts may dilute the value of a joint venture agreement upon incorporation. To encourage joint ventures, a limited liability vehicle that is truly flexible in formation, organization and control of the venture is an effective option since it holds out the potential to limit risk and deliver cost-saving benefits.

2.3 Family Firms

Family firms are the leading force in many sectors of the economy. Family-owned businesses promote growth and are generally viewed as job-creating companies. They continue to be highly competitive, particularly in emerging markets, due to their informal structure that provides: (1) a timely and effective decision-making; (2) a deep and intimate understanding of their local market; (3) close ties with regulators and government officials; and (4) strong horizontal and vertical relations in the market. Despite these built-up competitive advantages, family-owned businesses are often confronted with thorny governance and reorganization issues resulting from dynamic changes in both the family and business life cycle. With each generation of succession or alteration in business development stage, i.e., start-up, expansion, maturity, family-owned companies seem less able to draw on previous strengths which could eventually lead to bankruptcy or dissolution of the firm if no more formal governance structure is adopted. Family-owned businesses with clear governance rules and guidelines, a strong brand or access to leading edge technologies, are likely to survive and remain successful. There are a number of successful strategies for family-owned businesses that allows them to deliver exceptional performance and growth. Indeed, it could be argued that policymakers should concentrate their resources on developing flexible uncorporate forms that better enable families to embrace governance strategies that promote their long-term success irrespective of the stages of business development. Not only will improved governance provide a more effective means to deal with family matters that affect business, but may also free up managerial resources that are necessary to run the business well, and thereby make possible capital-intensive work to remain in a country.

2.4 Professional Service Firms

The evolution of legal forms does not only benefit commercial business firms like SMEs, joint ventures and family businesses. Until recently, the typical partnership, in which the partners are unlimitedly liable for the debts of the partnerships, was the dominant mode of organization – sometimes because professional firms were prohibited by ethical rules to employ a limited liability vehicle, but mostly because professionals simply preferred this 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.

Experience has shown that the liability concerns of professionals are often the instigator of new partnership-type limited liability vehicles (see Box 1). The partners of the big professional service firms (particularly, but not exclusively) feel the need for protection against liability for the malpractice or negligence of co-partners. If 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.

Box 1: The Rise of the Uncorporation in the United Kingdom

The introduction of the LLP in the United Kingdom (UK) in 2001 was motivated by a myriad of factors, including election politics, which contributed to its speedy passage. The Department of Trade and Industry (DTI) was directly involved in the establishment of the LLP. Prompted by competition from offshore LLP statutes, particularly that of Jersey, the UK legislature, lobbied by British accountants, decided to promulgate a Limited Liability Partnership Act. The LLP has legal personality, a partnership governance structure, limited liability, and partnership tax treatment. In drafting this legislation, DTI responded to the pent-up demand from existing professional partnerships wishing to transfer to LLP status. Although the LLP act was initially drafted to address the liability concerns of large accounting and other service providers in England, the statutory provisions, as enacted, cover all types of businesses.

It follows from the above discussions that the evolution of uncorporate-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. For example, 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. The next Section will distinguish between two types of uncorporations: (1) a partnership-type uncorporation and (2) a corporate-type uncorporation.

3. What is the Function of the Uncorporation?

From the perspective of law and economics, legal business form statutes offer standard form contracts that help to economize on transaction costs such as drafting, information and enforcement costs, and to limit opportunism and fill gaps in the relational contract. The framework suggests that business organization law offers models that cover the relationships between the participants inside the firm and the representation of the firm in their dealings with outside participants, such as creditors. The business statutes act as a set of 'off-the-rack' terms upon which business participants can fall back when establishing the distribution and allocation of powers and responsibilities for varying levels of control and commitment.

Certainly economic analysis provides valuable insights into the extent to which statutory provisions should be drafted as vague standards or specific and narrow rules.[11] Although the costs of promulgating rules exceed those of drafting standards, rules may internalize much of the transaction costs. In this respect, the benefits of rules are twofold. First, firms may spend less in learning the content of the law. Second, firms may become better informed about rules than standards and thus better conform their behavior to the law. Yet, even if it is necessary to promulgate a standard because costs prevent the *ex ante* drafting of specific terms, lawmakers may be able to convey inherent benefits to firms by allowing them to opt out and bargaining around stringent standards such as fiduciary duties.

Clear and simple default rules are typically economically efficient for small businesses in which all owners are active participants (see Box 2). Three reasons explain the efficiency effects. First, economic actors who choose to do business in a joint ownership relationship without contemplating a formalized agreement will likely find in the statute what they would have agreed upon had they negotiated a relational agreement. Second, the majority of business parties need not contract around the particular rules. Third, since the default rules mimic the hypothetical provisions that a

[11] See Louis Kaplow, Rules versus Standards: An Economic Analysis, Duke Law Journal, vol. 42, 1992.

majority of the partners would have bargained for if they could contract without cost, opting into a business form statute is a substitute for private bargaining, thereby reducing transaction and litigation costs.

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

Box 2: Why Small Businesses Overlook the LLP Structure in the United Kingdom?

In Box 1, we have seen that the United Kingdom has responded to the demands of a particular class of firms (*i.e.*, multinational professional service firms) that possess the resources and capacity to draft a comprehensive operational agreement that meets their special requirements. The outcome is that, while the UK-LLP extends limited liability to all types of firms, the effect of high transaction costs will arguably limit its suitability for most SMEs. Whilst the UK-LLP gives its internal participants limited liability, the disadvantages of the flimsy statute, which requires firms to comply with corporate default rules, outweigh the practical benefits of the legal form. It may even be argued that the UK-LLP is more similar to a corporation, in that many provisions of the statutes draw directly from the corporate model.

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

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

The constitution of an LLP is the creation of its members. The statute allows members to design their relations freely without publishing or disclosing their relational agreement. While it is common practice to design a written agreement, there is no legal obligation to do so. Oral agreements are recognized. In order to facilitate contracting, default provisions have been provided through the Limited Liability Partnerships Regulations 2001. A key default provision is provided for the management of the LLP which is vested in its members. Moreover, there is also a default provision for the equal sharing of profits and relations. The Companies Act will fill in the gaps where an agreement and the Regulations are silent. UK-LLPs are generally treated as partnerships for tax purposes.

One question remains: how many uncorporation statutes should there be? The evolution of uncorporate business forms may provide some tentative answers. It is clear that fully-fledged limited liability protection should be a common feature of the uncorporation. However, the accessibility, i.e., the incorporation and disclosure requirements, and governance structure differs slightly among the newly emerged uncorporations. For instance, the business forms that carry the partnership name usually require two or more partners to set up the business, whereas the "corporate-type" uncorporation acknowledge sole ownership structures. As we will see in Section 4, these variations partly explain the differences in popularity. This Section will compare the main components of uncorporate business forms that are responsible for limiting transaction costs, curbing opportunism and creating organizational structures that are compatible with entrepreneurial expectations. We will also explain the main differences between the partnership-type and corporate-type uncorporations. Table 1 provides examples of partnership-type forms, such as the LLP in the United States (US LLP), the United Kingdom (UK-LLP), Singapore (S-LLP), India (I-LLP) and Japan (Yugen Sekinin Jigyou Kumiai, J-LLP). Corporate-type uncorporations can be found in France (the Société par Actions Simplifiée, FR-SAS), Colombia (the Sociedad por Acciones Simplificada, C-SAS), Japan (Godo-kaisha, J-LLC) and the United States (US-LLC).

3.1 Limited Liability and the Uncorporation

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

For instance, the rapid enactment of new statutes in the United States is due to numerous state legislatures promulgating LLC legislation almost without hesitation, thereby failing to consider public welfare aspects (see Box 3). When other interest groups (*e.g.*, trial lawyers) opposed the expansion of limited liability beyond the realm of corporations, because of the possibility of creditors being detrimentally affected, they were generally no match for their opponents. The upshot is that even if a variety of legal restraints, such as difficult formation requirements, mandatory insurance and minimum capital requirements, are necessary to avoid the adverse consequences of expanding limited liability, legislatures are politically blocked by a sub-optimal trend in a competitive federal system. Furthermore, to the extent that the extension of limited liability to uncorporate business forms is a piece of interest group legislation, courts are unlikely to respond with a coherent set of principles to guide judicial veil piercing, which could limit the effects of excessive risk-taking in certain cases by allowing creditors to reach the personal assets of internal firm participants.

Nevertheless, law and economics scholars are divided about the merits of the efficiency of limited liability. On the one hand, proponents argue that limited liability fosters entrepreneurship, facilitates capital formation and protects firms against the troublesome developments in liability law. The debate on the efficacy of limited liability for uncorporations traced the outlines of the debate in corporate law on the subject of the extent to which limited liability should be restricted or curtailed. On the other hand, opponents have questioned the efficiency presumption of limited liability for closely held firms. In this view, the efficiency presumption of limited liability for closely held firms is under threat due to a series of interventions about its suitability in this context. The basic argument here is that limited liability is thought to have little impact on monitoring costs, liquidity, and risk diversification in firms that often do not separate ownership from control, have no intention of raising outside capital, and in which parties are often required to place all their eggs in a single basket. In fact, limited liability introduces the prospect of opportunistic behavior, *i.e.*, attempts by the participants to shift the risk of business failure to outsiders. More recently, building on earlier analyses, some have argued that limited liability should not be considered as part of the essential role of business organization law, unlike conferring legal entity status.[12]

Box 3: The Rise of the Uncorporation in the United States

The US Experience confirms the importance of investing in the development of new company law products. In the United States, the relatively simple landscape of company law has changed dramatically over the last two decades. For instance, the LLP emerged in Texas in 1991 to provide 'piece of mind' insurance to innocent partners in professional firms. Thereafter, the LLP spread rapidly from two states in 1992 to 50 states and the District of Columbia by 2001.

The LLC is yet another, and more successful, legal production that combines partnership features with corporate characteristics. In 1975, corporate lawyers advising Hamilton Brothers Oil Company lobbied for the introduction of a new business form, the LLC. After a failed legislative effort in Alaska, corporate lawyers lobbied successfully for the enactment of the LLC statute in Wyoming, another state with significant gas and petroleum production facilities, in 1977. In 1980, the Internal Revenue Service (IRS) issued a private letter ruling to the Oil Company securing the favourable partnership taxation for its Wyoming LLC structure.

Florida enacted LLC legislation in 1982 to attract foreign investors, particularly from South and Central America. However, the uncertainties surrounding the tax classification of LLCs in general severely hampered the rush to conduct business under this new statute, and consequently did not lead to the expected upsurge of economic activity in Florida. As late as 1988, the IRS clarified the tax treatment of the LLC by issuing a ruling stating that the eligibility for partnership tax treatment is conditional upon the business form's corporate features. If the LLC lacked two of the four corporate characteristics considered by the IRS to be crucial (continuity of life, centralization of management, limited liability and free transferability of interests), then the Treasury regulations would treat the LLC as a partnership for tax purposes. After this ruling, other states jumped on the LLC bandwagon, slowly and hesitantly at first. But, after 1990, LLC legislation swept rapidly through the United States, largely because of competitive pressures and domestic interest groups, more specifically corporate lawyers expecting additional clients and work from the LLC. LLC provisions have been adopted in all 51 US jurisdictions by the close of 1996.

Because there is little empirical evidence to support either the efficiency or inefficiency of limited liability for closely held firms, this is a very complex question to which there is no straightforward answer.[13] Despite the absence of evidence, most scholars find that the benefits of extending limited liability to closely held forms outweigh the costs. It has been argued that the rapid diffusion of limited liability within the United States contravenes the view that LLC statutes are inefficient. In reality, the ready acceptance of tort limited liability by all 51 states shows that the pent-up demand for limited liability was significant, and the absence of notable opposition by the malpractice and tort law lobbies indicates that the perception of risks was not so excessive as to justify expenditure to block adoption of this new form. Alternatively, the rapid adoption of LLC statutes merely reflected the delayed, but necessary, response by businesses and legislatures to tort law litigation movement, which had increased costs for parties overall.

Of course, the uncertainty surrounding the efficiency of limited liability does not lend support to those who seek to introduce federal regulations, such as minimum capital requirements, to protect voluntary and involuntary creditors to the firm. The reliance on these signaling devices to balance the levels of risk-taking is deceptive. By their very nature, these devices – which are often poorly designed and outdated – tend to impede innovation, entry and investment, and consequently create unnecessary barriers to trade and social welfare – Figure 1 gives an indication that easy access to limited liability vehicles increases the number of business registrations (see also Box 4). In any event,

[12] See Henry Hansmann and Reinier Kraakman, The Essential Role of Organizational Law, Yale Law Journal, vol. 110, 2000.
[13] See also Section 5.

direct creditors, which are not the main beneficiaries of such legislation, are able to bargain efficiently so as to avoid any risk that may arise in connection with any contracts involving such firms. More perversely perhaps, involuntary creditors are often unable, to adequately protect themselves under these devices, given their lack of information and bargaining power. For some type of firms, reputational barriers may well prove a more effective constraint when embarking upon risky projects. This may help explain why firms will be much better off when they use limited liability vehicles that are acceptable to customers, banks, employees and regulatory bodies in the state in which they are geographically located. In sum, the market for limited liability forms is unlikely to increase the risks for most parties, and in light of the degree of openness and competition in the market, will ultimately produce business organization laws that parties will prefer.

Table 1: Access to Limited Liability and the Rise of the Uncorporation

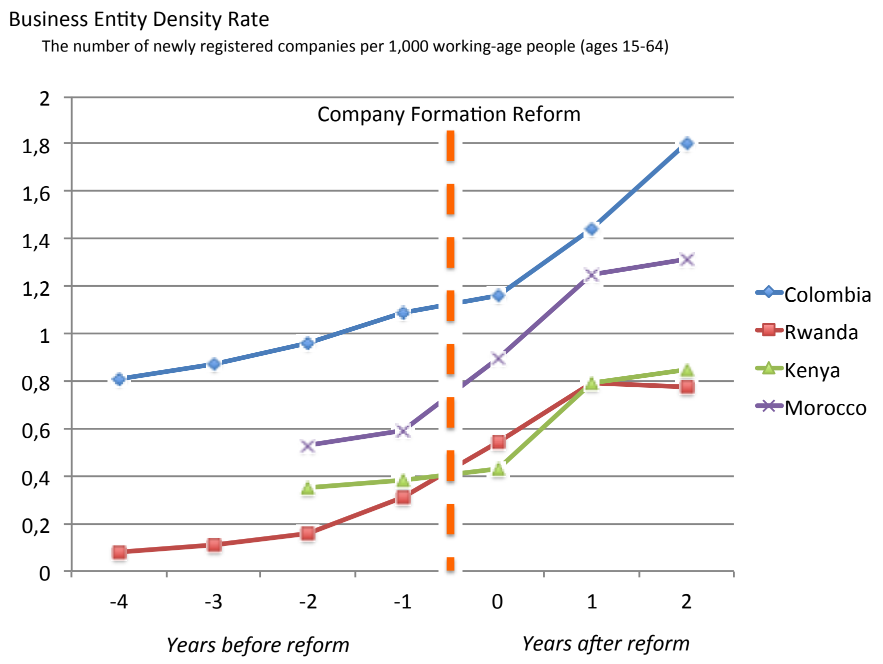
Country	**US-LLC Delaware**	**SAS France**	**SAS Colombia**	**J-LLC**	**UK LLP**	**J-LLP**	**S-LLP**	**LLP India**
	Corporate-type Uncorporations				***Partnership-type Uncorporations***			
Legal entity	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Limited Liability	Yes	Yes	Yes	Yes	Yes	Yes	Yes, but clawback provision before insolvency	Yes
Financial statements	Members have access / no public disclosure	Parties are required to disclose annual accounts	Shareholders must approve financial statements and annual accounts	Members have access	An annual return and annual statutory accounts must be filed	Members have access / creditors have access upon request	Accounts and other records must be kept for seven years	An annual return must be filed
Formation	Simple certificate of formation (filed at the Secretary of State	Registration at the Commercial Court	Incorpora-tion document filed at the Mercantile Registry (online registration)	Registration at the Legal Affairs Bureau	Registration at Companies House	Registration at the Legal Affairs Bureau	Online registration	Online registration
Number of partners	1 or more	1 or more	1 or more	1 or more	2 or more	2 or more	2 or more, but it is possible to have one partner for two years	2 or more, but it is possible to have one partner for 6 months
Notarization of charter	No	No	No	No	No	No	No	No

Box 4: Simple Formation Requirements Lead to More Entrepreneurial Activity

In Colombia, business parties can establish a C-SAS by filing a simple registration before the Chamber of Commerce (without going through the complicated and time-consuming incorporation requirements that apply to the traditional business forms, such as the mandatory rule to have a multiple number of shareholders and the appointment of fiscal auditors). The Law regarding the C-SAS make it clear that shareholders will be shielded from any liability concerning any obligations arising from the business activities of the corporation. Furthermore, the principle of freedom of contract is fully embraced. It is now, for instance, possible for shareholders to manage the company directly and/or obtain different classes of shares. The new Law even introduced an innovative and alternative enforcement mechanism, which referred conflicting parties to an arbitration or administrative adjudication procedure. The simplified incorporation procedure allowed the Chamber of Commerce to design an online system that facilitated the electronic filing of new SAS registrations. Currently, the incorporation process can take less than two hours. This is because the website of the Chamber of Commerce of Bogota, for instance, provides for a six step process: (1) the creation of an account, including the application for a corporate name and tax ID-number, (2) the filing of the articles of incorporation (in order to expedite the process, model articles of association are made available), (3) the online payment, (4) the request to issue a digital signature, (5) digitally signing the incorporation documents and (6) review of the documents by the Chamber of Commerce. The result is astonishing. The C-SAS was introduced in December 2008. In May 2010, a total of 31,856 C-SASs were registered.

An interesting feature of the India LLP is that, like in Colombia, it may be established through the Internet: the designated partners must apply for a Designated Partner Identification Number (DPIN) and a Digital Signature Certificate (DSC). The DPIN and DSC are necessary to register the I-LLP. After registration a trade name check will be conducted. The incorporation process is completed upon the payment of the registration fee by credit card. The website, which was set-up by the Indian government, also offers assistance in drafting the I-LLP agreement and registering the I-LLP (within 30 days of the incorporation). The website contains filing instructions and information about the number of I-LLP registrations. After sixteen months, 2,265 were established. One year later (on 1 August 2011), the number of registered I-LLPs was 5,788. The simplicity of the legislation, one of the advantages of the I-LLP, captured the attention of not only professionals, but also many other businesses across different sectors.

Figure 1 – Company Law Reform and Entrepreneurship



Source: Data derived from World Bank Entrepreneurship Database

3.2 Internal Governance

3.2.1 Partnership-type Uncorporations

In order to offer a clear and simple framework to economic actors who decide to opt in a joint ownership structure, the partnership-type uncorporations bestow entity status on the business relationship (see Table 1). It also clarifies that, except as otherwise provided in the operation agreement, the uncorporation owns the firm-specific assets. In order to give 'multital' effect to the joint ownership structure, the parties have joint control over the items of firm-specific capital. Since partners share usually equally in the firm's profits and losses by default, arguably they have a high-powered incentive to monitor the firm.

A further analysis of the 'equal sharing rule' points to the role of the uncorporation as a standard form contract for the smallest and most informal kind of business arrangements, which are largely governed by social norms and economic incentives. A richer set of insights, however, arises when comparing the uncorporation law statutes of several jurisdictions (see Table 2). In this case, it is not immediately clear that the equal sharing rule is an efficient default rule in these circumstances. For instance, the S-LLP in Singapore provides for dividing profits and losses according to the value of the partners' contributions. It might be argued that because partners often contribute unequally to capital or services and alter the operation agreement accordingly, it is difficult to hold that the equal sharing rule is the majoritarian rule that most parties would have wanted. To be sure, given the importance of human capital for the success of many business ventures, lawmakers increasingly recognize the fairness of the equal sharing rule compared to a proportionality rule in which the partners' human capital contribution is equal to that of the partner with the smallest capital contribution. However, if losses arise, lawmakers tend to think it is unfair for a services-only partner in an unprofitable venture to bear an equal share of the losses. It does not seem right for a partner to run the risk of losing all the value of his service contribution while a capital partner would lose only a part of the value of his investment.

Table 2: Internal Governance in Partnership-type Uncorporations

Country	**UK LLP**	**J-LLP**	**S-LLP**	**I-LLP**
Governance	Member-managed, unless otherwise provided - mandatory designated members	Flexible, but mandatory participation in management by all the partners	Member-managers, unless otherwise provided in the agreement	Member-managers, unless otherwise provided in the agreement
Financial rights	In absence of agreement equal sharing rights	Partners' unanimous approval required	If no agreement, sharing in proportion to the equity participation	In absence of agreement equal sharing rights
Freedom of contract	Yes, but some mandatory rules	Yes, but several mandatory rules	Yes	Yes, but some mandatory rules

Country	UK LLP	J-LLP	S-LLP	I-LLP
Transferable interest	No public offerings allowed	Members' unanimous approval required (mandatory rule)	LLP agreement - default: assignment of financial rights	LLP agreement - default: assignment of financial rights
Taxation	Pass-through	Pass-through	Pass-through	Pass-through

Box 5: Flexibility and Partnership Taxation

The J-LLC does not provide for pass-through taxation due to doctrinal factors and principles. This encouraged the Ministry of Economy, Trade and Industry (METI) to step in and submit, subsequent to the introduction of the Godo Kaisha, the Limited Liability Partnership Bill to the Diet in February 2005. As a consequence, the J-LLP or Yugen Sekinin Jigyou Kumiai came into effect on 1 August 2005 to encourage the creation of new business ventures, joint ventures and other strategic partnerships between high tech companies and research institutions. The J-LLP provides for the introduction of a vehicle that is characterized by limited liability, a flexible organization structure, pass-through taxation, and restrictions to the free transferability of partners' interests.

In order to respond to increased competition in Asia and the rapid development of China, the Singapore Legislature has also enacted an LLP statute (which came into effect on 11 April 2005). The Company Legislation and Regulatory Framework Committee (CFRFC) spurred the introduction of an LLP in Singapore. The S-LLP reflects "the acute awareness of the need to recognize and accommodate current international business and commercial practices". It is a legal entity that can sue and be sued and acquire and hold property. Like the Japanese counterpart, it offers a flexible management structure and pass-through taxation. The partners are not personally liable for the firm's debts and obligations. Yet, the partners are personally liable in tort for their own wrongful act or omission. The internal relationship between the partners is governed by the limited liability partnership agreement. In the absence of an agreement or when the agreement is silent on a matter, the First Schedule, acting as a model agreement, will apply. Although the S-LLP is required to keep accounts and other records, it is not necessary to prepare profit and loss accounts or balance sheets nor to have them audited and disclosed.

Similar to the J-LLP and S-LLP, the internal relationship among the partners is mainly governed by the I-LLP agreement in India. The 2009 Finance Bill has brought the taxation in line with a general partnership. This entails that the profits will be taxed at firm level. The distribution of profits is tax exempt. The I-LLP has at least two designated partners who are responsible for the registrations with the respective authorities. One of these partners must be resident in India. There are hardly any mandatory rules, except that the designated partners must file financial statements.

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

More generally, the partnership-type uncorporation creates an ownership structure that gives the partners joint management and control rights (see Box 5). In the absence of an agreement to the contrary, important decisions, such as an amendment to the partnership agreement, must be approved by all the partners. In order to keep decision-making costs down, however, matters arising in the ordinary course of the business may be decided by the majority of the partners. In addition, joint ownership rights imply that each partner, as an agent of the firm, is by default empowered to bind the partnership entity to third parties.

3.2.2 Corporate-type Uncorporations

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

The equal sharing rule could be viewed as a penalizing, information-forcing default rule in all but the egalitarian partnerships. More legally sophisticated partners who find equal sharing inappropriate will be likely to contract around the default rule if another division of the profits and losses is necessary to provide the required incentives to invest in relationship-specific assets. It is therefore understandable that the corporate-type uncorporations usually provide for a different default rule (see Table 3).

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

Thus, the corporate-type uncorporation can be considered as a legal organizational form providing a differentiated management and control structure in which members elect directors and participate in certain fundamental decisions, and directors establish policy, select managers, perform monitoring functions, and act as the firm's agents. Because the majority elects the directors and, hence, is able to control the management of the corporation, the minority is especially vulnerable to opportunistic acts by the majority.

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

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

Table 3: Internal Governance in Corporate-type Uncorporations

Country	**US-LLC Delaware**	**SAS France**	**SAS Colombia**	**J-LLC**
Governance	Member-managed, unless otherwise provided in the agreement	Parties are free to decide on the management structure. It is compulsory to have a "President"	Flexible. Shareholders may manage the company directly	Flexible
Financial rights	If no agreement, profits and losses allocated on the basis of the agreed value of the contribution	If no agreement, sharing in proportion to members' contributions	If no agreement (special classes of shares) sharing in proportion to shareholding	If no agreement, sharing in proportion to the equity participation
Freedom of contract	Yes, complete freedom	Yes, but some mandatory rules	Yes, but some mandatory rules	Yes, but some mandatory rules
Transferable interest	Yes, restrictions could be imposed by the agreement	No public offerings allowed	Yes, restrictions could be contractually imposed	Members' unanimous approval required
Taxation	Check-the-box	Corporate	Corporate	Corporate

3.3 Fiduciary Duties

Fiduciary duties have evolved differently across a range of contexts involving different types of parties and consensual relationships. For instance, traditional partnership law has developed broad and strict fiduciary duties. Partners expect honesty, fair dealing and mutuality of effort from each other. In this view, even though partnerships can be described as contractual in the broad sense that the partners have entered the relationship voluntarily, fiduciary duties are moral concepts of the highest order, and are not contractually modifiable. These duties are necessarily open-ended standards of performance that can be separated into (1) a duty of care and loyalty, (2) a duty to disclose information, (3) a duty to preclude from self-dealing transactions, personal use of partnership assets, usurpation of partnership opportunities, and competition with the partnership, and (4) a duty of good faith and fair dealing.

Because fiduciary duties are open-ended and vague, it might be argued that a breach of fiduciary duty is often hard for an outside party such as a court to verify, and consequently will only assist in preventing opportunism to a limited extent.[14] For instance, fiduciary duties are only brought into play when the trust-based relationship breaks down and ex post renegotiation is cumbersome. Yet, proponents of strict and broad fiduciary duties suggest that these high standards of performance have a distinct function that supplements the remedial actions provided by statute. Fiduciary duties help to foster the development and internalization of trust and norms in a particular business relationship. In this respect, fiduciary duties have a prophylactic function.

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

In terms of the fiduciary duties law concerning transactions with a dominant shareholder, managers are generally exposed to few risks. For instance, in the United States, courts have typically been reluctant to allow interested transactions with shareholders holding 50% or more ownership stake or exercising explicit control over the company. Nevertheless, business transactions with a controlling shareholder can be justified. Arguably, clever directors and officers, given weak fiduciary duties, will initiate many of their business transactions with favored shareholders.

It is not quite clear whether members/partners in uncorporations owe each other a fiduciary duty. As noted earlier, in some jurisdictions courts increasingly extend the application of strict partnership-type fiduciary duties to the members/partners of these companies. Because there are no capital market forces that help to constrain opportunistic behavior, there really is something to the partnership metaphor. It might be argued that in uncorporations, where management functions are (at least to some extent) transferred from directors to members/partners, strict fiduciary duties are justified to prevent the greater threat of opportunistic behavior. However, the convergence of fiduciary duties in partnerships and uncorporations also seems to have its limitations. Some law and economics scholars argue that strict and broad fiduciary duties at all levels of closely held firms could be counterproductive. In this view, broad fiduciary duties could encourage parties to engage in over-monitoring at the expense of productivity.[15]

For instance, joint venture partners rely more on renegotiation and reputational incentives than vague and open-ended fiduciary duties to overcome the consequences of incomplete contracts. Moreover, they often prefer to specify their rights and duties in an agreement. For example, they usually draft explicit buyout options in the joint venture contract. Vague fiduciary duty concepts may increase the transaction costs of negotiating the terms of the agreement and even foreclose potentially productive ventures. This is especially true of joint ventures between rival enterprises

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[14] See Frank H. Easterbrook and Daniel R. Fischel, Close Corporations and Agency Costs, Stanford Law Review, vol. 38, 1986.

[15] See Eric Talley, taking the 'I' Out of 'Team': Intra-Firm Monitoring and the Content of Fiduciary Duties, Journal of Corporation Law, vol. 24, 1999. He argues that broad fiduciary duties might be inefficient as they create incentives for the business participants to spend resources on monitoring each other rather than on productive activities.

that want to deal at arm's length outside the scope of the jointly held firm. These venturers normally do not want to be hampered by broad fiduciary duties.

Table 4: Fiduciary Duties in Uncorporations

Country	US-LLC Delaware	UK LLP	SAS France	SAS Colombia	J-LLC	J-LLP	S-LLP	I-LLP
Fiduciary duties	Access to information and records	Specific default duties in Regulations	Good faith - Articles of association could contain more detailed duties	"Abuse of rights" provision	Good faith	Defined by agreement	Defined by agreement - default provision in First Schedule: disclosure and non-compete	Defined by agreement - default provision in First Schedule: non compete

In light of this discussion, many legal scholars believe that fiduciary duties should vary across the type of business forms. They question whether broad fiduciary duties are optimal under different circumstances and recognize that opportunism in closely held relationships is not always best addressed by imposing broad and vague fiduciary duties. They conjecture that if fiduciary duties are varied to suit various relationships, the parties' ex ante adoption of a particular business form sends a signal about their organizational preferences. When uncorporations are best served by rules that are different from the traditional partnership rules, the statutes should arguably provide for narrow fiduciary duty provisions (see Table 4). The question arises: where does this leave the judicial role on minority protection? A possible answer to this question will be discussed in the next Section.

3.4 Conflict Resolution

3.4.1 Derivative Suits

Members/partners in uncorporations must more rely on judicial gap-filling to ensure that their rights are protected. Some jurisdictions provide for what are known as derivative suits. From the standpoint of the defendant, the incentives to bring these actions depend on the nature and character of the litigation and the size of the award. These derivative suits are brought by one or more members/partners in the name of the uncorporation and for the benefit of the uncorporation as a whole, and are an exception to the usual rule that a company's board of directors manages the company affairs. It goes without saying that these actions are often necessary to block the attempts of controlling shareholders to profit from self-dealing transactions with the uncorporation, since the managers are often largely controlled by a majority member/partner.

As derivative suits cause high litigation costs and great uncertainty, restrictions to prevent a dissatisfied minority member/partner to obstruct the successful operation of a firm by acting in his/her own personal interest are in place in many jurisdictions. For instance, traditional company law usually requires a minority shareholder to own stock at the time of the challenged action and throughout the suit. Moreover, although derivative suits create incentives for companies to settle the matter, settlements are often subject to judicial review. Finally, recoveries go to the company and will not benefit shareholders directly. In response, plaintiffs have sought to institute direct actions.

Thus, for uncorporations, a fundamental issue involves how to resolve disputes among the members of the firm. For example, the traditional derivative suit designed originally for corporations has been extended to LLCs in the United States without concern for its application or whether it will yield adequate results. Arguably, the remedy is unlikely to provide a good fit for closely held firms where members serve as management. Not only is there doctrinal incoherence, but some question whether this technique is too costly given the other legal remedies available to the firm. Indeed, the judiciary is often not able to keep pace with the economic and social evolution due to time constraints and the after-effects of precedents. Hence, the absence of statutory guidance, which could be adopted ex ante, may have a detrimental effect on both the firm and its participants. When end-period terms are prohibitively costly to arrange ex ante by the participants themselves and are not easily verifiable by courts and arbitrators ex post, responsive legislatures appear better suited to supplying the default rules for endgame settings.

For instance, the laws on uncorporations could include ex ante exit rules. The logic of providing these rules is to lower costs for the parties and to create a degree of predictability that could operate as a sanction against opportunism. Because exit mechanisms provide safety nets to ensure the parties' control rights and authority over the firm-specific assets, the question of which 'default exit rule' is socially efficient is crucial. As we have seen, default rules must act both as an incentive instrument and as a tool to discipline possible opportunistic abuse. These rules must be designed to contribute to the optimal governance equilibrium in the firm. In the next part, we attempt to determine the probability of national legislatures adopting a set of default rules that lowers the cost of contracting as well as the cost of judicial error.

3.4.2 Exit Rules

What should the statutory default rule provide? Upon first inspection, two categories of default exit rule could be contemplated. First, members/partners may have the right to compel the dissolution of the firm and liquidation of its assets. Second, members/partners may withdraw and/or be expelled from the firm and receive the 'fair' value of their ownership interests. In fact, both the dissolution and dissociation concepts may be subject to several conditions, which severely limit the voluntary and involuntary exit of participants. However, commentators have argued that in uncorporations both the majority and minority should be locked into the business and judicial intervention should be limited.[16] The minority could use easy exit rules opportunistically. When the uncorporation lacks the liquidity to pay the leaving party the buyout price or holds specific assets that cannot easily be unbundled without significant loss of value, the minority could threaten to use the exit rules and, by doing so, force the majority to satisfy their demands. One solution to the problem is for exit rights to be curbed in uncorporations.

That is not to say that, given the limited market for and often restricted transferability of interests in limited liability companies, business participants must always be locked into a very unpleasant investment in which hold-up problems abound. Obviously, the problem that arises in endgame settings can have a particularly heavy impact on both the firm and its participants. For instance, internal strife often encourages opportunistic behavior not only by the majority, but also by the minority. In order to help parties solve dissension and deadlocks, lawmakers could define specific rules that comprise the different involuntary and voluntary exit provisions. By providing clear rules litigation costs could be reduced, since disputes could more easily be solved at a preliminary stage before trial. For instance, the law could provide that a majority, holding more than 90% of the company's shares, has the right to expel the remaining shareholders by the payment of a reasonable price. However, these dissociation provisions are not entirely without difficulties. Thorny calculation issues, particularly concerning the valuation of interest and whether payment should be deferred, abound in these endgame settings, since it is also difficult for courts and arbitrators to verify the 'fair value' of interests. Consequently, it is submitted that statutory ex ante rules are also best equipped to provide guidance in relation to valuation issues. For instance, the rule could provide that dissociating shareholders receive the same amount in a buyout as they would receive if the company

[16] See Edward B. Rock and Michael L. Wachter, Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations, Journal of Corporation Law, vol. 24, 1999.

were dissolved. Goodwill will be taken into account when the buyout price is equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern.[17]

In light of the foregoing discussion, the limited liability company is best served by rules that lock-in the majority and minority participants by giving them a limited right to dissociate. This view relies on contractual arrangements by the participants themselves and on extra-legal mechanisms, such as self-enforcing norms of trust and loss of reputation, to constrain opportunistic behavior. However, extra-legal mechanisms can lessen but not eliminate the inefficient subtraction of private benefits from the firm. It is submitted that when gains of opportunism can be very large, legal rules are needed to prevent firm participants from engaging in opportunistic behavior. As prerequisites for these legal norms of performance, minority and majority opportunism must be discouraged, and the self-enforcing character of the relationship must be preserved.

3.4.3 Specialized Business Courts and Procedures

Judicial intervention is another approach to protect participants in uncorporations. They are likely to resort to this mechanism if other gatekeepers, like the reputational agents mentioned above, are insufficient. However, as already demonstrated in the derivative suits Section, the common view is the ex post adjudication is not only costly and time-consuming, but may also be prone to error. Judicial intervention can create a potential wild-card that creates costly uncertainty. While intra-company controversies are often observable to the exasperated parties, they may not be easily verified by a court, and even less so when personal relationships in families and between friends are involved. The difficulty of predicting the judicial outcome explains why in most jurisdictions relatively few disputes seem to end up in court.

The conventional views of court intervention in intra-firm disputes contrast sharply with the effectiveness of the Dutch Inquiry Procedure before the Dutch Enterprise Chamber, a division on the Amsterdam Court of Appeals and its Inquiry Procedure. The Enterprise Chamber shows the potential difference in performance between specialized business courts and a more general commercial court regime. This conclusion is reinforced by the fact that the Dutch court, through its Inquiry Procedure (see Box 6), has become a leader in the resolution of disputes against controlling shareholders of non-listed companies. Particularly, the grant of injunctive reliefs has induced business parties to seek out settlements of conflicts that might otherwise end up in further expensive and unwanted litigation. During the period of 2002-2008, for example, the Enterprise Chamber settled approximately one-third of the more than 300 disputes involving non-listed companies which came before it.

In conclusion: The quality of the Netherlands Enterprise Chamber can be evaluated in terms of five key factors: (1) their integrity and speed; (2) their level of deference to insiders; (3) their ability to focus on the key underlying issues before them; (4) the degree of formalism in their decisions; and (5) the concern they have for the effect of their decisions on other corporate actors. In making an assessment, we observed that the very few courts are able to respond as effectively (in terms of time) to matters presented for adjudication. Not only do parties benefit – from a cost standpoint – from lower litigation costs, but they also benefit from the consistent quality of the decisions rendered by the Chamber and the inducement to settle matters in a more informal setting.

[17] This example is derived from the Revised Uniform Partnership Act in the United States (§701).

Box 6: The Enterprise Chamber in the Netherlands

In 1994, the implementation of an injunctive relief in the Inquiry Procedure gave rise to the current popularity of the Enterprise Chamber in the Netherlands. Pursuant to Dutch Company Law, 'where an immediate remedy is required in connection with the condition of the company or in the interest of the inquiry, the Enterprise Chamber may at any stage of the proceedings, upon the application of the persons that requested the inquiry, order preliminary injunctions for the duration of the proceedings at most'. Since then, an application for an injunctive relief was the rule rather than the exception. In the period 2000-2007, out of 23 inquiry requests with respect to public companies, an injunctive relief was asked in 21 of these cases; a preliminary remedy was granted in 57% of these cases. In the context of close corporations, 234 injunctive reliefs were requested in 300 cases with a 'success rate' of 47%.

The 'fast-track' procedure is characterized by speed and informality. Even though the formalistic two-stage inquiry continues after the court has granted an injunctive relief, the preliminary nature of the decision furthered the judiciary's ability to assist in resolving the issues caused by the alleged improper management of the company. Data on the number of days before an injunctive relief bears this out. During the period of 2002-2008, the average number of days before injunctive relief is granted is 5 days for listed and 72 for non-listed. On both counts, the procedure offered is clearly efficient for shareholders. We speculate, moreover, that the process is much quicker for publicly listed companies due to the amount of media attention and greater pressure that can be exerted by institutional investors involved in the matter.

In terms of relief, the Enterprise Chamber has full discretion to order any preliminary remedy as it sees fit. The most popular remedies for publicly listed companies are: (1) the appointment of independent board members; (2) the prohibition of voting on particular agenda items; and (3) the deviation from the articles of association. Conversely, the preliminary remedies which are most popular for non-listed companies include: (1) suspending directors; and (2) suspending shareholder resolutions. These results confirm our hypothesis that the inquiry procedure is not limited to mere after-the-fact adjudication. The evidence, moreover, indicates that the Enterprise Chamber procedure assists the parties in overcoming their differences by promoting informal and supposedly efficient solutions. These non-formalistic remedies offer parties an additional round of after-the-fact bargaining either by themselves or under the supervision of independent observers. The principle of fast, informal and what we call judge-initiated 'mediation' or 'conciliation' appears to be very attractive to minority shareholders. In many cases, after the injunctive relief, the company and its shareholders tend to follow the preliminary relief or settle their disputes amicably under the 'supervision' of the Enterprise Chamber. In the context of non-listed companies, 120 out of 309 disputes in the period 2002-2008 were settled and published by the Enterprise Chamber.

4. What Are the Success Factors of the Uncorporations?

4.1 Limited Liability and Pass-through Taxation

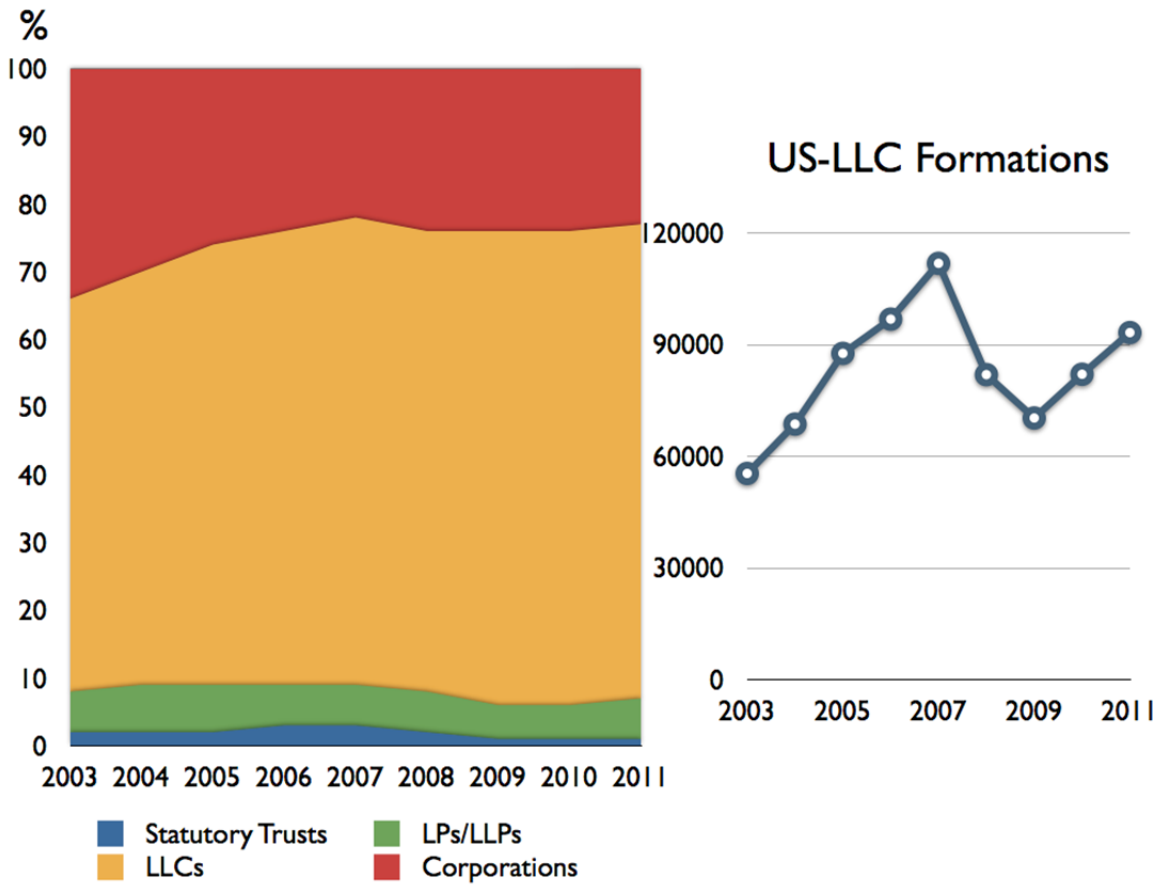
Why do firms increasingly choose to organize as an uncorporation? To analyze this question, let's start with an example. The success of the US-LLC can be attributed to the fact that it bundled together limited liability, a flexible governance structure and preferential tax treatment. The uncorporation required less ongoing paperwork than corporations. Also, it provided its members with an almost total shield against personal liability without cumbersome formation and capital maintenance rules. As for the consideration for the payment of shares/interests, most LLC statutes provide that contributions may be made to the firm in many different forms, such as tangible or intangible property or other benefits to the firm, including money, promissory notes, services performed, or other agreements to contribute cash or property, or contracts for services to be performed. Moreover, these statutes provide extreme flexibility with respect to internal organization.

The emergence of and experimentation with the US-LLC forced the tax authorities to explain in more detail the distinction between partnership and corporate tax treatment, which eventually led to a new federal 'check-the-box' tax rule. Under the IRS 'check-the-box' regulations, which became effective on 1 January 1997, 'uncorporated' associations are taxed as partnerships unless they affirmatively elect to be taxed as corporations. The partnership taxation—pass-through tax treatment—is based on the assumption that a partnership is a mere aggregate of individual partners who redistribute profits among themselves. Consequently, members of a US-LLC report their income and losses as if they were personally realized by the members, and income is taxed to the members as individuals.

The 'check-the-box' regulations triggered yet a third wave of amendments of the LLC statutes, thereby encouraging the development of corporate-type LLCs and the adoption of a wide variety of LLC statutes. Table 4.1, for example, shows the variety in enactment dates and the type of fiduciary duties regime. In terms of fiduciary duties, the table distinguishes between: ULLCA § 409 (Uniform Limited Liability Company Act), which mandates the duty of loyalty and care in a member-managed company; UPA § 21 (Uniform Partnership Act), which requires the members to act as a trustee for any profits derived without the consent of other partners; 8 Delaware Code § 144, which deals only with one aspect of the duty of loyalty, namely, the obligation to disclose self-dealing transactions in which there is a conflict of interest; MBCA § 8.30 (Model Business Corporation Act), which provides the standards of duty of faith and duty of care for directors; and RULPA § 107 (Revised Uniform Limited Partnership Act), which does not bind parties to fiduciary duties.

The development of corporate-type LLCs is also reflected in the recent revision of the Uniform Limited Liability Company Act of 1996. The Revised Uniform Limited Liability Act of 2006 (RULLCA) provides a modern, updated legislation governing the formation and operation of LLCs. The noteworthy new provisions clarify the ability of members to define and limit the duties of loyalty and care that members owe each other and the LLC. Moreover, the revised Act codifies buyout remedies similar to those found in close corporation statutes. To be sure, section 701(5)(B) of the Revised Act permits a member (but not a transferee) to seek a court order 'dissolving the company on the grounds that the managers or those members in control of the company . . . have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the [member]'. However, as in the close corporation context, section 701(5)(B)(b) allows courts to craft a lesser stringent buyout remedy (unless the LLC's operating agreement states otherwise). Lastly, although the Act preserves the distinction between manager-managed and member-managed LLCs, it gives members a more corporate-type authority to bind the company. Section 301 explicitly states that a member of an LLC is not an agent solely by reason of being a member. The Act thus recognizes that the partnership doctrine of 'statutory apparent authority', by which a member can bind the LLC for apparently acting in the ordinary business of the LLC, does not belong in an LLC statute. The development towards a more corporate-type LLC would undoubtedly convince more states to adopt the model provisions that are stated in the uniform act. The evidence revealed in Figure 2 reinforces the view that the US-LLC has become the choice of business form for closely held firms in the United States.

Figure 2 – The Market Share of the LLC in Delaware



Source: Data derived from Annual Reports, Delaware Department of State, Divisions of Corporations

The US-LLC example is obviously an extreme one, but the development of uncorporations in other jurisdictions is not so different from the US situation. Most of the time (see Box 7), the combination of limited liability protection and a preferential – pass-through – tax treatment ensures that the uncorporation will be considered a success. Consider the S-LLP in Singapore, which was greeted enthusiastically by business participants. From 2006-2008, 5,234 I-LLPs were incorporated, which was approximately eight percent of the newly established private firms registered in Singapore each year from 2006-2008. Even though this figure may appear small in absolute terms, the diffusion rate is considered a partial success due to the limitations of and limited experience with the new business form in Singapore. Another 'disadvantage' of the S-LLP is that this uncorporate form needs at least two members upon its inception.

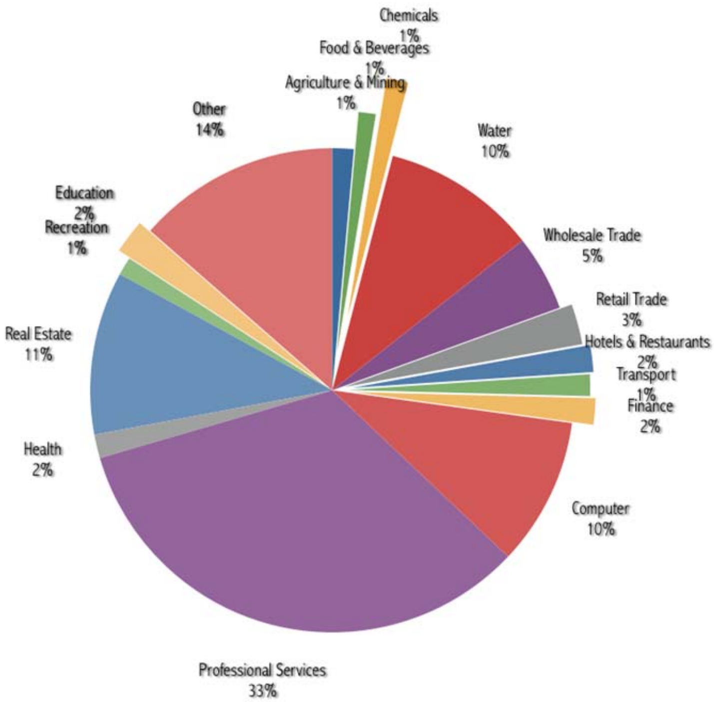
Box 7: Why Is the J-LLC More Successful Than the J-LLP?

As we have seen in Box 5, the J-LLP has attractive features, such as limited liability, a flexible organization structure and pass-through taxation. Despite these attractive features, the legislation mandates a number of highly restrictive and costly features including: 1) registration of the J-LLP agreement; 2) disclosure of financial information including the profit and loss statements and the balance sheet upon the request of creditors; 3) the mandatory obligation of partners to participate in J-LLP management and its operation; and 4) the right of partners to exit at will. These shortcomings, which reflect political compromises to obtain partnership tax treatment, have arguably led to the slow start as well as the already declining use of the J-LLP. Indeed, with respect to incorporations, the J-LLC has proved the more popular and enduring structure, partly due to the possible preferable tax treatment in international transactions: The J-LLC (in contrast to the traditional KK) could opt for a pass-through tax treatment in the United States. This pattern, which undoubtedly will improve the image and reputation of the J-LLC in the future, is revealed below, showing the increasing number of registrations from 2006 to 2010.

Entity	2005	2006	2007	2008	2009	2010
J-LLC	-	4066	9557	10785	13667	15772
J-LLP	366	1781	1725	1715	1650	1540

Source: Government of Japan, Ministry of Justice

Figure 3 – The LLP in India



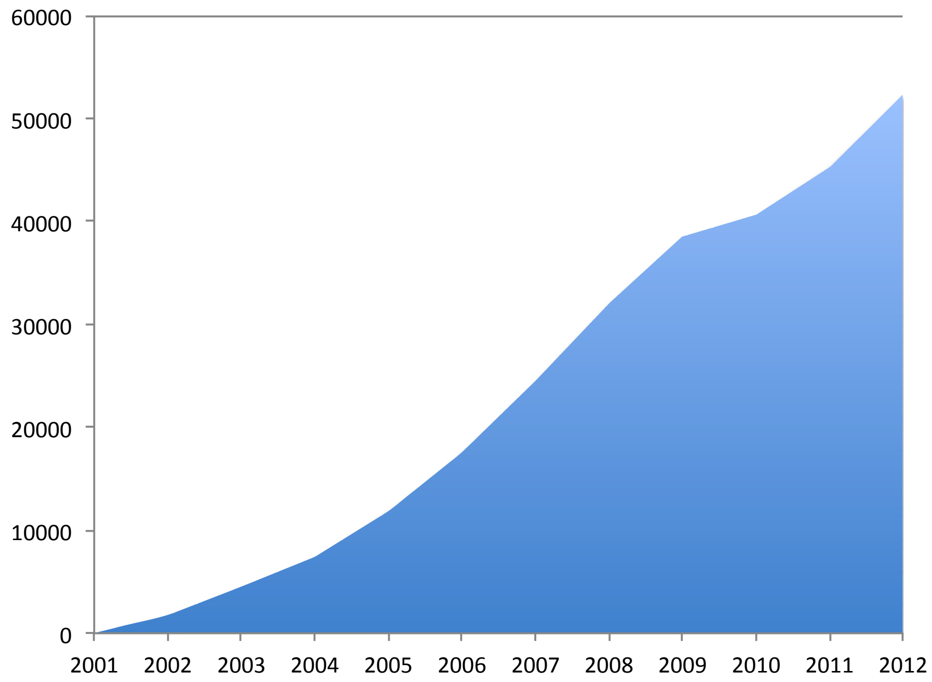
Source: Data derived from Government of India, Ministry of Corporate Affairs – 28 May 2012

In India, the LLP Act 2008 came into effect on 1 April 2009. The purpose of the Act is to stimulate the job-creation potential of SMEs. Despite the fact that I-LLP is a legal entity with two or more partners, the limited liability feature in combination with the partnership-type tax treatment, one of the advantages of the I-LLP, captured the attention of not only professionals, but also many other businesses across different sectors (see Figure 3). As of 28 May 2012, almost three years after its introduction, 9,395 I-LLPs were active.

4.2 Limited Liability and Simple Formation and Flexible Operation Requirements

It is widely acknowledged that choice of entity decisions are often based on tax considerations. Yet, the success of the UK-LLP and the French and Colombian SAS seems to cast doubt on taxation being the most important driver behind the success of uncorporations. Clearly, the corporate-type uncorporate forms in France and Colombia, which are both treated as corporations for fiscal purposes (see Table 3), have become the most favorable choice of entity for non-listed firms for other considerations than a more beneficial tax status. Indeed, the driving force behind uncorporations is often the concept of maximum flexibility and autonomy of the business parties (and their corporate lawyers) to structure the firm's internal affairs as much as possible free from the established legal principles and doctrines. For instance, while there are significant, unanticipated drawbacks during the pioneering development of the UK-LLP statute, corporate lawyers have already taken steps to avoid the most costly aspects of the Act by experimenting with key provisions within the LLP agreement for the benefit of the mixture of large and smaller firms that have contracted into this form. The result is that the UK-LLP has become a practical and useful vehicle for a variety of small and larger businesses, such as professional firms and joint ventures for property development. Particularly, the UK-LLP gained popularity during the recent economic downturn as it offers a simple and flexible business form with better protection for its members if the business runs into trouble (see Figure 4).

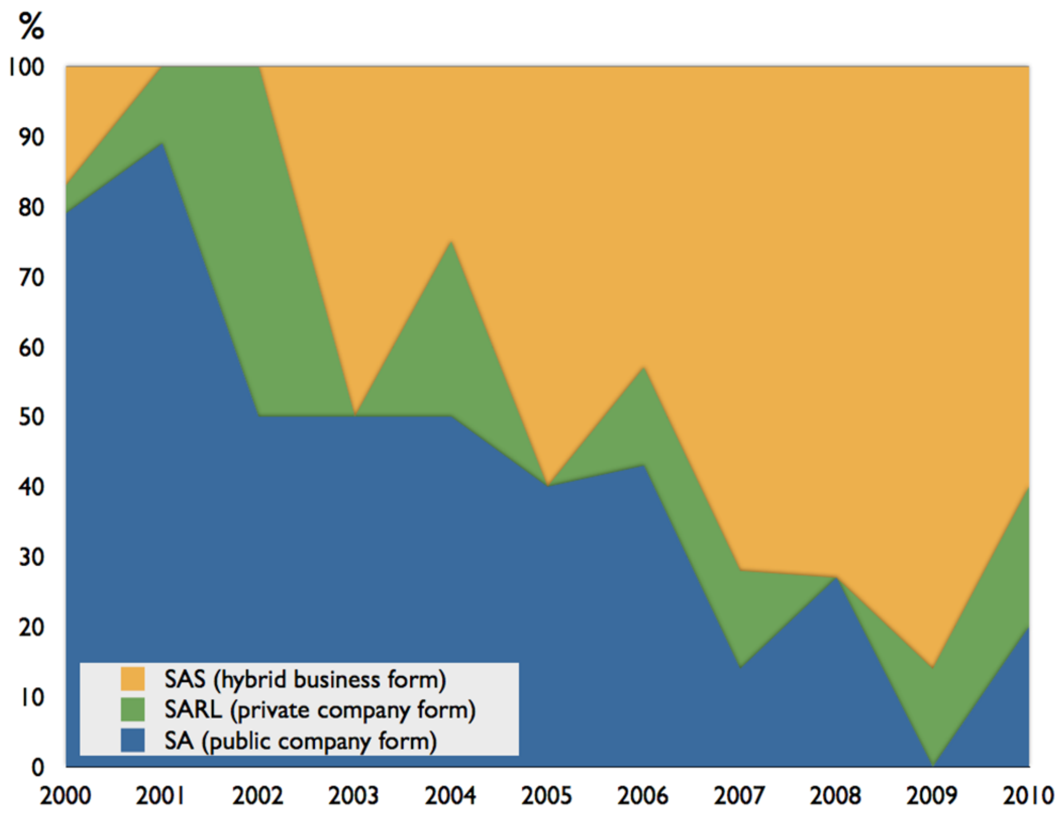
Figure 4 – The LLP in the United Kingdom



Source: Data derived from Companies House

In France, the SAS, already in 1999, created the opportunity for partners in a joint venture – and for other purposes – to adopt a legal structure that is sufficiently flexible in the organization and control of the firm. This vehicle allowed parties to choose the firm's decision-making structure and the contents of its bylaws. By making the corporate structure more adaptable to the business needs of SMEs and reducing barriers to incorporation, the French legislature has significantly increased the number of new domestic businesses and attracted an even larger number of foreign firms seeking a productive investment or joint venture. The most recent SAS reforms in 2008 were fashioned on the US-LLC. While the effect has been to create a more accessible legal business form for investors, some features of the SAS may require further attention by lawmakers. For example, the requirement to appoint a President to represent and bind the company sets a clear limit on the degree of organizational flexibility for the SAS. Moreover, unlike the US-LLC, the SAS does not provide a detailed set of default rules that could easily fill the contractual gaps for the parties' omissions. Despite these shortcomings, the SAS is perhaps the most entrepreneur-friendly uncorporation in Europe today that is also available to individuals. It should therefore come as no surprise that slowly but surely the SAS increasingly attracted high-tech start-ups and venture capital pioneers in France, which used to employ the public corporation (société anonyme) (see Figure 5).

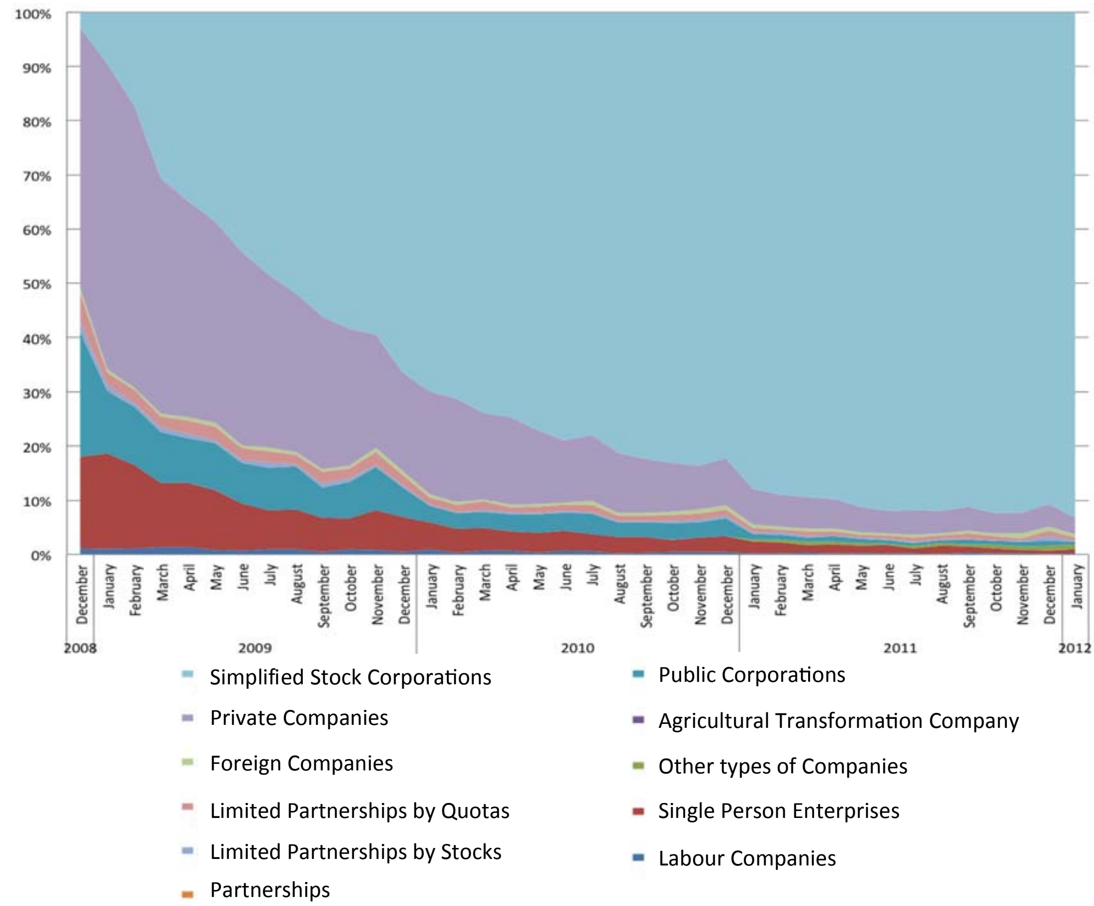
Figure 5 – The SAS in France



Source: Data derived VentureSource

In Colombia, the C-SAS ushered in a new way of doing business. Its flexibility and easy and cheap access to limited liability eclipsed the other forms of doing business, such as the private company and the stock corporation (see Figure 6).

Figure 5 – The SAS in France



Source: Francisco Reyes and Erik P.M. Vermeulen, Company Law, Lawyers and 'Legal' Innovation: Common Law versus Civil Law

4.3 A Model Act for Uncorporations

This Section considers the role of a Model Act in promoting the adoption (and eventual success) of uncorporate business forms in jurisdictions that still have a gap in the menu of business forms. A Model Act could provide a means to resolve coordination barriers which often beset lawmaking bodies. The function of a Model Act is to offer unsophisticated (and often unmotivated) legislators with the information, personnel, and scarce resources necessary to produce complex legal rules. In the United States, for instance, the American Bar Association 'participates' in LLC reform projects by publishing a Prototype LLC Act. The Prototype Act provides guidance for the analysis and resolution of issues surrounding the drafting of LLC legislation. The advantage of the participation of the Bar Association is that it can draw on its own resources when participating in the legislative drafting process. Even though there are high costs associated with participation in a law reform project, Bar Association members tend to place a high value on this service, partly because of the reputational benefits associated with the creation of new laws. In Delaware, for example, the top corporate law firms often pool their common resources to amend the corporation law statutes in order to satisfy their clients' needs for continuous updating and their own career concerns to retain their most valued corporate clients.

Model Acts create additional benefits: legislators can mitigate the negative effects of new legislation by relying on the reputation of the Model Act Committee. Indeed, model laws are for the most part drafted by disinterested lawmakers and experts, whose main concerns are reputational benefits and updating their legal expertise. Moreover, the Model Act drafting process, which relies on technical input from experts rather than interest groups, is more likely to produce coherent legislation. In contrast, the domestic lawmaking process, which relies on politically oriented decision-makers to reach substantive compromises, more closely tracks a political model of lawmaking. As a consequence, the legal rules produced will tend to reflect the interest group comprises overall. Finally, since drafters of model law are motivated by other considerations than uniformity, they will be less inclined to create value-decreasing statutes.

Given the several pitfalls in the evolution of uncorporation laws across jurisdictions, an international Model Act Committee appears to make sense. If a Model Act is widely adopted by jurisdictions, transaction and information costs will be reduced. A Model Act has the advantage of simplicity and lower administrative costs. It is also more appealing to the extent that the benefits of regulation are the same for all firms across jurisdictions. As a result, model laws help to encourage cooperation between firms situated in different jurisdictions. In addition to immediate benefits for firm participants, including investors and creditors, model laws are typically drafted with great care by panels of experts, thereby offering consistency in lawmaking. Finally, model laws have the potential to provide focal point solutions to coordination problems among jurisdictions. If model laws are viewed as being drafted by a group of experts and academics that takes into account the minimum needs of all of the states to an equal degree, these laws provide a prominent solution for coordinating behaviour. A Model Act would provide a focal point for each jurisidiction's expectation of what other jurisidictions expect a particular state expect to be expected to do. When more jurisdictions have adopted (parts of) the model solution, it becomes harder for other jurisdictions to stay behind.

5. What About the Uncorporations' Potential for Misuse?

5.1 Disclosure of Beneficial Ownership of Uncorporations

It is a common refrain that the corporate vehicles are often used to conceal the identity of beneficial owners, which obviously leads to an increased potential for fraud and illicit behavior. Specialists on financial crime and money laundering frequently note that perpetrators seek to avoid detection by creating a chain of company law vehicles in separate jurisdictions. Corporations, trusts, foundations, limited partnerships and now uncorporations, such as the LLPs and LLCs, are the vehicles most commonly associated with misuse. As we have seen, these corporate vehicles are relatively simple and cost efficient to set up. For example, an offshore company acts as nominee for an offshore principal. In this construction, the nominee company represents the offshore company, and transacts all the contracts and conducts the business on its behalf, including invoicing and accounting.

The advantages are that no invoices or other papers will appear in the file of the offshore principal. Such a construction, moreover, assumes that the nominee company will not trade in its country of incorporation, buy or sell goods in its own name, and sign contracts with the nominee company outside its home jurisdiction. In order to develop the chain, parties will go on to establish companies in a third jurisdiction and so forth. Setting up a chain of corporate vehicles is usually a cost-effective solution for multinationals in their efforts to establish corporate structures that help optimize the financial results of the group of companies. However, the anonymity created by these structures serves to benefit those involved in criminal activities. In this context, international institutions have moved to introduce measures that make information about the beneficial owners that control these chains of companies more readily available.

For instance, the OECD, which is concerned with combating corruption and money laundering, has articulated a number of policy objectives in respect of preventing the misuse of corporate vehicles.[18] The emphasis on restricting their misuse is in line with other international initiatives that seek to establish the appropriate standards to assist authorities and financial institutions that could effectively stem cross-border crime.

5.2 The Financial Action Task Force (FATF)

The Financial Action Task Force (FATF) issued its revised Recommendations (2012) to effectively combat money laundering, terrorist financing and the financing of proliferation. The 2012 Recommendations encourage countries to implement stricter rules and regulations that require companies or company registries to obtain and hold up-to-date information on the companies' beneficial ownership, or to have other comparable measures to ensure that such information is readily available. It is important to note that the FATF acknowledges that the implemented measures should be proportionate to the level of risk and/or complexity related to the use of beneficial ownership structures. By incorporating the 'principle of proportionality' in the Recommendations, the FATF significantly reduces the cost of regulation, while at the same time increasing compliance.

Transparency proponents may argue that the revised Recommendations do not go far enough. They view the 'principle of proportionality' as a serious obstacle to the implementation of the stricter Recommendations in practice. These responses suggest that the overall acceptance of the revised disclosure regime would be significantly higher if FATF puts more pressure on governments. In this context, it is noteworthy that recently US Senators Levin and Grassley introduced for the third time the 'Incorporation Transparency and Law Enforcement Assistance Act'. Under this proposal, the incorporation of corporate vehicles in the United States would require the collection and retention for beneficial owners of identity information for beneficial owners (names, addresses, driver's license or passport number) of corporations and limited liability companies (LLCs) which are not publicly traded or regulated. Moreover, the beneficial ownership information would be subject to subpoena by law enforcement. Despite the fact that promulgation of the Act would lead to a significant increase of the costs of incorporating in the United States, the Senators argue that the identification procedures will have a positive impact on the prevention of money laundering and illicit use of legal vehicles.

Indeed, we can observe that the company law reforms, particularly the emergence of the uncorporation, increasingly enable business parties to set up corporate vehicles without the intervention of professionals. It could be argued that this trend would only simplify the money laundering process. But there are other ways to improve acceptance of legal rules and requirements. One must bear in mind that corporate vehicles, in order to conduct activities, often have to open bank accounts that require the submission of VAT and corporate ID numbers. In fact, financial institutions remain the most suitable parties to prevent and combat money laundering. In this view, lawyers and other legal professionals provide an extra layer that serves as a safety net in the prevention of the financial system for the purpose of money laundering. It is thus important to encourage collaboration and information exchange between relevant regulators, supervisory authorities, intermediaries and private companies. FATF rightly puts emphasis on both national and international co-operation in relation to combatting fraud and illicit activities.

5.3 Intra-Governmental Collaboration and Information Sharing

If information about beneficial ownership in corporate vehicles becomes increasingly important in combating illicit activities, such a system stands or falls with the possibility for regulators, supervisory authorities and the like, to gain access to this information. Reforms in this area are geared towards

[18] See OECD, Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes, 2001.

the improvement of intra-governmental collaborations to not only obtain and maintain accurate information about beneficial ownership of corporate vehicles, but also to collectively detect and deter money laundering and tax evasion. In this respect, two different initiatives in Singapore and Australia are worth mentioning.

Singapore's Accounting and Corporate Regulatory Authority (ACRA) streamlined its company registration system and made it user-friendly by creating a one-stop business services portal (BizFile). The most important feature of the system is that government agencies are able to access secure information by simply obtaining a BizFile subscription. The web-based system can provide tailor-made information packages, thus eliminating unnecessary costs caused by going through irrelevant information, thereby reducing the risks of an information-overload. A web-based information system encourages intra-governmental collaborations.

Intensifying these collaborations has also been very successful in Australia under the name of Project Wickenby. This Project is a multi-agency task force that was formed in 2006 with an aim to protect the integrity of Australian financial and regulatory systems. It has been very successful as demonstrated by 'more than $1.1 billion in liabilities raised, as well as increased tax collections from improved compliance behaviour by participating taxpayers'. The task force combines the powers of several government agencies and authorities to conduct investigations, audits and prosecutions. Although the multi-agency collaboration has mostly focused on the fight against tax evasion, avoidance and crime, it arguably helps in reducing the illicit use of corporate vehicles. Activities under project Wickenby, such as civil investigations conducted by the Australian Securities and Investments Commission (ASIC), also help provide a clearer picture about beneficial ownership arrangements. If needed, the task force calls upon the assistance of governments and organizations around the world to jointly combat illicit activities.

But, encouraging information sharing among government agencies at a national level is not sufficient. At the same time, the internationalization of and innovations in financial markets make it necessary to intensify the collaboration among regulators and other enforcement bodies. There is an urgent need for information exchange on a more international scale.

6. Conclusion

The central reason for analyzing uncorporations is that this subject should begin to play a pivotal role in policy discussions around the world. If we consider the dominant position of the publicly held company in mainstream discussions on corporate governance, we understand why uncorporations have received less attention than the traditional corporate forms, particularly the public corporation. But there is no excuse for neglecting the needs of smaller companies. In this study, we have encouraged an expansive approach to company law and corporate governance, notably by bringing into focus the importance of the uncorporation, as a legitimate and important perspective for policymakers and lawmakers to think about when undertaking legislative reforms.

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