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## The Governance of Close Corporations and Partnerships: US and European Perspectives, Joseph McCahery, Theo Raaijmakers, and Erik P. M. Vermeulen (eds)

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## **The Governance of Close Corporations and Partnerships: US and European Perspectives**

Joseph McCahery, Theo Raaijmakers  
and Erik P.M. Vermeulen (eds)  
(Oxford University Press: Oxford &  
New York, 2004)

*Peer Zumbansen*\*

“Although large public corporations are certainly the most visible manifestations of the corporate form, they are not the most common”.<sup>1</sup> This observation could serve as the starting point for the inquiries that concern the authors contributing to this volume. In the context of the much debated and criticized model of the publicly traded corporation,<sup>2</sup> the contributors to *The Governance of Close Corporations and Partnerships* explore the regulatory and policy challenges of the small and middle-sized enterprises (SMEs), closed (or close) corporations, limited liability companies (LLC) and limited liability partnerships (LLP). Based on an international conference in 2001, their papers bring together the latest legal and economic assessments of these forms of business association.

The volume provides a welcome addition to international scholarship in this field of company law. The book’s editors, Joseph McCahery, Theo Raaijmakers, and Erik Vermeulen, are leading authorities on corporate law in

Europe and the United States (US). The void they fill may be illustrated by a cursory example from some recent legal literature: “There is a distinction between a private and a public company. A public company must have a minimum issued share capital ... A public company may, but a private company may not, offer its shares for sale to the public”.<sup>3</sup> Such a pithy observation hardly captures the complexity of private companies in today’s dynamic corporate environment.<sup>4</sup> As the changing economic realities of closely held corporations continue to challenge the traditional legal categorization of corporate forms, only a comprehensive assessment of their legal and economic milieu can provide an adequate picture of the close corporation. This volume succeeds in introducing the key issues raised by the law of close corporations and partnerships, while exploring the subject-matter from a variety of theoretical angles.

The book is well-structured and easy to navigate. It begins with an excellent introduction by Joseph McCahery, followed by 15 chapters grouped into four themes.

Part I of the book, dealing with the first theme, explores the “Theory of Partnership Law and Close Corporations”. It commences with the republication of Henry Hansmann’s and Reinier Kraakman’s seminal article, “The Essential Role of Organizational Law”.<sup>5</sup> Other important chapters in this section include “An Economic Analysis of Shared Prop-

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<sup>1</sup> C. Nicholls, *Corporate Law* (, 2005). 91.

<sup>2</sup> See only the successful launch of Joel Bakan’s *The Corporation* (2004), first published as a book, subsequently turned into a film.

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<sup>3</sup> J. Lowry and L. Watson, *Company Law* (Reed Elsevier 2001), 1.16.

<sup>4</sup> See only P. DiMaggio, ‘Introduction: Making Sense of the Contemporary Firm and Refiguring the Future’, in *The Twenty-First Century Firm* (P. DiMaggio ed., Princeton University Press 2004), 3-30.

<sup>5</sup> Originally published in (2000) 110 Yale L.J. 387.

erty in Partnership and Close Corporations Law”<sup>6</sup> (John Armour and Michael J. Whincop), “Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations”<sup>7</sup> (Ed Rock and Michael Wachter), and “Bracketed Flexibility: Standards for Performance Level the Playing Field”<sup>8</sup> (Claire Moore Dickerson).

Of the other three parts, the second addresses the “Evolution of Partnerships and Closely Held Partnerships”, with contributions from Larry Ribstein,<sup>9</sup> J. William Callison,<sup>10</sup> and the editors McCahery and Vermeulen.<sup>11</sup> The third section offers a distinctive comparative perspective, addressing “Legislative Reform Initiatives in the United Kingdom and the United States”. It includes chapters by Deborah DeMott,<sup>12</sup> Judith Freedman,<sup>13</sup> Geoffrey Morse,<sup>14</sup> Allan Walker Vestal,<sup>15</sup> and Donald Weidner.<sup>16</sup>

The fourth part and theme of the volume concerns “The European Private Company and Partnership Reform in the European Union”. It features chapters by Robert Drury,<sup>17</sup> Theo Raaijmakers,<sup>18</sup> and Peter Essers and Gerard Meussen.<sup>19</sup> The book closes with the text of the European Private Company Draft Regulation.<sup>20</sup>

For some time, the study of the governance of private companies<sup>21</sup> seemed a quiet backwater of legal research and policy reform. The noisy calls for corporate governance reform in the aftermath of financial scandals such as Enron, Worldcom and Tyco<sup>22</sup> further drew policy-makers’ and scholars’ attention away from the regulation of SMEs and its variants. The international debate over convergence or divergence of corporate governance regimes has been driven primarily by the integration of global financial markets and subsequent pressures on rules of corporate financial transparency and control. Close corporations remained – for a long time – un-

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<sup>6</sup> Previously published in (2001) 26 J. Corporation Law 983, as part of the Symposium on “Unincorporated Business Entities”.

<sup>7</sup> Originally published in (1999) 24 J. Corporation Law 913.

<sup>8</sup> Previously published in (2001) 26 J. Corporation Law 1001.

<sup>9</sup> “The Evolving Partnership”, previously published in (2001) 26 J. Corporation Law 819.

<sup>10</sup> “Federalism, Regulatory Competition, and the Limited Liability Movement: The Coyote Howled and the Herd Stampeded”, previously published in (2001) 26 J. Corporation Law 951.

<sup>11</sup> “The Evolution of Closely Held Business Forms in Europe”, previously published in (2001) 26 J. Corporation Law 855.

<sup>12</sup> “Transatlantic Perspectives on Partnership Law: Risk and Instability”, previously published in (2001) 26 J. Corporation Law 879.

<sup>13</sup> “Limited Liability Partnerships in the United Kingdom: Do They Have a Role for Small Firms?”, previously published in (2001) 26 J. Corporation Law 897 (with V. Finch).

<sup>14</sup> “Limited Liability Partnerships and Partnership Law Reform in the United Kingdom”.

<sup>15</sup> “Drawing Near the Fastness? The Failed US Experiment in Unincorporated Business En-

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ity Reform”, previously published in (2001) 26 J. Corporation Law 1019.

<sup>16</sup> “Pitfalls in Partnership Law Reform: Some US Experience”, previously published in (2001) 26 J. Corporation Law 1031.

<sup>17</sup> “Private Companies in Europe and the European Private Company”.

<sup>18</sup> “The Reform Agenda for Partnerships and Closely Held Companies in the Netherlands and the European Union”.

<sup>19</sup> “Taxation of Partnerships/Hybrid Entities”.

<sup>20</sup> See further S. Braun, “The European Private Company: A Supranational Company for Small and Medium-sized Enterprises?” (2004) 5 German L. J. 1393.

<sup>21</sup> For the historical background of the distinction between the public and the private company, see Nicholls, note 1, 92-97.

<sup>22</sup> See the excellent account by W.W. Bratton, “Enron and the Dark Side of Shareholder Value”, (2002) 76 Tulane L. Rev. 1275.

touched by this discussion and legislative reform.<sup>23</sup>

Recently, themes such as minimum capital requirements, disclosure rules and minority shareholder rights have in various ways preoccupied national regulators and reformers in the US and European Union (EU) member states.<sup>24</sup> Those developments are richly documented and analyzed in this volume. The discussion in Europe was facilitated by several seminal decisions of the European Court of Justice (ECJ). These rulings seriously undermine the so-called 'Real-Seat theory' (i.e., the applicable law is defined by the place of the company's central administration), which had for many years thwarted any meaningful discussion of the merits (and dangers) of regulatory competition in Europe.<sup>25</sup> National company law regimes governed the incorporations as well as the size and formation of the firm's minimum's capital requirements.<sup>26</sup> With

the Real-Seat theory preventing legal recognition of firms incorporated in other member states, companies in the EU effectively did not enjoy freedom of movement. Therefore, one could not speak about a market for corporate charters – such as had long been the case in the US.

Since the ECJ rendered its rulings in *Centros* (1999), *Überseering* (2002) and *Inspire Art* (2003),<sup>27</sup> a new climate for regulatory reform has emerged in the EU. But numerous regulatory and policy barriers remain. In Germany, for instance, a plethora of rescue attempts were made in the wake of *Centros* to maintain the hegemony of German company law over foreign corporations operating in Germany.<sup>28</sup> The pressure in Germany to adapt the new legal situation was particularly high.<sup>29</sup> It is against this background, that the debate over regulatory competition and freedom of choice in EU company law<sup>30</sup>

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<sup>23</sup> G. Bachmann, *Grundtendenzen der Reform geschlossener Gesellschaften in Europa*, 30 *Zeitschrift für Unternehmens- und Gesellschaftsrecht* (2001), 351 at 351.

<sup>24</sup> See the chapters in this volume by Raaijmakers, Vestal, Weidner and Callison, Freedman, Morse, and McCahery and Vermeulen. The latter, in "The Evolution of Closely Held Business Forms in Europe" (previously published in (2001) 26 *J. Corporation Law*. 855), comment: "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 presents a new departure".

<sup>25</sup> See already D. Charny, "Competition among Jurisdictions in Formulating Corporate Rules: An American Perspective on the 'Race to the Bottom' in the European Communities" (1991) 32 *Harvard Inter'l L. J.* 423.

<sup>26</sup> See O. Kahn-Freund, "Some Reflections on Company Law Reform" (1944) 7 *Modern L. Rev.* 54 at 57: "at the present moment, it is almost unbelievably easy

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and even more unbelievably cheap to form a corporation in this country."

<sup>27</sup> See Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.* For analysis, see H.C. Kersting & C.P. Schindler, "The ECJ's Inspire Art Decision of 30 September 2003 and its Effects on Practice" (2003) 4 *German L. J.* 1277.

<sup>28</sup> See only H. Halbhuber, "National Doctrinal Structures and European Company Law" (2001) 38 *Common Market L. Rev.* 1385.

<sup>29</sup> The latter might be documented by the ongoing and recently increased attempts to reform the minimum capital requirements of the German *Gesellschaft mit beschränkter Haftung* (GmbH – Limited Liability Company); see hereto P.C. Leyens, "Company Law in Germany – Recent Developments and Future Developments" (2005) 6 *German L. J.* 1407 at 1409.

<sup>30</sup> S. Deakin, "Regulatory Competition versus Reflexive Harmonisation in European Company Law", in *Regulatory Competi-*

is acquiring a more prominent place among EU company law scholars and policy-makers.<sup>31</sup> This development also highlights the particular regulatory challenges that follow from the type of corporation forms that prevail.

In his introduction, McCahery discusses the current challenges faced by reformers on the corporate law applicable to SMEs. His overview begins with the recognition that a single type of limited liability corporation cannot meet the specific demands that follow from businesses' commercial operations in different markets. The private company, the close, or closely held corporation – in contrast to the large, publicly held corporation – is evolving into different forms of limited liability companies (LLC) and limited liability partnerships (LLP). But while legislative reform has greatly improved the range of organizational flexibility, the need for an adequate regulatory framework of SMEs has increased. It seems that with every step towards a further reduction of the corporate owner's personal liability, the fundamental question resurfaces of how to effectively guarantee the protection of minority shareholders and creditors. Concurrently, reformers must determine the appropriate balance between organizational freedom and regulatory protec-

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*tion and Economic Integration. Comparative Perspectives* (D.C. Esty and D. Geradin eds, Oxford University Press 2001) 190.

<sup>31</sup> To assess the dramatic changes to the early beginnings, see only C. Schmitthoff, "The Future of the European Company Law Scene", in *The Harmonisation of European Company Law* (C. Schmitthoff ed, London 1973) 3, highlighting the crucial importance of harmonized company laws for the European market.

tionism. McCahery (later jointly with Vermeulen in the volume) rightly points to the traditional reluctance of many national lawmakers to improve their company laws. The tension between the Anglo-Saxon *enabling* approach to corporate governance, and the continental European emphasis on *mandatory* company law rules,<sup>32</sup> unfolds just as powerfully in the closely held corporation as it does with the large, public corporation.

The volume is also distinctive for the reconsideration some contributors give to the long-standing nexus-of-contracts theory of the firm.<sup>33</sup> They do so in light of the dynamics between the emergence of the unincorporated firm with limited liability, on the one hand, and private equity investors' desire for high standards of corporate governance, on the other. It is this tension that defines the SME compared to the larger, public corporation, where the traditional lines of conflict run between the dispersed shareholders (or, increasingly institutional investors) and the company's management.

Hansmann and Kraakman in their chapter explore this tension by revealing the Janus-faced nature of limited liability. They distinguish between two forms of corporate asset partitioning to meet creditors' claims. The first form, "af-

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<sup>32</sup> J.W. Cioffi, *Corporate Governance Reform, Regulatory Politics, and the Foundations of Finance Capitalism in the United States and Germany*, 1 CLPE Research Paper Series No. 01 (September 2005), 7-11.

<sup>33</sup> The original theory was developed by M.C. Jensen and W.H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", (1976) 3 J. Fin. Econ. 305; and A.A. Alchian and H. Demsetz, "Production, Information Costs, and Economic Organization", (1972) 62 American Econ. Rev. 777.

firmative asset partitioning”, prioritizes the claims of creditors against assets held by the company with whom the firm contracts in its own name. And only secondarily, if ever, will the claims of personal or business creditors of the firm’s owners be met. Thus, affirmative asset partitioning creates a distinct fund for the firm’s creditors, thereby giving them a prior claim on the firm’s assets before the owners’ personal creditors can realize their claims. In contrast, “defensive asset partitioning” shields the firm’s owners’ assets from creditors’ claims against the firm. In this form, limited liability shields investors’ personal assets. In both cases, limited liability distinguishes between the firm’s and the owners’ assets, but the perspective differs in each case. While the latter focuses on the traditional model of limited liability (limiting the investors’ risk while augmenting the creditors’ risk), the former strengthens the position of the firm’s creditors.

While Hansmann’s and Kraakman’s central contention is that property law eventually renders a better understanding of the limited liability firm than contract law,<sup>34</sup> their distinction between defensive and affirmative asset partitioning in fact illustrates much more. From the perspective of creditors’ rights on the firm, not only does the specific nature of the business entity become apparent, but also the nature and scope of the norms governing this entity.

Regulatory (jurisdictional) competition versus state intervention is a further important concern of many contributors in this volume. Ribstein underlines the relevance of regulatory competition that many perceive as having been notably strengthened through the ECJ’s *Centros* decision. He highlights the ex-

ample setting role of the US in allowing “‘horizontal’ jurisdictional competition to facilitate market-testing, variety, and evolution of laws”. He elaborates that: “the best path for Europe is to facilitate competition regarding business association laws rather than eliminating competition through ‘harmonization’”.<sup>35</sup> But Ribstein does not share the enthusiasm about the *Centros* case law in Europe, because he fears that “significant differences” continue to remain between the US and the EU. He is not convinced that *Centros* fully set aside the Real Seat doctrine: “inherent legal, cultural, language, historical, and other differences among European countries may play a greater role in constraining firms’ ability to choose from among different jurisdictions”.<sup>36</sup> Europe’s ways, then, may continue to follow different paths from those of the US. While Ribstein postulates that “[m]arkets, and not government, have the wisdom to guide firms in an uncertain world”,<sup>37</sup> in his view the EU is some way off from the type of regulatory competition pervasive in the US.

Indeed, not everyone has strongly supported regulatory competition.<sup>38</sup> While the generous availability of limited liability to small firms and partnerships – e.g. the introduction of the LLP in the United Kingdom (UK)<sup>39</sup> and

<sup>34</sup> Hansmann and Kraakman, note \_\_, 26

<sup>35</sup> “The Evolving Partnership (previously published in (2001) 26 J. Corporation Law. 819), 185.

<sup>36</sup> Ibid, 185-6.

<sup>37</sup> Ibid, 187.

<sup>38</sup> The debate has been going for a long time. For its beginnings in company law, see W. Cary, “Federalism and Corporate Law: Reflections Upon Delaware” (1974) 83 Yale L. J. 663; R. Winter, “State Law, Shareholder Protection, and the Theory of the Corporation” (1977) 6 J. Leg. Stud. 251.

<sup>39</sup> See the contributions from Freedman, Morse, and McCahery & Vermeulen, in this volume.

the enactment of LLC statutes by US state legislatures<sup>40</sup> – can provide investors with a flexible investment vehicle with attractive financial incentives, it has its drawbacks.<sup>41</sup> Other policy instruments must rectify the loss of security and monitoring leverage over the firm engendered by limited liability. Judith Freedman and Geoffrey Morse review this problem with regard to the UK, while J. William Callison critiques the supposedly firm theoretical basis for favoring limited liability corporations.

Joseph McCahery and Erik Vermeulen in their chapter recognize the obstacles in the EU for regulatory competition. But while their declared goal is “to extend the debate over regulatory competition to closely held organization forms”,<sup>42</sup> they argue that this alone will not suffice. “Solving the problems of European company law will take more than the introduction of competition between member states”.<sup>43</sup> The authors explain that though the recent blows to the EU’s Real Seat doctrine may create “incentives for governments to create better business organization vehicles”, national company laws retain significant differences concerning minimum capital requirements and public disclosure rules.<sup>44</sup> Striking differences among company law regimes throughout the EU continue to hinder attempts to move the EU Company Law agenda forward.<sup>45</sup> And yet,

the momentum for change is in place, induced by stock corporation and securities law reforms among other pressures.<sup>46</sup> Demands among foreign institutional investors and other stakeholders are pushing all EU states inexorably towards better disclosure rules and corporate financial transparency.<sup>47</sup>

Yet, McCahery and Vermeulen, after reviewing regulatory changes in the UK, France and Germany, observe that “the linkage of public corporation law to closely held corporations is likely to be inefficient”.<sup>48</sup> This leads not only back to the debate about the economic efficiency of extending limited liability to close corporations,<sup>49</sup> but it also touches on the scope and shortcomings of the draft European Private Company (EPC) prepared by an international group of business leaders and legal experts. McCahery’s and Vermeulen’s verdict is as short as it is decisive: offering insufficient default rules that can be readily applied and too few incentives for corporate reorganization, the EPC is imbued with “the EC company law inertia”.<sup>50</sup> However, even an incomplete regulatory competition might provide some incentives for national legislators to learn

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<sup>40</sup> See the contributions from Ribstein, Callison, Vestal and Weidner in this volume.

<sup>41</sup> Callison, note \_\_, 254 explains: “It has been widely noted that corporate law limited liability provisions create incentives for excessive risk-taking by permitting corporations and their owners to avoid the full costs of their activities”.

<sup>42</sup> McCahery and Vermeulen, note \_\_, 193.

<sup>43</sup> Ibid.

<sup>44</sup> Ibid, 194.

<sup>45</sup> P. Zumbansen, “European Corporate Law and National Divergences: The Case of

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Takeover Law”, (2004) 3 Wash. U. Glob. Stud. L. Rev. 867; J. Wouters, “European Company Law: Quo Vadis?” (2000) 37 Common Market Law Review 257.

<sup>46</sup> See, e.g., M. Rhodes and B. van Apeldoorn, “Capital Unbound? The Transformation of European Corporate Governance”, in *Theories of Corporate Governance. The Philosophical Origins of Corporate Governance* (T. Clarke, ed. Routledge, 2004), 243.

<sup>47</sup> J.W. Cioffi, “Restructuring ‘Germany Inc’: The Politics of Corporate Governance Reform in Germany and the European Union” (2002) 24 Law & Policy 355.

<sup>48</sup> McCahery and Vermeulen, note \_\_, 206.

<sup>49</sup> See Hansmann and Kraakman, Wachter and Rock, and Ribstein in this volume

<sup>50</sup> McCahery and Vermeulen, note \_\_, 208.

from their neighbors. With their eyes close to the ground, McCahery and Vermeulen believe that “as Europe enters the competitive law making environment, lawmakers will mainly focus on the needs of business firms that are most likely to engage in forum shopping”.<sup>51</sup> The numerous incorporations of “German” firms under the rules of Britain’s LLC must thus be seen in direct correlation with the increased attention given in Berlin to reforming the *Gesellschaft mit beschränkter Haftung*. The authors’ note that the work of the quasi-private corporate governance commission has brought about the largest changes in German (public) corporation law since the last major reform.<sup>52</sup>

Finally, this volume is significant for its contributions to the debates about the supposed efficiency and democracy of the limited liability corporation. Callison, following McCahery’s and Vermeulen’s chapter on EU developments, traces the dramatic extension of limited liability privileges to partnerships in the wake of the rise in importance of limited liability companies in the US.<sup>53</sup> Callison identifies the origin of this development as the decoupling of partnership tax classification from personal liability, achieved when the US Internal Revenue Service granted limited liability companies favorable partnership taxation. Thereafter, most states in the US enacted limited liability partnership (LLP) stat-

utes. Callison revisits the lobbying and legislative processes behind the reforms, and is critical of the heavy influence of business lawyers at the expense of other voices that would have illuminated better some of the potential costs of extending limited liability.<sup>54</sup> He is also critical of much of the law and economics theory and its claims about the efficiency enhancing effects of limited liability on smaller companies.<sup>55</sup> Callison believes that that theory was built around the experiences of large, publicly traded companies and was not originally intended to apply to SMEs.

Callison’s critique goes even further to challenge the nexus-of-contracts theory. Drawing on theory ranging from communitarian social theory to critical legal scholarship, Callison questions the application of the individualistic, nexus of contracts doctrine to the closed corporation and the partnership, now equipped with limited liability.<sup>56</sup> He believes that the nexus-of-contracts theory wrongly assumes people to be rational and ego-oriented actors without social ties or moral obligations. Consequently, the theory inappropriately separates the corporation and its shareholders from their broader socio-economic and cultural environment. Limited liability in this context reverses the traditional corporate law understanding, “in which the partnership is viewed as acting on the partners’ behalf of and under their control and in which partners have unlimited liability”.<sup>57</sup>

Callison’s chapter achieves the rare result of presenting us with no sim-

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<sup>51</sup> Ibid, 222.

<sup>52</sup> See T. Baums, “Reforming German Corporate Governance: Inside a Law Making Process of a Very New Nature”, interviewed by Peer Zumbansen for (2001) 12 German L. J. 2.

<sup>53</sup> See especially W.W. Bratton and J. McCahery, “An Inquiry into the Efficiency of the Limited Liability Company: Of Theory of the Firm and Regulatory Competition” (1997) 54 Wash. & Lee L. Review 629.

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<sup>54</sup> Callison, note \_\_, 253.

<sup>55</sup> See, above all, F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (\_\_\_, 1991).

<sup>56</sup> Ibid, 266.

<sup>57</sup> Callison, note \_\_, 262.



ple answers but instead highlights the ambiguities inherent to most arguments in the debate: “theoretical bases for extending limited liability protection to unincorporated business organizations are uncertain and indeterminate.”<sup>58</sup> Arguments can “be made for efficiency and for inefficiency, for autonomy and for community, for democracy and for limits on equal treatment”.<sup>59</sup> This captures well the lessons to be learned from this rich volume.

Overall, *The Governance of Close Corporations and Partnerships* will likely become a key reference for future research into the structure and the regulatory challenges of the close corporations. While many of the chapters were already published, the editors have assembled, edited and added to the existing literature to produce a book that both seasoned scholars and students of company law will surely find very useful. Further, the book should appeal not only to company lawyers in the EU and US, but also to people in other jurisdictions including Canada where similar regulatory challenges are emerging.

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<sup>58</sup> Ibid, 268; see likewise McCahery and Vermeulen in this volume, at 217: “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” (with reference to Bratton and McCahery. note \_).

<sup>59</sup> Callison, note \_, 268.