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Abstract

Close corporations have become the preferred vehicle for small and medium-sized enterprises in Europe. While scholars have debated the advantages of close corporation statutes for more than a decade, some who favour reform suggest that lawmakers devise new business organization statutes that are more varied, less complex, and can potentially enhance efficient outcomes. Indeed, since in most jurisdictions close corporations are a mirror image of their publicly held counterpart, small and medium-sized enterprises are burdened by a number of regulatory requirements, which cause them to incur substantial costs in carrying out their normal business activities. In particular, the imposition of many of the European Community's harmonized corporate law provisions on smaller firms is viewed as disproportionate and over-regulatory, and tends to impede the development of an efficient supply of legal rules.

Reform-minded scholars, supported by product and capital market pressures to supply the most competitive business statute for small and medium-sized enterprises, point to the success of the US Limited Liability Company (LLC), a flexible business form that combines the best features of partnership and corporate law. The aim of this article is to consider the possibility of making new business forms available in the European Union based on for instance the US LLC, which arguably leads to an increase in the number of start-up firms while also satisfying the needs of range of closely held firms. It is submitted that the combination of organized interest group pressure and the significant switching costs are an important barrier to the creation of new business statutes. Hence an important question is whether the introduction of competition pressures could limit the difficulties encountered in creating a flexible business form with few mandatory rules. Indeed, the combination of the European Court of Justice's recent judgments and the legislative inertia in the European Community's corporation law harmonization program has stimulated considerable interest in the role of competition among jurisdictions. This article suggests that, despite a significant pent-up demand across Europe for businesses to incorporate in low-regulation jurisdictions, it is difficult to predict with certitude the circumstances that would lead to the development of regulatory competition in the closely held business form context. However, we argue that standardization of law could be a contributing factor in the introduction of new business forms within the European Union.

JEL Classifications: G34, K20, K22, L20

The Evolution of Closely Held Business Forms in Europe[*]

Joseph A. McCahery and Erik P.M. Vermeulen

1 Introduction

This chapter grows out of the on-going debate among European academics on the need for an expansion of the menu of business organization forms to meet the needs of firms at all levels. Advocates of such reforms claim that company law structures in Europe, which provide a highly developed legal framework and limited liability, are cumbersome and costly for closely held firms to apply. Proponents who favour reform suggest that lawmakers address the problems by devising new business organization statutes that are more varied, less complex, and can potentially enhance efficient outcomes. Traditionally the business organization law available for small businesses has been structured around the needs of larger, publicly owned companies. In most jurisdictions, closely held business forms are burdened by a number of regulatory requirements causing firms to incur substantial costs in carrying out their normal business activities. Moreover, the imposition of many of European Community's (EC) harmonized company law provisions on small firms is viewed as disproportionate and over-regulatory, and tend to impede the development of an efficient supply of legal rules. The current debate on the regulation of closely held firms can be explained in terms of a tradeoff between the need for creditor protection, in case of firm failure, and the commitment to supply legal rules, which gives owners the ability to maximize wealth (DTI 1999: 57).

European scholars who express concern about the importance of mandatory requirements as a mechanism to protect creditors and other interests in the firm have justified harmonized rules as a means to avoid a race to the bottom (Deakin 2001). According to this view, the mandatory rules, such as minimum capital requirements, disclosure rules and accounting rules, play a fundamental role in the development of the regulation of companies in Europe. The law and economics perspective stands in contrast to the EC's uniform approach (Romano 1993). A large body of work has focused on the benefits and costs of uniformity. On the one hand, uniform rules have the advantage of simplicity and lower administrative costs. Moreover, uniform rules are more appealing to the extent that the benefits of regulation are the same for all firms. On the other hand, uniform rules lead to higher costs for different types of firms. If firms are heterogenous, efficient regulation calls for the provision of diverse menus of rules in order to reduce the risk of suboptimal uniformity. In EC context, the common thread in this body of work has been the effort to demonstrate that harmonized rules are cumbersome and costly measures which are not sufficient to regulate externality problems. For instance, minimum capital requirements aimed at protecting the

[*] An earlier and different version of this essay was published in the proceedings of the Tilburg University Law School Conference on Close Corporation and Partnership Law Reform in Europe and the United States, and in the Journal of Corporation Law.

welfare of creditors are costly and haphazard restrictions, which interfere with private orderings while promoting inflexible financial structures (Enriques and Macey 2001: 1186-1194; Freedman 2000: 335-38). Consequently, the ability of private parties to obtain superior protection in the market demonstrates, in certain circumstances, the EC mandatory law framework cannot be an efficient approach to limit externalities.

More recently, the relative merits of designing legal rules aimed at the needs of the closely held firm has been stimulated by product and capital market pressures to supply the most competitive business statute for small and medium businesses (SMEs) (DTI 1999: 58). While scholars have debated the advantages of private company statutes for more than a decade, the discussion of competition-based lawmaking for limited liability companies in Europe represents a new departure. Given the presence of market-driven pressures, national regulators are being forced to begin making changes in their corporate law regimes. However, in the absence of freedom of choice in corporate law, it cannot be assumed that lawmakers will generate optimal business law forms for different types of firms.

Indeed, to the extent that national lawmakers have few revenue-based incentives for researching and designing the optimal rules for all types of firms, they have attempted -- for the most part -- to apply to governance structure and mandatory provisions designed for publicly held firms to their closely held counterparts. Thus, the persistence of the suboptimal statutory frameworks is explained by the failure of small firms' to lobby lawmakers to create a new business organization form that benefits their special needs. Ultimately, the issue posed is whether, in the absence of regulatory competition, the 'integrated framework' that seems to prevail across Europe will dominate, or whether as a result of increased competition, the 'free standing approach,' which involves creating a separate limited liability company statute for small firms, can emerge.[1] Under the circumstances, concentrated incumbents may have the political power necessary to constrain the struggle between the two approaches, and the current bundle of rules may persist despite the possibility of an alternative that promises to yield greater value.

The current debate addresses the relative merits of each model. Reform-minded scholars have pointed to the efficiency enhancing characteristics of the US Limited Liability Company (LLC) and Limited Liability Partnership (LLP), which are tailored to meet the special needs of closely held businesses (Ribstein 2001). On the other hand, critics have questioned the effectiveness of these new forms for small businesses and whether they promote economic welfare (Freedman 2000: 327-34). An important reason why commentators are concerned about the new closely held firms is that, by virtue of the organizational structure, there is a natural fear of opportunism which may turn out to be harmful to participants in these firms (Vestal 2001). Nevertheless, the LLC is becoming very attractive because it provides for small companies a standard form contract that combines the most

[1] To be sure, many European jurisdictions have a separate limited liability vehicle for closely held firms, e.g., the German limited liability company (Volhard and Stengel 1997: 6-8).

attractive features of partnerships and corporations (Ribstein and Kobayshi 2001). From a European vantage point, the new business statutes are attractive if they are likely to enhance the productivity of small firms. However, the efficiency- enhancing characteristics of the new legal structures may be a weak factor in a politically constrained environment. The combination of organized interest group pressure and the significant switching costs could limit the allure of new business statutes. In such circumstances, policymakers may be strongly disposed to adapting the main features of the existing regime.

The aim of this paper is to give consideration to the possibility of making available new business forms in the EU based on the LLC, which could lead to an increase in the number of start up firms as well as satisfying the contracting needs of a range of SME firms. This chapter examines the theoretical arguments about the importance of new organizational forms, inspired by the LLC, for entrepreneurs and SMEs. An important question is whether the introduction of regulatory competition is necessary to overcome the difficulties encountered in promulgating a vehicle that has few mandatory rules. One goal of our paper is to extend the debate over regulatory competition to closely held organization forms. In principle, one could imagine a European member state becoming the dominant producer of law as product by moving first to establish a legal infrastructure and a bundle of rules that fully benefit the firms incorporating in the jurisdiction. More specifically, the point of this chapter is to show how the development of an innovative business organization form like the LLC– which arguably has significant cost advantages for a broad class of closely held firms (particularly start-ups) – can be expected to strengthen the company law regime of the state choosing to create the statutory innovation, thereby potentially inducing rival member states to supply similar sets of rules.

The purpose of our paper is not to show that the introduction of a new free-standing form will induce competitive lawmaking in Europe, but that its emergence may create additional pressure on legislatures to respond faster and more effectively to the changing needs of start-ups and other closely held firms. Solving the problems of European company law will take more than the introduction of competition between member states. As such, the approach taken in this paper has the potential to shed light on the nature of institutional and legal problems that pervade the company lawmaking process and offer insights into how a new organizational approach could affect changes.

This chapter has five sections. Section 2 begins by setting out the recent history of European company law. A competitive environment for reincorporations has yet to develop due to the siège réel doctrine that governs in most member states. In recent years, however, the combination of a new decision by the European Court of Justice (ECJ) and the legislative blockage in the EC's company law harmonization program has stimulated considerable interest in the competition between jurisdictions. While the real seat doctrine continues to restrict firm mobility, the ECJ's recent judgment in Centros[2] and Überseeing[3] may, in the near term, encourage the introduction of competitive lawmaking within the European Union (EU). This analysis is extend the analysis by pointing out that member states may gain by competing to supply flexible business organization forms for closely held businesses. In fact, some of this sort of competition which is stimulated by cross-border tax competition (Carney 1997: 327; Code of Conduct Group: 1999). Consequently, there are adequate incentives for governments to create better business organization vehicles. However, the recent expansion of private business forms which have appeared over the last decade are disadvantaged by a legal framework that includes European company law requirements, particularly the imposition of a minimum capital requirement and other disclosure rules, and legal rules that derive from public company law. This paper argues that there are a number of interest group barriers (e.g., notaries) that prevent member states from adopting legal business structures that would make closely held firms better off. The legal regimes that entrepreneurs use for their businesses are likely to give rise to high costs and do not meet the full range of contracting needs for, for instance, banks and suppliers of private equity and entrepreneurs.

However, this chapter suggests that the United Kingdom, which has important differences from Delaware, has recently taken the necessary steps to provide a wide menu of business forms. We maintain that the combination of interest group pressures and a suitable company law regime is confirming evidence that the conditions are favorable for regulatory competition. Further support for this view is evidenced by the interest of government regulators to supply new business statutes in response to the treat of competition posed by offshore jurisdictions for reincorporating entities. Even though there is significant pent-up demand across Europe for businesses to incorporate in law-regulation jurisdictions, it is nevertheless difficult to predict with certitude the circumstances that would lead to the development of regulatory competition in the LLC context.

Section 3 analyzes the institutional and legal structures in the United States and Europe that give rise (albeit to differing degrees) to competitive lawmaking in the field of partnership-type business forms. In section 4, we argue that the creation of a separate statute, based on the US LLC, is desirable because it would result in substantial benefits to entrepreneurs and investors lead to the erosion of barriers that limit the introduction of these statutes. We argue, despite the potential efficiency-enhancing effects of such a form, there may be considerable resistance to its adoption. We conjecture, however, that an entrepreneurial state could be well placed to begin changing their legal structures in response to the needs of the business community. Section 5 concludes.

2 Reflections on European Company Law

In this section, we briefly describe the current developments in European company law. Three

[2] Case C-212/97, Centros Ltd. v. Erhverv-og Selskabsstyrelsen, 1999 E.C.R. I-1459 (1999), 2 C.M.L.R. 551 (1999).
[3] Case C-208/00, Überseering BV v NCC Nordic Construction Company Baumanagement GmbH.

central trends appear to emerge. First, the basic requisites for regulatory competition are missing in the EC. Second, in terms of the debate over competitive lawmaking, the emergence of new judgments from the European Court of Justice (ECJ), which apparently reflects changes within the EC about decentralized lawmaking, provides evidence that regulatory competition for newly formed corporations is an imminent possibility. Third, the development of new statutory organization forms for closely held firms could be stimulated by increased competitive pressures.

2.1 Developments in European Corporate Law

One of the most important debates in European company law is whether the market for corporate law will ultimately emerge within the European Union, and if so, whether it will be based on a Delaware-like model in which companies can freely select their country of incorporation (Ebke 2000: 625-28). The virtual absence of any lawmaking behavior that arguably resembles American charter competition, in the face of mounting economic pressure to reduce existing levels of regulation, suggests that there are substantive legal and procedural barriers to the establishment of jurisdictional competition in the European Union. Indeed, European company law seems to be immune from the evolutionary pressures of competitive lawmaking due largely to the implementation of the European Directives that have given the substantive corporate law of the member states a mandatory quality. The framework of European corporate law can be viewed largely as a patchwork quilt of mandatory rules on accounting standards, capital maintenance, disclosure standards, domestic mergers, the formation of companies, and securities regulation. The gaps in the company law harmonization program are significant (Hopt 2002: 189-93). They can be traced to fundamental disagreements among member states with regard to employee participation, the EC's subsidiarity principle and its presumption favoring decentralized regulation, and the reluctance of member states to implement the harmonized rules (Wouters 2000: 275). As well as having little legislative success with key aspects of the EC's harmonization agenda, the diversity in corporate law norms in the various member states is thought significant enough to create an additional structural barrier to the Community's economic integration efforts. For instance, at the national level, there are noticeably few incentives for lawmakers to modify regulatory design or reform inefficient rules because of legislative inertia and special interests. At a fairly high level of generality, the differences in the normative arrangements between the continental and common law systems partly explain the deeply rooted conflict among the member states over the direction and pace of the company law harmonization program. These insights provide important clues as to why only a small number of EC-level policy initiatives have met with legislative success.

At present, the debates about the blockage of company law harmonization initiatives all attempt to deal with the substantive conflicts and practical administrative concerns among member state governments and their difficulties in arriving at a productive compromise. It is under such conditions, that a number of scholars have argued that increased exposure to competitive market pressures could, in the absence of legislative change, alter the pattern of existing governance structures. For example, John Coffee (1999) has asserted that the impressive recent growth of continental European stock markets could have a beneficial influence on regulatory reform, reinforcing a shift toward increased levels of disclosure and investor protection. For a number of reasons, the EC has been successful in its efforts to harmonize securities law. It is reasoned that, given the close relationship between securities regulation and corporate law, it should be possible by extension to replicate the success with corporate law harmonization (Coffee 1999: 658-59). Still, despite the increase in capital markets pressures, a strong coalition of interest groups and other path dependent forces have largely limited the ability of lawmakers to alter or substantially modify inefficient rules in the European Union.

Scholars who have expressed concern about the barriers to legal convergence have argued that the increased European cross-border acquisition of firms operating in weakly protective governance systems by companies with better access to external capital will have a positive effect for investors and may prompt corporate governance transformations. For some commentators, it will be the decline of the governance and funding role of main banks, and the corresponding influx of institutional shareholders from high quality corporate governance systems, that will likely trigger a disruption in ownership patterns and the stability of control-oriented governance systems based on exclusionary relations between main banks and firms (Gordon 1998). The post-2000 decline in the high technology stock market and the diminishing pace of IPOs will, if anything, additional pressures, which are already formidable, for governance reform. As a result, the changing market relations will give way to increased competition and formal convergence. The common thread of this diverse body of work has been the effort to identify changes in capital market activity and regulation with the convergence of corporate governance institutions.

The traditional European perspective on company law stands in contrast to the functional convergence model of legal change. Most European scholars are not optimistic about the prospects for market-induced reform of the institutional and legal infrastructure in the EC, notwithstanding the partial harmonization of securities regulation. Fundamentally, the forces, which encourage the development of higher disclosure standards and investor protection, have not had sufficient political support to induce changes to the EC's corporate law structure. The recent inability of the EC Council of Ministers to adopt the 13th Directive on Takeovers is an obvious example of the ability of large German-based corporations, and family-owned firms, which benefit from the current inefficient practices, to block transformational measures (McCahery et al. 2003). Viewed in this light, it would appear that the institutional environment of European decision-making, notwithstanding the advent of a more flexible approach to company law harmonization, is ill-suited for the introduction of agency-reducing corporate law.

It should also be stressed that, besides the existing institutional barriers at the EC level, the development of corporate law has been constrained by several other factors. First, reincorporation costs in Europe make firms immobile. Under the siège réel doctrine, which is followed by the majority of member states in the European Union, a corporation is regarded as fully formed and constituted in the jurisdiction where its headquarters are located. A reincorporation trigger taxes on hidden reserves--effectively restricts demand for firms to opt into different national governance systems. Second, European patterns of corporate regulation and equity capitalization do not open up market opportunities for revenue-seeking jurisdictions. National governance systems do not allow for much shareholder litigation and some restrict shareholder voting rights. Third, Europe's normative landscape is complex. Crucially, labour codetermination in Germany and employee participation structures elsewhere create a barrier to a regulatory system directed to the preferences of managers and shareholders (Wymeersch 1998: 1045). This dampens the demand for responsive lawmaking in the European Union. It is not surprising, therefore, that national legislatures and non-shareholder groups are happy with the current institutional arrangement that impedes legal reforms aimed at improving the welfare of shareholders.

However, even though the dynamics of European company law have not changed fundamentally in more than thirty years, recent developments in EC case law could eventually undermine the siège réel doctrine and set the stage for strong competition among jurisdictions in furnishing corporations with optimal rules. This chapter takes the occasion of the European Court of Justice's recent decision in Centros and Überseering to enter the debate about the desirability of competitive lawmaking in the EU. The Centros case, which appears to question the Court of Justice's Daily Mail judgment that the siège réel doctrine is compatible with the freedom of establishment, has injected new interest in the need for more flexibility and contractual freedom in EC company law. Proponents of regulatory competition submit that Centros permits start up companies to select the least costly legal system. For example, Ronald Gilson (2001), in trying to explain the implications of the ECJ's judgment for the introduction of regulatory competition, argues that the Centros case creates a hybrid mechanism of formal and functional convergence. He contends that the mechanism is form, in the sense that what is at issue is the selection of binding rules of business organization law, but functional, in the sense that as a result of the ECJ's decision, European law is sufficiently flexible to allow at least newly formed firms to adapt their governance structures in response to changing economic conditions.

Even though regulatory competition may not be the aim of the ECJ's intervention, Centros could very well usher in a new era of competitive lawmaking with regard to business forms in Europe. Of course, commentators may take refuge behind a phalanx of obscure and convoluted statements in the ECJ's decision in order to defend the siège reel doctrine (Halbhuber: 1409). That said, the conclusion that Centros stimulates regulatory competition is in line with the policy laid down by the European Commission in the 1985 White Paper on Competing the Internal Market. This new approach to lawmaking aims to limit harmonization efforts to the essential minimum, and provide for mutual recognition of national regulations (Woolcock 1996: 289-90). It is only to be expected that the ECJ will continue along the path it set about developing in Centros. The Centros decision constitutes the necessary causal conditions for further evolution of the regulatory competition framework. The ECJ's judgment also affects litigation decisions and the lawmaking process in general. In this respect, it is worth pointing to the Überseering case, referred to the ECJ by the Seventh Chamber of the German Supreme Court, involved a Dutch close corporation (Besloten

Vennootschap (BV)) which had moved its actual central administration to Germany. In its judgment of 5 November 2002, the ECJ found that where a firm incorporated in accordance with the law of a member state (A) in which it has its registered office, is deemed, under the law of another member state (B), to have moved its actual center of administration to member state B, Articles 43 EC and 48 EC preclude member state B from denying the legal capacity and, consequently, the capacity to bring legal proceedings before its national courts for the purpose of enforcing rights under a contract with a firm established in member state B. But even if one takes the view that the siège reel doctrine is not wholly contrary to European Union law and decides that the matter must be dealt with by future legislation or conventions, European lawmakers will be on the brink of embracing competitive lawmaking in the context of business forms.

As a consequence of Centros and Überseering, start-up firms can choose from among the number of member states that offer less restrictive regulations and more favorable conditions to long-term relational contracting. As noted above, the absence of a minimum share capital requirements is also an attraction for many small undercapitalized firms. In this context, the United Kingdom, which has signalled its commitment to regulatory responsiveness by offering a varied and high quality corporate law, could be well-placed to establish itself, like Delaware in the United States, as the leading state for incorporations in Europe (Cheffins 1997: 435-40). To be sure, charter fees and franchise taxes, which provide a high-powered incentive to Delaware to enter the competition for business forms, do not encourage the United Kingdom. However, the United Kingdom could dominate firms' domicile choice as a side-effect of its aspiration to attract large volumes of business and risk capital. The United Kingdom has a substantial body of case law and a highly respected judiciary that could be an important advantage in this respect. The United Kingdom also has a responsive legislature that may be motivated to develop amendments to its company law regime in response to demands in the marketplace. Another attractive feature which could have a significant effect on attracting firms is that UK company law is significantly more flexible vis-à-vis other European jurisdictions. Furthermore, the popularity of the United Kingdom for larger companies and financial intermediaries suggests that it will be willing to offer legal rules that may be attractive for these firms. To the extent that UK attracts a large number of new companies and is seen as the jurisdiction where a company might keep its corporate headquarters, lawmakers have incentives to provide legislation that can attract firms incorporated in other states.

Paradoxically, further harmonization could be the last resort for member states to protect their present system against the competitive pressures of the United Kingdom (Ebke 2000: 658; Ribstein 2001). Viewed in the context of deregulation, simplification of laws and subsidiarity, there is not much prospect of the EU issuing new directives and extending their scope to closely held business forms. Indeed, recent evidence shows that a number of member states which are highly vulnerable to the pressures of market competition, such as Germany, may be driven to institute reforms to their closely held business forms so as to stem the flow of out-migrating firms to the United Kingdom (Bachmann 2001: 365). The foregoing developments suggest that the United Kingdom company law regimes poses a competitive threat to EC member states and could be well-positioned to compete successfully for out-of-state incorporations as this market fully develops. Moreover, even if UK lawmakers lack a charter revenue motive to attract foreign corporations, they will seek to provide legal rules that are attractive to firms' managers because British business lawyers and accountants will benefit from increased fee revenue (Cheffins 1997: 435). Unlike their counterparts in the US, the British bar associations have yet to step in to solve collective action problems regarding the drafting and enactment of beneficial legislation. Of course, UK lawyers and accountants will be even more willing to undertake the commitment to develop new corporate law when they face competition from other states to retain in-state companies. As will be shown, British accountants have, to the extent they are sufficiently incentivized to externalize costs, mobilized to lobby lawmakers to enact legislation in order to meet their demands and preferences

2.2 Recent Developments in Closely Held Company Structures: The European Union

The previous section argued that the recent ECJ's decision in Centros and Überseering should encourage the development of competitive lawmaking for entrepreneurs, SMEs, and other newly incorporating firms. According to the analysis presented above, the United Kingdom may stand to benefit from meeting the needs of businesses by supplying them with a full range of limited liability forms that can create value. In this section we focus on the factors that led the UK to enact a separate LLP statute into English law. This section will finish by discussing other initiatives to reform business organization laws in continental Europe and at the level of the European Union.

2.2.1. United Kingdom

For many years, European policymakers have been concerned with introducing new organizational forms intended to provide cost advantages for entrepreneurs and small firms. The existing body of empirical evidence, however, reveals that few jurisdictions have rushed to supply flexible business organization statutes that offer cost-saving advantages for closely held businesses. In this context, we have witnessed recently a new UK initiative from the Department of Trade and Industry that involve the establishment of new partnership arrangements that may entail economic benefits for individual firms. Prompted by competition from offshore LLPs, particularly that of Jersey, UK lawmakers recently promulgated a Limited Liability Partnership Act.[4] The legislation introduces a vehicle that has legal personality, a partnership governance structure, limited liability, and

[4] Limited Liability (Jersey) Law 1996. Motivated by liability and tax considerations, British accountants provided a wholly crafted statute to Jersey lawmakers, a largely passive and accessible body, that decided to adopt the statute. In speedily adopting the statute, Jersey signalled its commitment to a comprehensive set of business forms for foreign organizations. However, high switching costs and doubts about the prospective benefits of incorporating as a Jersey LLP may explain Jersey's failure to capture a share of the UK partnership market, see Freedman and Finch (1997: 414-15) (enumerating potentially serious problems for firms intending to move to Jersey); (Payne 2000: 134).

partnership tax treatment.[5] In drafting this legislation, the Department of Trade and Industry responded to the pent-up demand from existing partnerships, which wished to transfer to limited liability partnership (LLP) status. Although the LLP Act was initially drafted to address the professional negligence concerns of large accounting and other service providers in England, the statutory provisions, as enacted, cover all types of businesses.

Yet even if it represents a new policy direction in partnership law, it cannot be viewed as creating a successful, low cost solution for SMEs--notwithstanding the flexibility and access to lower-cost rules afforded by the introduction of the Act. Among other considerations, firms that opt into the LLP form are required to comply with many of the provisions of Part VII of the Companies Act 1985, concerning the preparation of audits and publication of accounts, some provisions of the Companies Act in relation to the registration of charges, the delivery of accounts; the investigation of companies and their affairs, and the Insolvency Act in relation to voluntary agreements, administrative orders, and the winding up of the business. As a consequence, with respect to some operating formalities, the LLP resembles a corporation. In some other respects, and chiefly its decision-making rules, the LLP resembles a partnership. However, the new LLP makes it very costly for entrepreneurs and small firms to structure their relationships through this particular type of business organization form. Even though the LLP supplies its internal members limited liability, the disadvantages of the flimsy statute, which requires firms to comply with corporate default rules, outweigh the practical benefits of the legal form. Hence, unlike its US namesake, the UK LLP is not a general partnership with limited liability. On the contrary, like the US LLC, the UK LLP is a hybrid between a partnership and a corporation. Both business forms are intended to allow firms to obtain the benefits of limited liability while retaining the tax treatment of a partnership. However, they are superficially more similar to a corporation, in that many provisions of the statutes draw directly from the corporate model.[6]

In short, that UK 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 to meet their special requirements. The outcome is that, while the LLP extends limited liability to all types of firms, the effect of high transaction costs will arguably limit its suitability for most SMEs. While there are significant, unanticipated drawbacks during the

[5] The Limited Liability Partnerships Act 2000, and the Finance Act 2001, provide that LLPs be classified as tax partnerships.

[6] The ULLCA draws many provisions from RUPA. However, many state statutes adopt a more corporate law approach, see Hamilton (2000: 25). As for the UK LLP, it is likely that where there is no agreement and the Regulations do not help, the default position is corporate law. This is reflected in section 1(5) of the LLPs Act 2000, which states that, except far as otherwise provided by this Act or any other enactment, the law relating to partnerships does not apply to a limited partnership. See Comment Company Lawyer (2000: 96) (noting that the international tax treatment of an LLP by non-UK countries may not be transparent, because an LLP is not actually a partnership but rather a corporate body); Freedman (2001) (arguing that 'LLP' is a misnomer for the UK legal form, which is closer to a corporation).

pioneering stage of the LLP statute, the statutory framework may eventually evolve into a more efficient regime. Assuming that a large number of firms convert to the LLP form, the increasing use of the law should lead to the creation of more beneficial statutory terms. If the LLP proves to be insufficiently flexible and ill-suited to meet all of the needs of small and medium firms, lawmakers might—in light of the government's policy to provide the most competitive legal firms possible for commercial businesses seeking limited liability and transferability of shares—eventually take steps to adopt new legislation targeted to the needs of the class of firms effectively barred from switching to the LLP form.[7] However, while the prospects for new legislation depend on the success of the lobbying efforts of organized interest groups in combination with the threat of external competition, in the absence of a revenue-based incentive, it is far from clear whether lawmakers will undertake a new company law initiative for the benefit of unorganised small firms.

2.2.2. France

A second example of responsive lawmaking in Europe is the 1994 introduction of the société par actions simplifiée (SAS) and its subsequent modification in 1999.[8] In recent years, the competition between states for real inflows of capital has caused member states to adopt a variety of new business forms designed to stem the outflow of taxable resources. The pressure of competition from the Dutch private company (besloten vennootschap, or BV), which is viewed as a more suitable closely held business form, stimulated French lawmakers to adopt a new organizational structure that has significant cost benefits for firms (Wouters 2000: 286 n. 120; Wymeersch forthcoming 2004). As conceived, the SAS creates the opportunity for partners in a joint venture—and for other purposes—to adopt a legal structure that is truly flexible in the organization and control of the firm. This vehicle allows for parties to choose the firm's decisionmaking structure and the contents of its bylaws. Arguably, the SAS holds out the potential to provide cost saving benefits that may attract new incorporations, allowing France to compete effectively with Germany, the Netherlands, and the United Kingdom. By making the corporate structure more adaptable to the business needs of SMEs and allowing its shareholders to be both individuals and legal entities, the French government

[7] See Freedman (2001). Despite its complex and cumbersome quality, the earliest empirical evidence on registrations of LLPs complied by Jordans shows that, in fact, SMEs are most attracted to this new limited liability vehicle. Astonishingly, more than 75% of the 600 or so of the LLPs registered since April 6, 2001 have been drawn from the wider business community. See News Digest Company Law (2001: 317). Allegedly, SMEs are attracted to the LLP, as this form has important advantages over other business forms, such as the private company and the general partnership. For instance, by forming an LLP a firm avoids paraphernalia associated with companies, while obtaining credibility. Moreover, the LLP might be viewed as a focal point around which a new network will arise. That professional firms are lagging behind other business firms could partly be explained by the reluctance of professionals to disclose their financial details (Freedman 2001; Peel and Eaglesham 2002). Nevertheless, the publication of the Statement of Recommended Practice for Accounting for LLPs is expected to increase interest in the LLP even more. As at 8 July 2002, 2580 LLPs had been registered in England and Wales.

[8] Law No. 94-1 of Jan. 3, 1994 J.O., Jan 4, 1994, p. 129; Law No. 99-587 of July 12, 1999, J.O., July 13, 1999, p. 10396. See Guyon 1999.

would probably have increased the number of new domestic businesses, and perhaps a small subsection of SMEs. Regardless of whether business activity increases as a result of the adoption of the SAS, critics argue that the complexity of the SAS may lead to incomplete contracting, since the statute fails to supply a comprehensive statutory template that the parties can fall back on when establishing the distribution and allocation of powers and responsibilities. There are a substantial number of issues that parties cannot contract for themselves ex ante due to the absence of sufficient legal precedent necessary to write joint venture agreements.

Moreover, provisions in the French civil code relating to the companies (as well as all the SA provisions) apply to the SAS (Lazarski and Lagarrigue 2000: 108 & n.10). It is clear that incorporation under the SAS framework may be costly and problematic. Not only are the general corporate law provisions complex and onerous, but management must take steps to draft bylaws in order to ensure that general corporate law provisions are not applicable. It is clear, moreover, that the judicial application of the corporate law provisions to the SAS might also lead to some uncertainty. Even if contract parties are willing to accept the challenge of drafting an agreement for the SAS, transaction costs, information asymmetries, and strategic behavior could prevent them from bargaining their way to an optimal agreement. Consequently, even if the SAS can provide more flexibility for closely held firms, the costs involved in complex legal drafting to adapt the public corporation framework to the needs of a close corporation will discourage most firms from incorporating under the SAS. If this is the case, the difficulties in modifying the SAS to benefit small and medium firms could prove problematic. Indeed, French lawmakers have been slow to revise the inefficient statutory provisions that have a costly impact on smaller firms (ibid. 106). By allowing SMEs to employ the SAS framework, without the value of corresponding benefits for these enterprises, French lawmakers were apparently motivated by calculations of self-interest to offer window-dressing than introduce reforms that redistributive effects. As with the UK LLP, government lawmakers will likely achieve much more by developing a variety of legal rules that are directly beneficial to closely held firms.

2.2.3. Germany

Whilst bereft of competitive pressures, the German legislature has made several amendments to its traditional partnership forms through the revision of the Commercial Law in 1998.[9] For instance, the German legislature followed the recommendation of the European Commission that member states should introduce the continuity of partnerships into their national laws. In this view, the unsophisticated entrepreneurs should not be victimized by inefficient fallback provisions that oblige them to dissolve their businesses (e.g., in the event of the unforeseen death of any partner) (See §131(3) German Constitutional Code (Handelsgesetzbuch (HGB)). In all likelihood, the continuity of business is the appropriate default rule. It may well reduce transaction costs, because most

[9] The German legislation has reformed several provisions of partnership law as part of the Handelsrechtsreformgesetzes in 1998 (Schmidt 1998).

partners will be spared the need to reach a private agreement on this issue.

The revision of the Commercial Code does not benefit partnerships generally, however. (See §131(3) German Commercial Code (Handelsgesetzbuch (HGB)). It only applies to the commercial partnerships formed and registered for commercial purposes, such as general partnerships and the limited partnership.[10] The law concerning the civil partnership[11], which does not have commercial objects (e.g., agriculture, forestry, educational and professional activities), does not recognize the continuity of the partnership as a legal principle. The death or bankruptcy of any partner causes the dissolution of a German civil partnership when nothing to the contrary has been agreed.

While there is no distinction between civil and commercial law in Commonwealth countries, the principle has been deeply rooted in continental European jurisdictions. In partnership law, it entails that professional service firms are prohibited in principle from using a commercial partnership. While the distinction may explained by history rather than compelling logic, there are nevertheless several important consequences attached to the commercial qualification of a partnership (Kessler and Schiffers 1999). Most importantly, commercial partnerships are generally characterized as legal entities by code or by judicial usage. Typically, entity status can be acquired by official registration. But even when legal personality is not explicitly conferred to commercial partnerships, which the case in Germany, there is a preponderance of entity-based features: the partnership has its own rights and obligations; the partnership may sue and be sued in its own name; and the partnership can hold title to property (See §124 German Commercial Code (Handelsgesetzbuch (HGB)).

Yet the difference between civil and commercial partnerships is gradually diminishing over time. Commercial law reform in Germany has broadened the scope of general and limited partnerships not explicitly regulated by the commercial code ((See §105(2) German Commercial Code (Handelsgesetzbuch (HGB); Schmidt 1998: 62). The only prerequisite is that the partnership must be entered in the commercial register. Moreover, case law and commentary increasingly attribute entity features to ‘external’ civil partnerships, which enter into legal relationships with third parties (Gummert 1995). In fact, it might be argued that the German legislature has more or less confined the entity status of the civil partnership (See §§190 German Business Transformation Act (Unwandlungsgesetz (UmwG)).

Despite the improvement, the question of whether the civil partnership may sue and be sued in its own name is still open to dispute (Gummert 1995; Schmidt 1997: 1805-18). Furthermore, despite

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

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

the efforts to attribute entity features to partnerships, creditors generally maintain their right to enforce their claims against partners individually. Partly because of the acceleration of malpractice claims, professionals organized as civil partnerships had to find another way to structure their business with some kid of limited liability protection. In order to meet their special needs, the German legislature promulgated a professional limited liability partnership (Partnerschaftgesellschaft) in 1995 and 1998.[12] The German limited liability partnership offers the benefits of the ability of partnerships to sue and be sued in its own name and adopts techniques for limitations of liabilities arising from contractual and tort claims against the partnership.

In response to British legislative initiatives, German academics do recommend that domestic lawmakers become more involved in responsive lawmaking. Corresponding pressures have not sufficiently emerged in practice to warrant German legislative attention to the competitive pressures highlighted in the academic debate. Nevertheless, Germany's popular commercial partnership-type business form, the GmbH & Co KG (Meyer 2002: 182), which has already created considerable learning and network effects in Germany, has the potential to increase Germany's share of the European venture capital industry. Further more, the limited partnerships with shares (Kommanditgesellschaft auf Aktien (KGaA)), in which the general partners have exclusive management control and the limited partners may transfer their shares freely, appears to respond to the pent-up demand for more easily tradable equity investments.[13] As interest in venture capital funds already change hands increasingly in the secondary market, the conversion to a combination of limited partnership and public corporation, which offers ready access to liquidity and market price, could be a viable alternative. In order to be competitive, legal and fiscal complications regarding these hybrid business forms should be minimized. Although Germany has recently created law and regulations clarifying the positions of these vehicles,[14] more needs to be done to

[12] Initially the Partnerschaftgesellschaft, which is regulated by the Gesetz über Partnerschaftsgesellschaften Anghöriger Freier Berufe (Part GG), was not very popular. Indeed, at the time of enactment, case law also paved the way for professionals to incorporate. See BGH NJW 1994. 786 and BayObLG NJW 1995, 1999, and Sommer (1995). Recently, the German legislature acknowledged professional corporations such as the Anwalts-GmbH (Römermann 1999). Professionals have the choice of either selecting the Partnerschaftgesellschaft or incorporating. Since both procedures appear to be costly and cumbersome to individuals (for instance, the Partnerschaftgesellschaft statute is linked awkwardly to both the civil and commercial partnership rules), they had often attempted to limit their liability by publicly limiting the authority to act for the partnership and adding 'limited liability' (mit beschränker Haftung, mbH), to the civil partnership's name. This attempt to introduce limited liability into the partnership form was rejected by the German Supreme Court (BGH v. 27.9.1999-11 ZR 371/98). The Court stated that a partnership's liability could not be limited by either a name extension or other indication.

[13] This hybrid form was used frequently in the period when corporations existed by virtue of a concession by the government. Currently, the KgaA is viewed as an intermediate business form between the close corporation and the public corporation (Meyer 2002: 186-87).

[14] For example, the enactment of the conversion code (Umwandlungsegesetz) in 1994 simplified the procedure of converting a GmbH or GmbH & Co KG to a GmbH & Co KGaA. See Halasz et al (2002). The popularity of the KGaA may increase with the recognition of the German Supreme Court in 1997 (BGH v. 24.2.1997—II ZB 11/96, BGHZ 134, 302) that a corporation could be the sole partner in a limited partnership with shares.

make them the standard structure for European venture capital funds. For instance, consideration should be given to codifying 'safe harbour' provisions that state to what extent a limited partner may participate in the control of the firm so as to improve certainty and accessibility to foreign investors. The law should also be more generous in liability protection for a limited partner, if the formation of the limited partnership or the admission of the limited partner have not been filed in the commercial register.[15]

2.3 Developments at the EU Level: the European Private Company

The foregoing discussion of the difficulties in changing national corporate law regimes to create a framework that meets the needs of closely held firms leads to a general observation: the linkage of public corporation law to closely held firms is likely to be inefficient. States seldom supply default rules that are optimal for the operation of closely held firms. This raises the question whether it is necessary from a cost-benefit standpoint to propose the adoption of a common set of European rules for closely held firms.

While EC regulators have pursued harmonization of public corporations and the protection of shareholders in order to achieve further Community integration, there has been no real attempt to adopt a series of similar measures for the benefit of closely held companies (Boucourechliev 2001). Over the last decade, Brussels lawmakers have adopted a series of approaches to the development of common rules, notably the 12th Directive and the European Economic Interest Grouping. Beginning in 1995, a group of European business leaders and legal experts of different nationalities, brought together on the initiative of CREDA, the research centre of the Paris Chamber of Commerce and Industry, have been attempting to develop an appropriate organizational structure for SMEs.[16] The group has proposed the introduction of a draft European Private Company (EPC)

[15] The §176(1) German Constitutional Code (Handelsgesetzbuch (HGB)) states that a limited partner who agreed with the commencement of the business is unlimitedly liable for the limited partnerships' debts and obligations incurred before the registration of the partnership in the commercial register §176(2) provides that a new limited partner is unlimitedly liable for debts and obligations incurred after his admission and before the amendment to the registration. For an example of §176, see Schmidt (2002). This article gives an intended limited partner explicit protection from general partner liability if he erroneously believed he was a limited partner and did not give a third party any reason to believe—in good faith—that he was actually a general partner at the time of the transaction. Re-RULPA §303 provides that a limited partner is not personally liable, even if the limited partner participates in the management and control of the limited partnership.

[16] In general, Brussels lawmakers have focused on publicly held corporations and their equivalents. Over the last decade, they have adopted a series of approaches to the development of close corporations, notably the Twelfth Directive on single member companies and the EEIG (Lutter 2000: 7-8). However, the High Level Group of Company Law Experts released, on 4 November 2002, the final Report on a Modern Regulatory Framework for Company Law in Europe which stated that the EPC is not considered a priority for the European Commission in light of the concern to pass a Tenth and Fourteenth Directive on cross-border mergers and the transfer of registered or head office. Recently, the EC accepted the recommendation of the High Level Group that a feasibility study be conducted to assess the implications of a legal statute for SMEs (Commission of the European Communities 2003: 21-22).

which is designed to be flexible enough to accommodate all types of firms in different business situations (Helms 1998: 1-3). In contrast to the European Company, which is grounded on the German Aktiengesellschaft and therefore mainly aimed at publicly held firms, the EPC has been designed so as to offer closely held firms, which are particular SMEs wishing to develop on the European market, a Europe-wide, simple and effective form that meets their specific requirements. The draft EPC regulation is very concise, comprising only thirty-eight articles (CCIP/CNPF 2001). The EPC draft articles of association require that parties specify the rights of the shareholders, the organization and operation of the company, and the powers of its governing bodies. These steps appear to make the EPC a less complicated and a more flexible form of business entity. For example, the draft EPC Regulation offers substantial flexibility to vary the firm's decisionmaking structure by providing, like the US LLC, the opportunity to vary from a shareholder-managed governance structure to a manager-managed structure. Usually most European close corporations are viewed as owner-controlled firms; consequently, the new form may offer parties more flexibility than other business forms.

The drafters have incorporated few mandatory rules into the EPC regulation which should suit the needs of different types of firms. At first blush, the flexibility of the EPC structure, combined with limited liability, would be sufficient to outweigh the absence of some defaults and the utilization of certain EC Directives. However, few believe that the new draft EPC regulation can resolve the practical difficulties which prevent its immediate adoption and implementation by the member states. Besides the resistance from national groups, there is concern that the draft regulation holds out few cost-saving benefits for small firms. The first problem is that, despite the significant differences between close and public corporations, the draft EPC regulation, which is designed to offer enterprises in the European Union a genuine European corporate form, incorporates the Second EC Directive, which presents an insuperable barrier (Schutte-Veenstra 2001: 322). Second, the draft EPC regulation supplies few default rules that the parties can adopt off-the-rack.[17] From a

[17] The European Private Company aspires to become an all-purpose vehicle with respect to closely held business forms. The draft regulation (see Appendix, this collection) allows business parties much leeway in organizing their firm and the relationship between them. In order to help parties save substantially on transaction costs, the drafters of the EPC regulation have created a model standard form 'Articles of Association' (Article 13). Model A is a standard form for small 'member-managed' quasi-partnership firms. Model B is intended to meet the needs of larger businesses with one or more 'passive' investors. Statutory ambiguity and linking problems are likely to ensue from the 'unified business form' approach, which expects all types of closely held business firms to organize under one statute. With respect to the EPC, the vexed question is one of which fiduciary duties courts will apply to shareholders of an EPC. The Regulation and the Model Articles of Association are silent on this issue. The Explanatory memorandum, however, states that the EPC should be viewed as a company 'not issuing shares to the public, and the shareholders of which are bound by a strong bond of partnership, a true company of associates.' Unless these complex issues are resolved by the drafters, we can expect few firms to be willing to opt into this European business form, given the uncertainties. It might be argued that the omission will lead to incomplete contracting, since the Regulation and model Articles of Association fail to supply a comprehensive statutory framework. The fact that Article 12 of the Regulation provides that the 'matters governed by this Regulation shall not be subject to application of the law of Member States, even with respect to those points which it does not settle expressly'

small firm vantage point, the costs involved in creating their own contract-based rights are substantial, and parties will obviously have few incentives to reorganize under the current draft EPC regulation. It should, however, be possible for the drafters to create default terms that enhance the private ordering by making the law clear and predictable to parties governed by such terms. Presumably, the number of firms that would be forced to incur the costs of contracting around the untailored default rules is very small. The foregoing point about the evolution of the draft EPC regulation suggests that the persistence of inefficient terms may be due to the inability of the drafters to overcome the EC company law inertia that prevents the promulgation of off-the-rack standard form contracts tailored to meet the needs of small firms.

2.4. Path Dependency

The previous Section asserted that the needs of close corporations are not easily met through the adaptation of public corporation statutes or EC Directives, emphasizing the theoretical importance of making available a coherent set of standard forms that provide limited liability and direct management in a separate statute. Not surprisingly, a free-standing legal business form may be necessary to modify the current corporate law framework, which is inefficient and burdensome for closely held and public firms. Much as in the US context, a separate framework may be necessary for closely held firms because of the uncertainty created by the judicial interpretation of EC Directives (which were intended to regulate public corporations) by the ECJ (Wouters 2000: 265-66; Ayres 1992: 387-88).

In light of these and other factors, what explains the persistence of inefficient rules for closely held firms in Europe? There are a number of explanations. First, even if a particular business organization form would make closely held firms more efficient, it may not be in the interests of most lobby groups (i.e., professional advisers and creditors) to modify the law to allow more efficient forms to emerge. Predictably, governments respond by failing to adopt value-increasing legislation from which they could derive valuable tax revenues and other economic benefits. Consequently, lawmakers present a good case for adapting the existing, suboptimal regime to meet the needs of small firms (DTI 1999: 64-65).

Second, there are few incentives to introduce legal innovations. The standardization of provisions in corporate codes may account for the lock-in to the existing mandatory provisions. Many law-and-economics scholars take for granted that when network externalities or learning effects are present, the value of a contractual term increases (Kahan and Klausner 1996). Statutory terms under the public corporation codes confer large network benefits to users of those statutes. In most EC member states, the majority of firms are organized under the provisions of a general corporate code.

only complicates the practical use of this form. In addition, the reference to the general principles of the Regulation, Community company law, and the general principles common to national laws (see Article 12 of the Regulation) does not exactly clarify the gap-filling discretion of courts.

Such codes not only create large network benefits, but firms also expect to obtain further benefits as new companies incorporate. The learning benefits which come from the use of the corporate code also explain why most parties that originally opted into the general corporation code have an incentive to continue to use the regime (Bratton and McCahery 1995: 1900). If these benefits are taken into account, newly formed companies will likely migrate to the business corporation statutes that confer larger network benefits to the user. This will mean that demand will be higher than it otherwise might be, which in turn will lead to the supply of standardized terms rather than customized terms that benefit small firms. Because standardized terms offer certainty, business lawyers, when advising clients about incorporation decisions, will recommend a standardized term—even if suboptimal—rather than draft a customized term that could lead to a higher expected value for a client (Bernstein 1995: 248). The result, in turn, is that continuous use of the dominant business form, even if not ideally suited for some firms, will serve to reduce the incentives for lawmakers (and lawyers) to innovate. Like other areas of law reform in continental Europe, the reluctance to diverge from the existing company law framework means that, even if new business forms were adopted, parties might be unwilling to substitute the standard form for nonstandard terms (DTI 1999: 64). In short, the benefits that accrue to a standardized general corporation regime may be sufficient to outweigh the benefits that small firms could realize by shifting to a separate statute designed for small companies.

3. The Prospect of Regulatory Competition in Europe

The potential introduction of new business forms holds out the prospects of overcoming the negative effects of lock-in. We now turn to regulatory competition theory and ask whether competitive lawmaking provides sufficient incentives to create adequate demand for the introduction and diffusion of new LLC and partnership-like forms in Europe. The recent development of closely held business forms appears to be consistent with the assertion that even imperfect regulatory competition is an effective means to bring about more efficient laws.

3.1 The US Experience: Competition among States

In the context of corporate law, regulatory competition (a legislative process in which governments endeavour to provide a more favourable regulatory environment, to promote the competitiveness of domestic businesses or to attract more business activity from abroad) (Woolcock 1996: Bratton and McCahery 1997b: 220-43) has been well publicized in the United States (Romano 1993). The US legal system traditionally views business organization law in general as a local matter reserved to the states' governments (Bebchuk 1992: 1438). Consequently, the corporation statutes of some states may differ appreciably from those of most other states on many critical matters. Once US business owners decide to incorporate, they must select an attractive state of incorporation. Under traditional conflict-of-law rules, courts will respect this choice even if the corporation in question has no other contact with the chosen state. The corporate laws of the incorporating state govern the basic rights and duties of a corporation and its participants. As a result, the revenue generated by the charter fees and franchise taxes, which can be collected directly from incorporating firms, gives smaller states a high-powered incentive to provide attractive rules (Romano 1993: 38). The ability of firms to incorporate in those states with the most attractive legal regimes, and the eagerness of states to 'steal' corporations from each other, have led to the emergence of a potentially robust market for incorporations in the United States.

At the end of the 19th century, New Jersey and Delaware, concerned about incorporation decisions, adopted modernized general incorporation statutes. Eventually, Delaware's statute made it the leading incorporation state in the United States since the 1920s, presently serving as the state of incorporation for nearly half of the corporations listed on the New York Stock Exchange and more than half of all Fortune 500 firms (Romano 1993: 6-17; Fisch 2000: 1061). In addition, Delaware is also the leading destination for firms that opt to reincorporate. Clearly, Delaware's value to incorporating firms is more than an up-to-date statute. The possibility of other states rapidly free-riding on the efforts and resources of the Delaware legislature by copying its statute would entail Delaware's lead being exhausted in a very short period of time. Free-riding by other states acts as a severe disincentive to invest any resources in legal innovation. If the possibility existed of other states rapidly free-riding on its legislative efforts and resources, Delaware would not consider legal change so as to keep its rules attractive for a variety of firms in the future (Ayres 1995: 545-50). Nevertheless, the attractiveness of Delaware as the incorporating state lies in significant 'first-mover' advantages in the production of corporate charters. For instance, the less easily replicated judicial expertise and other enduring advantages, such as a well-developed corporate case law, learning and network benefits, herd behaviour, and the superiority of Delaware's specialized chancery court, arguably preserve Delaware's leading position over time (Easterbrook and Fischel 1991: 212-13; Fisch 2000: 1063; Kahan and Kamar 2001: 121214; Romano 1985).

Delaware's corporate law plays a key role in the evolution of corporations in the United States, not only because regulatory competition has caused a widespread diffusion of its law (Carney 1997), but also because Delaware law provides an alternative set of rules which serve firms and their legal advisers across the country. Consequently, many commentators have dealt with the vexed question of whether the choice of Delaware's corporate law eventually leads to value maximization. In other words, is regulatory competition better described as a 'race-to-the-bottom' or as a 'race-to-the-top'? This question has been debated extensively in the US literature. Since this discussion is likely to become increasingly relevant to Europe it is worth providing a brief summary of the literature here (Bebchuk et al. 2002: 1800-1812; Daines 2001: 528).

3.2 Regulatory Competition: 'Race-to-the-bottom' or 'Race-to-the-top'?

As management decides where to incorporate, it is generally agreed that Delaware has produced corporate statutes that are attractive to incumbent management. Cary (1974), who started the debate on regulatory competition, argued that in order to attract corporations, Delaware had systematically tilted its corporate law to favour management at the expense of shareholders, creating a race-to-the-bottom. Against this background, Cary viewed regulatory competition as a means to achieve a sub-optimal level of regulations, and proposed a federal corporate statute that set minimum standards in selected areas of corporation law. Shortly after Cary's article was published, Winter (1977) criticized the race-to-the-bottom thesis. He argued that regulatory competition is an effective means to discipline self-interested government authorities, to promote innovation and supply optimal rules and regulations. In this view, management chooses the state of incorporation to maximize shareholder welfare. If this were not the case, corporations would raise less money from investors, and the value of a firm's stock would decline relative to stock in a similar firm incorporated in a state with value-maximizing laws, thereby increasing the probability of the incumbent management being displaced by a hostile takeover. In this view, regulatory competition induces states to enact corporate rules that are beneficial to shareholders. The race-to-the-bottom thesis offers no theoretical or empirical explanation of why shareholder investors, who are generally risk-averse, voluntarily entrust their money to managers who have no incentive to maximize their welfare or invest in firms incorporated in Delaware. Conversely, empirical work by Romano (1985: 265-83) and Daines (2001) supports Winter's assessment by demonstrating that Delaware law actually maximizes value, thereby undermining Cary's position that shareholders are victimized by regulatory competition (Easterbrook and Fischel 1991: 214-15; but cf. Bebchuk et al. 2002: 1886-90).

Yet some commentators continue to point to possible shortcomings of the competitive process that ensue from the divergence between the interests of managers and public shareholders (Bebchuk 1992; Bebchuk et al. 2002). In their view, the development of state anti-takeover legislation perfectly exemplifies the shortcomings of regulatory competition. Because of the ability of firms' management to capture state legislation, states (including Delaware) have developed anti-takeover statutes and judicial decisions permitting the use of defensive tactics that are overly protective of incumbent managers at the expense of shareholders (Bratton and McCahery 1995: 1887-89). If the possibility of shareholder exit by tender to a hostile offeror is severely threatened, market mechanisms cannot adequately align the interests of managers and shareholders. By providing a constant and credible risk of hostile acquisitions, the takeover market creates a powerful incentive for managers to restrain from managerial self-dealing. Assuming that the 'market-for-corporate-control' is economically efficient in that it increases firm value, regulatory competition has serious implications for the race-to-the-top thesis. Consequently, according to this argument, mandatory federal rules should at least ensure that the market for corporate control remains active, robust and competitive (Bebchuk 1992; Bebchuk and Ferrell 1999).

It is doubtful, however, that US business organization laws will be placed under federal jurisdiction in the near future. Although it is conventional wisdom among US scholars that regulatory competition produces a race-to-the-top with respect to some areas of corporate law (Bebchuk and Ferrell 1999: 1171), it certainly has its flaws. First, states do not pursue regulatory competition solely by offering rules that meet their clients' needs. High-powered interest groups within a particular state induce the competitive process because of considerable tangible benefits. It has been argued that Delaware's corporation law is devised to maximize the amount of work performed by lawyers who are members of the Delaware Bar (Macey and Miller 1987: 491-98). By providing standards and ambiguous default rules rather than rules that are clear in application, Delaware law enhances the amount of litigation in the state (Bratton and McCahery 1995: 1887-88; Kahan and Kamar 2001: 1217). Delaware lawmakers thereby respond to the lobbying efforts of in-state lawyers who are able to capture a considerable share of the incorporating revenues, due to litigation-increasing standards.

Furthermore, since Delaware can rely on its dominant position in the market for incorporations, it could allow itself to prevent the emergence of optimal legal rules that would prevail in a perfectly competitive market (Kahan and Kamar 2001: 1252). Finally, recent empirical research indicates that regulatory competition in the context of corporate law is imperfect as not only the product quality, but also the location of the 'seller' plays a pivotal role. It appears that since firms display a marked home preference with respect to business forms, states are more successful in retaining in-state firms than attracting out-of-state business formations (Bebchuk and Cohen 2001). Thus, Delaware closely resembles a monopolistic 'seller' possessing market power and competitive advantages that other jurisdictions cannot replicate. The increasing return mechanisms act as substantial barriers to other states wishing to enter the market for out-of-state business formations.

Nevertheless, the shortcomings of regulatory competition are hardly a ringing endorsement of centralized lawmaking. Regulatory competition may not automatically yield an efficient outcome, but its legal product is arguably superior to what a centralized regime would produce. Even though it might be argued that the absence of competitive conditions gives domestic special interest groups less power to influence national lawmaking (O'Hara 2000: 1579-88), a centralized legislature in a federal regime is likely to be the object of the same or more intensive lobbying (Romano 2001: 573). In addition, that path-dependence factors will miraculously dissipate under a centralized regime is simply not plausible. Then again, the presence of conditions conducive to regulatory competition gives a state legislature at least some incentive to be responsive to changing needs and conditions of the business environment. Not doing so could arguably detract from the state's leading position.

To illustrate the point, let us suppose that regulatory competition induces state legislatures to benefit special interest groups, and local Bar members in particular. As we have seen, the Bar has an incentive to lobby for arbitrary amendments that give rise to judicial clarification. The leading state is likely to respond to the lobbying efforts as statutory modification and updates make it more difficult for other states to develop copycat legislation (Ayres 1995: 558-59). Yet interest groups appear to play a seemingly innocuous role when competitive forces from outside the legal system are present. It is therefore reasonable to infer that regulatory competition results in laws that are more public-regarding (Carney 1997). Even in the case of the enactment of anti-takeover legislation in Delaware, which suggests a stronger negative participation of the organized Bar in a competitive lawmaking process (Bratton and McCahery 1995: 1887), it is vital to note that Delaware's takeover statute has not been an innovative step, but rather a reluctant reaction to contemporary developments (Ayres 1995: 555-56). Interest groups' gain from inefficient legal procedures, and increasing litigation is arguably constrained by jurisdictional competition, which appears to provide a safety valve against harmful laws (Romano 1993: 862). The recent history of state takeover laws demonstrates the merits of state competition. That some jurisdictions have no or only mild anti-takeover regulation restricts how far other jurisdictions can go, as well as the influence of interest groups, especially when the milder laws are in leading states. That said, the moderation in lobbying efforts varies from one type of law to another. Because firm participants adopt business organization laws ex ante, the presence of competitive forces may well predict that lawyers' involvement in this field will produce a more efficient outcome.

The potential introduction of new business forms holds out the prospects of overcoming the negative effects of lock-in. We now turn to regulatory competition theory and ask whether competitive lawmaking provides sufficient incentives to create adequate demand for the introduction and diffusion of new LLC and partnership-like forms in Europe. The recent development of closely held business forms appears to be consistent with the assertion that even imperfect regulatory competition is an effective means to bring about more efficient laws.

3.3 Regulatory Competition and Closely Held Business Forms: the US Experience

The recent development of closely held business forms in the US appears to be consistent with the assertion that even imperfect regulatory competition is an effective means to bring about more efficient laws. To be sure, closely held firms usually employ local business forms. They are mostly organized according to the business organization laws of the state in which they have their principal place of business (Johnson 1997: 255). For many closely held firms, the relatively high costs of operating outside the formation state may exceed the benefits of organizing under a more efficient foreign business form (Ribstein 1992: 266). They must usually pay charter fees and franchise taxes to the formation state – not only for organizing within that state, but also for maintaining the entity status. In addition, they must pay (sometimes overlapping) taxes to the local state for the privilege of doing business there. More importantly, local business lawyers may be loath to give legal advice on the laws of other states. Generally, closely held firms, which are naturally hesitant to obtain legal services, have no alternative but to employ a domestic business form. This seems especially true of small and informal partnerships, as the participants may have no real expectations concerning the applicable law. In addition, the business organization laws for partnerships used to be remarkably uniform, making choice-of-law decisions largely irrelevant. For instance, the Uniform Partnership Act has been adopted in 50 of the 51 US jurisdictions, although there were variations in the wording of the Act.

The weak financial incentives for states to compete for closely held firms suggest that competitive lawmaking has no influence on the evolution of partnership-type business forms (Ayres 1992: 376-78; Bratton and McCahery 1997a: 675). Until fairly recently, state legislatures did not exert themselves in researching and drafting closely held business organization laws. However, recent empirical research seems to indicate that jurisdictional competition has gained a foothold in this area of the law as well.[18] The limited liability company (LLC) bandwagon that rolled across the United States in the early 1990s indicates that most states are responsive to competitive forces in the drafting and enactment of these business organization laws (Goforth 1995: 1271-72; Macey 1995: 447). Increasingly, states have supply-side incentives to take a proactive attitude toward legislative innovations in the field of organization laws, so as to capture and retain closely held firms. For instance, new entrepreneurial ventures are more mobile than large publicly held corporations in terms of the low decision-making costs of changing their state of organization in response to inefficient legal rules. Hence, smaller states that have acknowledged Delaware's supremacy with regard to corporate law may want to shift to another playing field not dominated by Delaware (Ribstein 2002: 39). By focusing on closely held business forms, these states may be able to 'skim a little cream' from Delaware (Kahan and Kamar 2002).

Still, Delaware does seem to have non-financial supply-side incentives to keep up with legislative innovations in the field of business organization laws in general. First and foremost, Delaware has to live up to its reputation of having a good business climate. Not doing so could have a bad spillover effect on its public corporation business (Romano 1992: 415). Conversely, publicly held firms could infer from its general preeminence in business organization laws that Delaware should also be responsive to their particular concerns. Second, even though the formation of partnership-type business forms would only constitute a small percentage of the franchise tax draw, Delaware's lawmakers have every reason to increase the share in the market for closely held firms, including joint ventures and investment funds (Bratton and McCahery 1997b: 677). As in corporate law, Delaware periodically amends its partnership-type business forms to keep them current and to maintain its national preeminence. Delaware has increasingly become a major forum of choice for the organization of limited liability companies and limited partnerships, for instance.

Because states do not have a high-powered incentive to compete for franchise fees, some US

[18] It appears firms participants in partnership-type business forms had not expectations concerning the applicable law, as there has long been a high degree of uniformity in state partnership law. Yet uniformity has broken down with regard to traditional partnership forms, and has never existed with respect to limited liability partnership and limited liability company forms, thereby increasing the importance of choice-of-law issues. In fact, state legislatures increasingly provide explicitly for statutory enforcement of formation state law for new entities, such as LLPs and LLCs. The Revised Uniform Partnership Act (RUPA) §106(a) replaces the complex Restatement (Second) of Conflicts §294 stating that subject to contrary agreement the law of the place of the chief executive office is applicable to relations among the partners and between the partners and the partnership (O'Hara and Ribstein 2000: 1204-05) (arguing that for the sake of predictability and certainty, the internal affairs of partnership-type business entities should be governed by the law of the jurisdiction in which they are formed; unregistered general partnerships should be governed by the law of the state of their principal place of business instead of the chief executive office). But see Vestal (1994: 256)(arguing that the Restatement (Second) rule meets the goals underlying the choice-of-law rules better than RUPA, which allegedly sacrifices the last vestiges of fiduciary-based partnership law).

commentators conclude that the evolution of new closely held business forms must be efficient. They point to a body of evidence supporting the rationale that regulatory competition produces welfare-enhancing outcomes (Ribstein 1995a, 2001). It might be argued that Delaware's Limited Partnership Act, like its corporate law statute, primarily accommodates the needs of the managers – the general partners – who choose the place of organization and, correspondingly, that it tends to be less protective of the investors, the limited partners (Bromberg and Ribstein 1999: §12.25(c)). However, since there is generally less or no separation between ownership and control in closely held firms, an inefficient trend in closely held business form legislation, like the anti-takeover statutes and judicial decisions, is unlikely to occur (Miller 1992: 407). The LLC, for instance, tends to evolve toward efficiency. First, by supplying the best features of corporations and partnerships, it offers an innovative solution for closely held firms locked into the less efficient corporation framework. The combination of flexible management, corporate-type continuity and limited liability presents clear advantages over both the traditional corporate and the partnership forms for a wide range of closely held firms. The inherent benefits of the LLC could help overcome disadvantageous increasing return and herd behaviour effects. Second, even though regulatory competition promotes diversity and experimentation, it appears that in the event of uniformity being efficient, LLC statutes have evolved toward uniformity (Ribstein and Kobayashi 2001: 118-19). The evidence, thus, suggests that the linking of the evolution of closely held business forms to regulatory competition generally should constitute a race-to-the-top.

Yet critics have questioned the efficiency of this 'product of regulatory competition' (Callison 2001; Freedman 2000). Proponents contend that, by virtue of their organizational structure, the new business forms create the conditions for opportunism, which may harm minority participants (Callison and Vestal 2001: 275). More importantly, critics are concerned about third parties. On this view, limited liability is not wholly efficient in the context of closely held firms. The proliferation of LLC statutes is only an indication of the legislatures' responsiveness to the business lawyers, who supported the LLC so as to increase fee revenues, and other special interest groups (Bratton and McCahery 1997a: 682-84; Callison 2001; Goforth 1995: 1272-74). In the light of the rapid enactment of new statutes by rivals, numerous state legislatures promulgated LLC legislation almost without hesitation, thereby failing to consider public welfare aspects. When other interest groups (e.g., trial lawyers) opposed the expansion of limited liability beyond the realm of corporations, because of the possibility of creditors being detrimentally affected, they were generally no match for their opponents. The upshot is that even if a variety of legal restraints, such as mandatory insurance and minimum capital requirements, are necessary to avoid the adverse consequences of expanding limited liability, legislatures are politically blocked by a sub-optimal trend in a competitive federal system (Bratton and McCahery 1997a: 667). Furthermore, to the extent that the extension of limited liability to partnership-type business forms is a piece of interest group legislation, courts are unlikely to respond with a coherent set of principles to guide judicial veil piercing, which could limit the effects of excessive risk-taking in certain cases by allowing creditors to reach the personal assets of internal firm participants.

Clearly, this has important implications for the efficiency of the lawmaking process in the US federal system. If the costs of limited liability are felt outside of the state providing the limited liability vehicle, a race-to-the-bottom could occur. Yet it does not necessarily lead to the conclusion that the effects of regulatory competition on closely held business forms are undesirable and inefficient. For instance, law and economics scholars are divided about the merits of the efficiency of limited liability (Easterbrook and Fischel 1991: 41-44; Leebron 1991; Hansmann and Kraakman 1991; Grundfest 1992; Alexander 1992). On the one hand, proponents argue that limited liability fosters entrepreneurship (Klein and Zolt 1995: 1029-30), facilitates capital formation and protects firms against the troublesome developments in liability law (Oesterle 1995: 881). The debate on the efficacy of limited liability for partnership-type business forms traced the outlines of the debate in corporate law on the subject of the extent to which limited liability should be restricted or curtailed (Ribstein 1991: 101-06). On the other hand, opponents have questioned the efficiency presumption of limited liability for closely held firms. In this view, the efficiency presumption of limited liability for closely held firms is under threat due to a series of interventions about its suitability in this context. The basic argument here is that limited liability is thought to have little impact on monitoring costs, liquidity, and risk diversification in firms that often do not separate ownership from control, have no intention of raising outside capital, and in which parties are often required to place all their eggs in a single basket. In fact, limited liability introduces the prospect of opportunistic behaviour, i.e., attempts by the participants to shift the risk of business failure to outsiders (Easterbrook and Fischel 1991: 49-61; Freedman 2000: 331-32). 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 (Hansmann and Kraakman 2000).

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 (Bratton and McCahery 1997a: 635). Despite the absence of evidence, many scholars argue that the benefits of extending limited liability to closely held forms outweigh the costs. It has been argued, for example, that the rapid diffusion of limited liability within the United States contravenes the argument that LLC statutes are inefficient. In reality, the ready acceptance of tort limited liability by all 51 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 (Ribstein 2001). 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.[19] Ultimately, neither of these claims provides theory or evidence that suggests

[19] For instance, in an era of excessive liability claims, professionals may refuse to provide their services in overly risky situations. The fear of legal liability also results in professionals taking more precautionary steps that have minimal expected benefits. Professionals hope that the use of limited liability vehicles lightens the liability burden.

that limited liability for small firms is likely to be efficient.

Of course, the uncertainty surrounding the efficiency of limited liability does not lend support to the introduction of federal regulations, such as minimum capital requirements, to protect voluntary and involuntary creditors to the firm. The reliance by some US states on these signalling devices to balance the levels of risk-taking is deceptive.[20] 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.[21] In any event, direct creditors, which are not the main beneficiaries of such legislation, are able to bargain efficiently so as to avoid any risk that may arise in connection with any contracts involving such firms.[22] More perversely perhaps, involuntary creditors are often unable, to adequately protect themselves under these devices, given their lack of information and bargaining power. For some type of firms, reputational barriers may well prove a more effective constraint when embarking upon risky projects. We must also bear in mind that firms will be much better off when they use limited liability vehicles that are acceptable to customers, banks, employees and regulatory bodies in the state in which they are geographically located. The conclusion is that the market for limited liability forms is unlikely to increase the risks for most parties, and in light of the degree of openness and competition in the market, may produce business organization laws that parties will prefer.

[20] In almost all states, regulatory competition has broken down the anachronistic mandatory capital requirements for corporations and LLCs. Most states in which minimum capital requirements for limited liability vehicles were practically universal three decades ago have sent these requirements into oblivion, since their protective effect was insufficient and only discouraged entrepreneurship. Ironically, the first LLP statutes were reluctant to provide partners with fully fledged limited liability protection. The first versions of the first LLP statute in Texas, for example, only shielded partners from liability claims created by errors, omissions, negligence, incompetence, or malpractice committed by other partners or by employees supervised by other partners. In addition, it required an LLP carry at least $100,000 of liability insurance or provide $100,000 of funds specifically designated and segregated for the satisfaction of judgments against the partnership. Slowly but surely, though, the idea of a corporate-type limited liability for partnerships—liability protection for both tort and contract claims without minimum capital requirements—seems to be accepted. See Bromberg and Ribstein (1998); Hamilton (1995); Ribstein (2002b). The reasoned acceptance of LLPs is yet another indication of the efficiency of easily accessible limited liability vehicles.

[21] In Europe, the current debate on the regulation of closely held firms can be explained in terms of a trade-off between the need for creditor protection in the case of firm failure and the commitment to supply legal rules that enable owners to maximize wealth.

[22] Closely held firms, although they are organized as limited liability vehicles, frequently extend liability to firm participants in the form of personal guarantees. Furthermore, since participants in a closely held firm have a substantial portion of their wealth tied up in the firm, they are unlikely to take excessive risks. See Meyer (2002: 250) (noting that empirical research in Germany shows that most participants in closely held firms cannot shield their personal liability in the case of bankruptcy). Thus seen, protection is perhaps illusory, but this illusiveness is no reason to prevent entrepreneurs from flocking to limited liability forms (Booth 1995: 562-63).

3.4 The Evolution of Business Organization Law in Europe

The evolution of European business organization law may well turn on the prospect of national lawmakers finding a compelling reason to abandon the defense of well-entrenched legal forms and the mandatory rules that reinforce their position and consequently block the diffusion of new innovative legal rules. However, given the way in which lawmakers have responded up to now, the emergence of a new separate legal statutes responsive to the needs of closely held firms would appear unlikely, particularly in the absence of the conditions necessary for competitive lawmaking. In most European jurisdictions, the SME business community is not likely to play a featured role in the development of corporate law legislation. Aside from the United Kingdom, where accountants already have played a central role in the adoption of an LLP statute, the national lawmaking process is led by civil servants who give priority to the preferences of large firm managers. Thus, unless SMEs and affiliated interest groups have the ability to influence the pattern of lawmaking, any statutory changes made will not be particularly beneficial to closely held firms. Nevertheless, we argue that where national lawmakers may decide to enter the regulatory competition arena by bringing to the fore legal rules that are acceptable to different interest groups, new statutes could promote the emergence of an efficient set of legal provisions and undoubtedly foster the conditions for competitive lawmaking.

It is important for responsive lawmakers to concentrate on the needs of closely held firms, not so much to attract these firms to their jurisdiction, but to create positive spill-over effects. Highly developed legislation for business firms at all levels signals that a jurisdiction is responsive to the demands of the business society. Furthermore, by having a legal framework in place for the smallest and simplest firms, jurisdictions mitigate the cost of statutory ambiguity and, hence, negative spill-over effects for business forms that focus on meeting the needs of more sophisticated firms. From this perspective, introducing an LLP-form designed with the 'think small first' approach in mind is arguably necessary to prevent distortion of choice-of-business-form decisions and the resulting legal problems that arise when economic actors choose sub-optimal structures.[23] This would allow choice of business forms to send a clearer signal about the parties' organizational needs, which is attractive to more sophisticated parties who do not want courts meddling in the internal affairs of the firm. It is submitted that there may be less need for liability protection for these very small

[23] Here, LLPs are viewed as a legal form for business associations consisting of two or more partners. However, US commentators point to the discriminating effect of having an easily accessible and flexible limited liability vehicle in place for businesses with two or more owners. In this view, a 'one-person LLP' should be recognized that not only allows individual entrepreneurs easy access to liability protection, but also gives them the advantage of the affirmative asset portioning that they lack when they conduct their own business as a sole proprietor, because there is no separation between the proprietors and the business they own (Hansmann and Kraakman 2000). Easily accessible limited liability vehicles for the smallest firms obviously raise the question of why limited liability is not simply a default rule for business forms at all organizational levels. Limited liability would then become an opt-out rather than an opt-in provision. In view of path dependence factors, however, it might be argued that lawmakers are generally not willing to prescribe to a limited liability default rule (Klein and Zolt 1995; Weidner 2001).

firms. However, it simply cannot be denied that many small firms, whether encouraged by 'legal' advisors or not, choose a business form because it furnishes them with the limited liability feature.

An LLP form should be formally linked to the default provisions of standard general partnerships.[24] This could be achieved simply by making the LLP provisions part of the general partnership statutes (RUPA: 1997: §306(c) and §1001). Even though limited liability diminishes the harm that partners can inflict on each other, firms that opt for an LLP form, i.e., the small 'mom and pop' businesses, arguably expect the same default rules as if they were organized as a standard partnership (Dickerson 2001). In fact, the LLP form should be the realization of the 'incorporated partnership' with easy exit provisions and broad fiduciary duties. Linkage also has the advantage that general partnerships can easily convert to an LLP without having to deal with the cumbersome formalities of changing to a completely new form. Finally, by organizing as an LLP the firm has access to the same network and learning benefits as the general partnership form.[25]

Yet outside the realm of small closely held business forms, linking involves significant costs (e.g., increased information costs and uncertainty, distortions in the signalling function of business forms, decreased coherence of terms, erroneous gap-filling by courts and negative spill-over effects) that outweigh possible linking benefits (Ribstein 1995b: 203-06). It is therefore suggested that a menu of separate business statutes would be more efficient in providing firms at different levels with different sets of default rules. In this respect, alternative business forms imply varying levels of control and commitment and help firms to tailor the organization of the business to their idiosyncratic needs. These distinct sets not only help to define the firm participants' expectations ex ante, but also assist judiciaries and arbitrators in filling gaps in the statute or the parties' contracts ex post.[26] Another advantage is that it is easier for lawmakers to create coherent and clear benefits for 'delinked' business forms, which are consequently better able to attract firms to their network

[24] For an overview of the different forms of linkage between statutory business forms, see Ribstein (1995b). Besides the situation in which business form statutes are linked in the sense that rules from one statute are applied to a business form created under another statute, Ribstein distinguishes three other variations on linkage: (1) explicit linkage (one statute governs two business forms); (2) implicit linkage (a business form statute imports language from other business form statutes); (3) implicit de-linkage (firms may waive certain provisions of a particular business form statute and so create a different business form).

[25] See Ribstein (2001). In the United States, the LLP is formally linked to the general partnership form and is therefore linked to the existing network of partnership law. In order to benefit from this network, firms could be expected to prefer the LLP to the LLC, which is not explicitly linked to the general partnership. However, empirical research shows that firms prefer the LLC business form (Ribstein and Kobayashi 2001). This evidence does not prove that network and learning benefits do not influence the choice-of-business-form decision. It suggests rather that other factors have played a more important role. For instance, LLCs used to give a broader protection against claims against the firm than LLPs. Moreover, if lawyers and other business advisors promote the formation of an LLC, the LLC may act as a focal point around which economic actors expect a new network to arise.

[26] It might be argued that the business form is becoming detached from the substance of how the firm is run. Admittedly, concerned outsiders of the firm, such as investors and creditors, are interested mainly in the substance of how the firm is run. However, standard forms can reduce the outsiders' cost of learning the terms of each the firms with which they contract (Ribstein 1995a: 375).

(Ribstein 2001).

The diversity of business firms could be a problem in designing appropriate sets of default rules. Most firms do not fit into a single mould. There are simply too many different types of firms, resulting in statutes that are either too constraining or too flexible and vacuous. An array of business forms could easily lead to inconvenience and confusion, thereby raising the partners' costs of choice and third parties' information costs of dealing with these different forms (Goetz and Scott 1985: Freedman 1999). It is surely inefficient to provide a business form for every possible type of firm. A greater number of business forms would not only overshoot the target of economizing on formation and information costs, but would also hamper the potential of conferring large network and learning benefits, which play a role in choice-of-business-form decisions.

The question is therefore of how many business form statutes there should be. The evolution of business forms in the United States provides some tentative answers. It is argued that the current menu of choices in the United States (consisting of the general partnership, LLP, LLLP, LLC and a flexible corporate form, among others) efficiently reflects firms' needs (Ribstein 2001). The impact of regulatory competition on the emergence and development of these business forms indicates that lawmakers contemplating reform must have taken the wishes and requirements of business firms into account. However, as most business forms are still evolving in the United States, it may be too simple merely to emulate the US approach, particularly given distinct legal and economic cultures within Europe. For instance, the US menu does not supply straightforward answers to the question of the extent to which business forms should be linked to each other. On the one hand, the development of the LLLP and the Re-RULPA suggests that the linkage between general and limited partnership law resulted in confusion in interpreting and applying limited partnership statutes (Vestal 1995). On the other hand, the evolution of the LLC reflects a tendency towards a process of ultimate linking – i.e., combining separate business forms into a single unified form. First, the LLC statutes are largely linked to general and limited partnerships and corporations. To the extent that LLC statutes do not contain explicit linking provisions, the 'pick and mix' of provisions of other business forms could entail implicit linking problems. If the statutes are silent on a particular issue, the import of general partnership provisions could imply that gaps should be filled with other partnership law rules. In the absence of statutory authority, courts could decide to extend general partnership principles to the LLC and to treat different business forms alike. For instance, since the Uniform Limited Liability Company Act (ULLCA) uses identical language to RUPA for its fiduciary duties, it is obvious that there will be some undesired spill-overs from one business form to the other (ULLCA 1995: §409). Second, even though most LLC statutes provide for decentralized management by default (Ribstein and Keatinge 1999: §8.02), it is also possible to opt for centralized management (ULLCA 1995: §203). This raises the issue of whether other default rules should also differ according to the parties' choice. In this respect, ULLCA provides for different fiduciary duty provisions, but similar dissociation and dissolution provisions. Courts could view this as a legislative omission and decide to apply corporate law rules to centralized management LLCs when the underlying relational contract remains silent. The incorporation of corporate governance principles could transform the LLC into an all-purpose vehicle, in which uncertainty and linking problems abound. However, in light of the jurisdictional competition, the emergence of a corporate-type LLC could also indicate that the menu of business forms in the United States is evolving towards a more efficient set of forms that reflects the preferences of a variety of firms (Ribstein 2001).

In Europe, as we have seen, the pressures of competitive lawmaking have also induced domestic lawmakers to take action and initiate law reform projects with respect to business organization law. To the extent that these lawmakers had few revenue-based incentives for researching and designing the optimal rules for all types of firms, they have attempted – for the most part – to apply the legal provisions designed for typical small partnerships or large publicly held enterprises to a wide range of closely held firms. The issue here is whether, in the context of regulatory competition, the 'integrated framework' that seems to prevail across Europe will dominate, or whether, as a result of increased competition, the 'free-standing' approach, which involves creating separate business forms, can emerge. Because most national legislatures in Europe voluntarily apply the EU Directives on publicly held corporations to the closely held corporate form (implicit linkage), it might be argued that the integrated approach prevails. This suggests that a major source of lock-in for most jurisdictions appears to be the implicit linkage of close and public corporation structures. We proposed, in contrast, that in a competitive legal environment, where the signalling function of business forms becomes more important, business forms for firm organization provided for by law should be adapted to prevailing forms of ownership and incentive structures. Given the significant role of a specialized judiciary and related case law in conferring large benefits to firms, a 'delinked' legal form that has distinctive statutory qualities for a certain group of business firms is arguably better equipped to commit courts and arbitrators to future responsiveness.

It seems clear that as Europe enters the competitive lawmaking environment, lawmakers will mainly focus on the needs of business firms that are most likely to engage in forum shopping. Since the Directives regarding publicly held corporations have reduced the feasibility of competition in the context of large corporations, European lawmakers will begin to turn their attention to 'closely held firms', such as large professional firms, venture capital funds, joint ventures and start-ups generally. Although jurisdictional competition in Europe is still in a developmental stage, the empirical evidence lends support to this view (Levin and Tadelis 2002; Milgrom and Roberts 1992: 522-23). We can already foresee a pattern of regulatory competition in context of business organization law that prompts competitive lawmakers to innovate by initiating law reforms and introducing new legal entities that are better equipped than the traditional partnership and corporate forms to meet the (changed) needs of these firms. In the next sections, we briefly review the evidence bearing on our claim that there is an urgent need for European jurisdictions to develop modern business organization statutes for professional service firms, venture capital funds, and joint ventures and start-ups.

3.4.1. Professional Service Firms

Due to its many advantages, the general or civil partnership form has long dominated the professional service industries. First, because the professional partnerships are very human capital-intensive and the need for physical and financial capital is small, the partnership governance structure, in which mutual self-monitoring is the default, was more efficient than having an outsider attempt to monitor the partners. The free-rider problem, which seems to loom in large professional service firms, was partly mitigated by informal incentive mechanisms. The professionals teaming up with partners that were doing similar sorts of work and shared common educational backgrounds arguably stimulated incentive mechanisms. Not only did the partners' similar type and ability solve monitoring problems, but it also reduced decision-making costs in partnership (Kandel and Lazear 1992). While malpractice claims were uncommon, the partners' being unlimitedly liable for the firms' debts helped to overcome the monitoring problems and, more importantly, to send a signal of quality commitment to a market in which clients cannot perfectly observe and monitor the professional's performance. It is submitted that, since market monitoring failed, the partnership's principle of re-distributing profits among the partners also played a pivotal role in guaranteeing a high quality of service. The redistribution of profits provided a disincentive for partners to bring in new employees, resulting in an incentive to hire only people that could meet the high quality standard (Levin and Tadelis: 2).

Recent trends in professional service industries have put serious pressure on the ethos of efficiency of traditional partnership law. The acceleration of liability claims resulted in a stampede away from the unlimited liability feature. But even without the liability problems, there are other pressures working against the traditional partnership form. It is obvious that the many partners (sometimes over 1,000) of a large, international law or accounting firm cannot all be involved in the day-to-day decision-making process. Large professional firms often appoint a committee or use a corporate management structure to deal with daily affairs (Peel and Eaglesham 2002). However, unlike shareholders in a typical publicly held corporation, the non-managing partners are not passive investors but specialists in different areas who, by forming alliances, capture potential gains and diminish the variance of income. Ironically, the specializations that emerge in large professional service firms are the main reasons why partnerships unravel, and its monitoring and incentive systems fail (Carr and Mathewson 1998: 499).

Another emerging problem is the destabilization of professional service firms. If one takes a closer look at large law firms, one sees that a recent change in the culture of law practice also imposes a burden on the traditional partnership form (Hillman 2001). There is considerable evidence that the instability of law firms can be attributed to the decisions of lawyers to move their practices (and sometimes departments within firms) elsewhere. Enhanced monitoring by corporate counsel has made the market knowledgeable about the quality of a law firm's legal services. As a result, the large corporate clients will be more likely to leave a particular law firm if the quality level is not sufficient. This reduces the importance of the firm's brand name as a sunk commitment to assuring the delivery of quality, and shifts the goodwill balance from the firm to the lawyers themselves. This has stimulated the level of competition among law firms who have focused on hiring lawyers with a large clientele whose reputation may attract even more clients. Certain corporate clients are likely to follow their favourite lawyers from firm to firm. Consequently, the value of goodwill and undermined loyalty of lawyers to their firms has eroded significantly. Law firms have become confederations of individual lawyers, in which partners have their own clientele but wish to share office space, equipment and staff. In this respect, limited liability vehicles seem to fit into the changed business climate.

This increase in the mobility of lawyers took place in the presence of strong and mandatory fiduciary duties. In practice, the standards are much lower, largely due to the high litigation costs and difficulties of pursuing damages under an indeterminate standard. For the most part, partners' fiduciary duties are matters of process and disclosure. At the same time, attorney ethics rules, such as the norm of client choice, are generally consistent with the substantive laws of partnership. It is recognized that the recent decline in lawyers' loyalty to firms has been matched equally (or even exceeded) by the demise of the firms' loyalty to lawyers, a development evident in the activities of firms that systematically review their membership to eliminate less productive partners (Vestal 1997, 1998). The experience of law firms under this new regime shows that most have quickly adjusted by changing their hiring, promotion and retention practices.

These trends may be working against traditional partnerships in favour of the corporate form, but the latter is not free of difficulties. For instance, the demand for high levels of public revelation of the firm's financial details (and the partners' profit shares) is viewed as particularly cumbersome. Moreover, corporate law statutes contain unwanted default rules and often do not offer the freedom to tailor the statutory provisions to meet the needs of professional services firms. It appears that large professional services firms prefer a highly flexible business form that allows partners to adopt a more corporate-style decision-making and monitoring structure, has highly flexible and waivable fiduciary duties, and provides for limited liability without losing partnership-type flexibility and privacy (Ribstein 1999b: 418-20).

3.4.2. Venture Capital Funds

The previous subsection has found evidence that suggests that professional service firms would benefit from the introduction of a LLP statute. In this subsection, we again suggest that most of the evidence favors the enactment of a business organization form that makes it possible to emulate the most efficient US venture capital contracts.

It seems clear from the recent history of the reform of the private equity limited partnership, the standard organization form used by venture capitalists in the United States, the United Kingdom and continental Europe to supply finance to start-up firms (Gompers and Lerner 1999; Lerner and

Schaor 2002), that governments have strong incentives to create efficient legal rules designed to meet the needs of these funds. To be sure, the success of the venture-capital funds experienced a climax during the bubble years of the late 1990s when they succeeded in turning innovative ideas rapidly into gold. However, the fact that the venture capital industry has undergone a profound change over the past few years, in that venture capital funds have lost most of the millions of dollars invested in high-technology firms, does not mean that these funds went out of fashion. In reality, with bank credit becoming harder to come by, venture capital funds are still the only hope for start-ups (Saunders and Schmeits 2002: 139-52). The adaptability of these funds is a necessary quality in an ever-changing business environment.

In the UK, the limited partnership organizational form owes its popularity mainly to the venture capital industry. In particular, the tax benefits, the flexibility surrounding its structure and terms, and its fixed life make the limited partnership the dominant venture capital fund vehicle. Individuals and institutions invest in a limited partnership and delegate all investment and monitoring decisions to the venture capitalist, who act as the general partner. These limited partnerships share publicly held and closely held aspects: passive owner-investors entrust their money to powerful and entrenched owner-managers who have substantial discretion over the funds. The flexibility of this business form allows the internal and external firm participants to enter into covenants and schemes that align the incentives of venture capitalists with those of the outside investors and reduce agency costs (Gompers and Lerner 1999: 29-55; Sahlman 1990: 489-94). Despite several drawbacks, such as limited partnership shares not being publicly tradable and the archaic law governing this form, the UK limited partnerships have become the standard structure used by European venture capitalists in general (Myners 2001: 155). That said, the UK's prominent position is under threat from other jurisdictions that have introduced or plan to design modern legislation on limited partnerships. It is not surprising, therefore, that policymakers are planning to revise the Limited Partnership Act 1907 by proposing to abolish the rule on the maximum number of partners (presently limited to 20) and introduce 'safe harbour' provisions similar to those found in the Delaware Revised Uniform Limited Partnership Act and Jersey's limited partnership form. These provisions clearly establish that limited partners may participate in the control of the firm so as to improve certainty and accessibility to foreign investors. The threat of competition, combined with the lobbying efforts of venture capitalists and sophisticated investors will arguably make UK limited partnership law more sophisticated and suitable for venture capital investment. Consequently, the limited partnership law reform fits the UK government's objectives of creating modern business organization forms that support the needs of a competitive economy.

3.4.3.Joint Ventures and High-tech Start-ups

In this subsection, we show that many of the contractual provisions for dealing with joint ventures and venture-sponsored firms are particularly ineffective and tend to increase transaction costs for entrepreneurs and investors. We show that parties, in the presence of such costs, would favour the introduction of business organization statutes that could serve their needs while yielding substantial governance benefits.

Joint ventures blur the line between a closely held firm and a long-term relational contract through the market. A joint venture is often described as a 'quasi-firm', as the joint venture, owned and actively co-managed by usually pre-existing, independent firms that pool resources for a specific objective, resembles long-term relational contracts in many important respects. First, the independent joint venture partners are often simultaneously competitors outside the scope of the venture (Pèrez-Castrillo and Sandonís 1996). Second, since joint ventures usually involve the development of a particular product, their average life span is not usually very long. Third, joint venture partners may rely more on renegotiation and reputational incentives than on the firm's organizational structure. In fact, joint ventures may be merely contractual arrangements that do not involve any joint ownership of assets. However, they usually employ some kind of firm-like organizational structure. This is especially true of joint ventures that explicitly employ a legal business form.

Joint venture partners may prefer to specify their rights and duties in an agreement when those prescribed by law are deemed inappropriate (Chemla et al. 2002: 1). For instance, they may rely on explicit buyout options rather than vague and open-ended fiduciary duties to overcome the consequences of incomplete contracts (Holmström 1999: 81). These vague 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 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 concepts of trust while renegotiating their deals. Yet contractual provisions are obviously not the only sufficient means of overcoming the consequences of incomplete contracts. It appears that the equity structure also plays a significant role in the financial and organizational design of joint ventures (Hauswald and Hege 2002). Theoretical and empirical research indicates that a corporate-type equity structure is very useful to create optimal incentive mechanisms and to allocate control and ownership rights that help to alleviate or resolve opportunistic behaviour in joint ventures (Belleflamme and Bloch 2000). Moreover, corporate-type share capital facilitates easy transfer and listings opportunities. In this view, a joint venture business form statute should therefore, in addition to the contractual freedom to specify the rights and duties of the joint venture parties, provide for a corporate-type management and equity structure and limited liability protection.

Such a business form could also be attractive to firms backed by venture capital, which, like joint ventures, have to deal with a 'double-sided moral hazard' problem. Both the entrepreneurs and the venture capitalists must be actively involved in the venture for several reasons. The setback of the 'new economy' has shown that the passive investors who merely provide capital are not sufficient to fertilize a promising and innovative idea. Consequently, the venture capitalists closely monitor their investments, actively participate in the venture's strategic decisions and furnish the venture with value-added services. These services (e.g. identifying business opportunities and management assistance) are often more important than their financial resources. In this respect, start-up firms are typical closely held firms. However, these firms also resemble publicly held corporations. For instance, in order to help make the venture a success and to professionalize the internal organization, outside directors are brought inside the firm, thereby separating effective control and management from risk-bearing (Hellmann 1998: 58).

The next section will discuss in more detail which organizational and legal structures are favourable for the formation and development of innovative start-ups and joint ventures. It is suggested that the introduction of a legal framework, in which equity, contractual and non-legal incentives interrelate, is crucial to further stimulate the development of a successful venture capital market in Europe.

4. Providing a Free-Standing Limited Liability Company

At first glance, it appears that an LLC statute which affords a workable menu of beneficial provisions and is attractive enough to be widely used could provide a focal point around which new networks might arise. The fundamental problem, however, is to develop an LLC form that is desirable for many SMEs and is likely to be adopted in most member states. In such circumstances, the question is to what extent the drafters of the proposed LLC statute should endeavor to build on earlier attempts to coordinate private company law in the European Community. While there is great appeal to the utilization of existing frameworks, it is important—given Europe's excessive reliance on mandatory law—to produce a statute that functions as a coherent whole and is sufficiently attractive from a cost-benefit perspective to persuade firms to opt-in to the new form. In order to achieve this objective, the design of a new business statute should be tailored so as to supply firms with limited liability, flexible legal rules, and preferential tax treatment. Such a proposal would enable business ventures to better structure their legal identity in respect of their organizational requirements and could attract (semi-) strong interest groups. In making this projection, US scholars have argued that new business forms tend to be efficient because they offer small firms comprehensive sets of terms which limit the drafting and information cost burdens while providing limited liability and sometimes even free transferability of shares (Oesterle 1995: 919-20; Ribstein 1995a; Talley 1999: 1002). Hence, the creation of an off-the-rack standard form contract designed to meet the needs of SMEs is the legal equivalent of a simple, low-cost incorporation. To the extent that the new business statute offers firms and legal decisionmakers a set of simple and coherent terms, the legislation will provide an acceptably low-cost vehicle for business planning and operation and the resolution of conflicts. We suspect that the supply of clear and simple default rules will be regarded as value-enhancing. The adoption of the default terms will also provide firms with opportunities that otherwise might not be available which, in turn, could improve the competitive position of a state's corporate law regime.

Thus, if the new statute were to offer the appropriate protections and incentives that draw start-up firms into its framework, we should expect support from a number of organized businesses and professional groups. In this respect reference can be made to the emergence of the LLP in the

United Kingdom. As a prerequisite to success, the inherent benefits of the new form must exceed the benefits lost by leaving the current private corporate law. It might be suggested that these considerations alone do not support a convincing counter-story to the foregoing analysis. But if we look to the governance benefits that emerge from the introduction of new business statutes, we expect that an innovative model form, if adopted and suitably tailored, will attract those new-style, entrepreneurial firms that cannot benefit from the older, existing legal forms (Rock and Wachter 1999; Ribstein 2001). Furthermore, evidence from the United States show that the introduction of a new form could provide the necessary impetus to help erode the mandatory nature of EC corporate law rules.

The introduction of a new, separate statute modeled on the US LLC holds out the prospect of overcoming the negative lock-in effects that inhibit the adoption of new statutes. The attractiveness of the U.S. LLC statutes can be contrasted with other similar-styled business forms. The American form provides virtually a complete shield against personal liability (this is important given the risk inherent to a highly innovative start-up) without cumbersome formation and capital maintenance rules. As for the consideration for the payment of 'shares,' most LLC statutes provide that contributions may be made to the firm in many different forms, such as 'tangible or intangible property or other benefits to the company, including money, promissory notes, services performed, or other agreements to contribute cash or property, or contracts for services to be performed' (Uniform Limited Liability Act 1995: § 401; U.L.A. 1995: 455). These LLC statutes provide extreme flexibility with respect to internal organization. Although a legal entity, an LLC is best viewed as a contract among the members of the firm. The operating agreement even overrides the articles of organization in the case of a conflict. However, a great majority of LLC statutes provide for decentralized management directly by the members unless otherwise provided.

However, the default rule for the governance structure of the LLC is not optimal for those entrepreneurial 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 (Callison 2000: 114; DeMott 1997: 614). The principal-agent literature shows that the failure to separate ownership from control will limit the benefits of specialization in the firm's decisionmaking. For example, if members are prepared to undertake the financial risk and supply services for the firm's ventures, it does not necessarily follow that these members will be equally suited and talented to make the appropriate management decisions about the allocation of firm resources. Second, the integration of ownership and control means undifferentiated management decisionmaking, which entails a more cumbersome, costly, and restricted process. Finally, a member-dominated firm will suffer higher costs due to the absence of monitoring and intervention devices to intervene on behalf of investors.

To be sure, the difficulty of the failure to separate ownership from control could be overcome by careful drafting of the firm's LLC agreement. In fact, some LLC statutes provide that a firm may be centrally managed if the statute provides for decentralized management but allows the parties to contract around the statute (Ribstein and Keatinge 1999: §8.02). However, devising the optimal LLC structure is difficult to achieve. On the one hand, the flexibility afforded by LLC statutes takes into account the diverse organizational needs of a variety of firms. In this regard, the LLC statute can play a significant role in business planning and design. On the other hand, there is an important trade off between a high degree of flexibility and the cost of specificity. Indeed, as US evidence shows, extensive tailoring of default rules of an LLC statute to satisfy the needs of venture-capital-backed firms, may be problematic due to the effort and transaction costs involved in contracting around the statutory defaults. It appears that investors are reluctant to choose and modify an LLC statute despite its beneficial tax treatment and flexible structure.

An optimal free-standing business form should also allow investors to exit their investments via an IPO. Even though the U.S. LLC allows for publicly traded 'units,' (which are nothing more than depository receipts for the owners' property interests) the efficiency of selling units is called into question because underwriters are probably unwilling to employ 'units' on a large scale. If European lawmakers wish to create a favorable business environment for new firms, they should design an LLC statute that permits owners to have a share capital that is similar to corporate forms. We suspect also that the incentive and protection mechanisms, which are necessary to prevent opportunistic behavior, may be best achieved by the employment of corporate-type stock.

4.1 The Prospects for the Emergence of an LLC-type Form in Europe

Although repeated attempts have been made to encourage the development of a European Law Institute (Buxbaum and Hopt 1988; Ebke 2000: 658-59), the absence of a Europe-wide organization of lawyers hampers the emergence of such a private lawmaking group and, as a consequence, the drafting of model business form legislation. However, given the transformation occurring in European lawmaking, there are strong reasons to believe that a private legislature or association of lawyers will eventually emerge, due to increased pressures from businesses operating in a number of member states.

In terms of assessing the likelihood of the enactment of a new LLC-type statute into national law, there are several classes of firms that might be attracted by its cost-saving benefits. The first class is made of prospective start-up firms that will only come into existence in the new limited liability form if the form is available. It is expected that low formation costs will appeal to potential entrepreneurs who cannot afford a typical European corporate form. If the new form also provides an extensive set of protective default provisions for both investors and entrepreneurs, the number of start-ups may very well increase. The second class consists of future start-ups, which, but for the new form, would employ the more costly corporate form. The third class contains prospective portfolio companies that, at the insistence of investors, will convert into the proposed LLC-like form. A fourth class contains the existing portfolio firms for which cost savings will accrue in the event of reorganization to this form, with the savings exceeding the cost of reorganization. Presumably, the number of firms in this last class will be very small, as dramatic contractual changes are not likely during the firm's development phase.

The appearance of more successful start-ups will undoubtedly foster prosperity and economic welfare. However, the powerful forces of efficiency and public welfare alone are not always sufficient to prompt lawmakers to undertake reforms along these lines. Granted that special interest groups can sometimes help to persuade the legislature that this is a propitious moment for reform, the question remains which powerful groups will support the proposal and what are the chances of its eventual enactment. In this case, the alliance of market sector interest groups may emerge as a strong interest group. In most jurisdictions, the domestic equity exchanges conceivably could join in the lobbying process. In a period of fierce competition among European stock markets, good listing opportunities for an attractive business vehicle could result in the desired spurt of listings. Finally, entrepreneurial firms will have high-powered incentives to lobby for this innovative business form, which disposes of the cumbersome, time-consuming formation requirements and bolsters entrepreneurship.

In terms of assessing the prospects of success, we expect that on the positive side some business lawyers may have sufficient incentives to support reform proposals. They can expect increased fees as a consequence of many classes of firms being attracted to a new, low cost business vehicle. Conversely, the notaries—lawyers who specialize in incorporations and have qualified to issue a notarial deed—could organize themselves as a significant interest group, blocking innovative measures and frustrating attempts at effective implementation. In continental Europe, a notary deed is usually required for all incorporations. Given the notaries' well-entrenched position and proximity to the lawmaking process, establishment of new forms would preferably not require issuance of such a deed. If an LLC statute were to gain adherence amongst investors and popularity with business lawyers, the notaries' fee revenues might therefore drop substantially. Since their losses are probably more acute than the possible gains of the business lawyers generated by the pent-up demand, the notaries will have a particularly high-powered incentive to block this new form. Since both types of lawyers often practice together in law firms, these professionals will strongly disfavor reform. However, well-organized professional firms, if they lack sufficient choice to shield their liability, may have sufficient incentives to exercise political influence over legislatures to supply an LLC-type form that they prefer. We expect further that Treasury and Revenue officials employed by national governments will be opposed to legislative action to the extent that the new business form's tax treatment implies revenue losses and could well organize interest group opposition to the introduction of new forms. However, the rapid diffusion of LLC statutes in the US suggests that these considerations are secondary to most lawmakers.

4.2 Predicted Result

If we compare and weigh the competing interests on the demand side of legislation, we cannot predict with certainty the likelihood of enactment of a statute by national governments across Europe. The outcome will depend largely on the political power of the alliance of market sector interest groups. However, an adequate prediction cannot be made without taking into account the supply side of the legislation process. Legislative procedures reduce the stakes interest groups have in regulation, and, as a consequence, the supply side (i.e., the political and regulatory institutions) plays a decisive role with respect to a new legal form. As far as governmental institutions are maximizers of public welfare, an innovative business form might be enacted if the policymakers are convinced that it is beneficial to an increase of government revenue, job-creation, and technology developments. Conversely, some governments, which have sufficient resources and a well-organized interest group, may choose to act entrepreneurial themselves. They may be motivated to lift the curse that rests on Europe's small and medium size business environment by actively attempting to 'attract investment or business activity or to promote the competitiveness of indigenous industries by adopting a more favorable business form. If the future brings a significant increase in the number of start-up firms to the most favourable jurisdictions, as envisaged by the ECG's recent case law, increases in interest group pressure can be expected. As noted earlier, the United Kingdom would be a likely candidate to enter the competitive lawmaking environment for the supply of legal product. As such, a leading state could reap the benefits by coming to fore with a set of rules that are ideally-suited to SMEs in need of outside capital. If such a state were among the early group of movers to adopt a corporate type LLC form, it could very well create a focal point leading to a significant number of domestic and foreign firms to select form a new generation of business forms (Bratton and McCahery 1997b). This could, in turn, give such a state the lead in start-up formations and, due to favourable IPO opportunities, a more vibrant and competitive financial market.

5. Conclusion

The needs of closely held firms are not easily met through the adaptation of a European business form, emphasizing the theoretical importance of making available a coherent set of standard forms. Despite the increased pressures from SME organizations and professionals, law reforms tend to be piecemeal and reactionary, leading to the creation of inefficient legal codes and paucity of limited liability vehicles. This chapter has shown that new business forms may be necessary to modify the current framework, which seems to be inefficient and burdensome for closely held firms of all kinds.

We offered a number of explanations with respect to the persistence of inefficient rules for closely held firms. First, even if a given business form would make closely held firms more efficient, it may not be in the interest of most lobby groups to modify the law to allow more efficient business forms to emerge. Predictably, legislatures respond by failing to adopt value-increasing legislation from which they could derive tax revenue and other economic benefits. Second, European firms have considerably less freedom to adopt particular provisions that match their own needs. The existing structure of corporation law imposes significant costs on closely held firms that are required to comply with highly formalistic and technical requirements. Third, the standardization of provisions of in corporate codes may account for the lock-in to the existing mandatory framework. When increasing returns are present, the value of the existing provisions increases. In most European member states, the majority of closely held firms are organized under the provisions of close corporation codes. These codes not only create considerable learning benefits, but firms also expect to obtain further benefits as new firms incorporate under the same code. Moreover, because the standardized corporate form offers certainty, business lawyers, when advising clients about choice of business form decisions, tend to recommend the close corporation—even if it is sub-optimal. The conclusion is that continuous use of the close corporation—even if not ideally suited to a wide range of closely held firms, will serve to reduce the incentives of lawmakers to innovate. In most European jurisdictions, the SME business community is not likely to play a featured role in the evolution of business forms.

One strategy for law reform, explored in this chapter, would attempt to meet the needs of close corporations through deregulation and modification of the general provisions of corporation law. Proponents of this approach would re-conceputalize corporation law by allowing greater contractual flexibility. Typically, this means providing a separate statute that offers a bundle of legal rules regarding transferability of rights, dissolution and internal governance rules. The promulgation of the LLP in the United Kingdom and the SAS in France clearly demonstrates the movement toward the establishment of new arrangements that could involve economic benefits for individual firms. A second factor, coinciding with these changes, is the renewed debate within the European Union about the merits of regulatory competition, which could eventually give rise to a market for business formations. Our view is that if Europe succeeds in creating conditions more conducive to competitive lawmaking, one could expect more states to be involved, as in the United States, creating a variety of legal rules that are beneficial to different types of closely held firms.

Finally, we considered the merits of the competitive lawmaking process in the United States. Commentators have rightly noted that some provisions created by state competition have led to outcomes that would not be considered desirable. For instance, state lawmakers seem to conduct their business experiments without an underlying theory, thereby creating complexity and undesirable results. In this view, the benefits of a well-designed and theoretically appropriate model of business organization laws outweigh the benefits of competitive lawmaking. Yet one must weigh up all the benefits and costs of jurisdictional competition. New partnership law, which resulted in the an increased choice of form in the United States, provided a kind of laboratory for business organization law reform in which to test new regulatory approaches. By doing so, new partnership law helped erode restrictions on the formation and operation of business firms in general. In this view, the ultimate outcome of regulatory competition rather than the initial experiments must be taken into account.

From a European perspective, it does not matter which side one takes. Obviously, there are substantial legal and cultural barriers to the near-term development of a US-type market for business forms. Consequently, despite the pent-up demand for law cost business forms across Europe, we find it difficult to predict the circumstances that would lead to the development of regulatory competition within the European context. In any event, our analysis questions whether the introduction of regulatory competition is necessary to overcome the difficulties in promulgating a new business vehicle with few mandatory rules. In particular, this chapter has attempted to extend the debate about competitive lawmaking to the closely held business forms. We have shown that one could imagine a European member state becoming the dominant producer of business organization laws as products by being the first to establish a legal infrastructure and a bundle of rules that fully benefit firms organizing under its laws. Indeed, we argue that the development of an innovative business organization form can be expected to strengthen the business organization law regime of the state choosing to create the statutory innovation, thereby potentially inducing rival member states to supply similar sets of rules.

On a final note, the relatively unimportant role of state competition has played, thus far, in the development of business forms within the European Union means that more attention must be paid to creating adjustments in the lawmaking context that would play a role in stimulating regulatory competition and experimentation in legislative products. To some extent a private legislature or association of lawyers could facilitate the introduction of legal rules that meet the needs of distinct firms while introducing standards that reflect the ever-changing dynamics of the environment in which firm operate. Our analysis suggests that the standardization of law, in conjunction with regulatory competition, could serve as the much-needed stimulus for legal innovation and change within the European Union.

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