Company Law, Lawyers and Innovation
Common Law versus Civil Law

Francisco Reyes and Erik P.M. Vermeulen
Abstract
In this essay we make two major claims. The first is that public legislatures should think seriously about giving maximum effect to the principle of freedom of contract in company law. This would not only give corporate lawyers the tool they need to provide legal services that match the needs of the current global business community, but also encourage legal experimentation. The second claim is that corporate lawyers in common law systems are more open to legal change and innovation than their civil law colleagues. The difference seems to lie in the more experimental nature of common law compared to civil law systems.

Keywords: business entities, civil law, common law, company law, corporate lawyer, LLC, legal origin, innovation and entrepreneurship

JEL Classifications: K20, K22, L22, L26, L51
Company Law, Lawyers and Innovation: *Common Law versus Civil Law*

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I. Introduction

Arguably, there is a relationship between company law, lawyers and innovation. The editorial in the Economist of 18 December 1926 clearly describes the relationship: “The economic historian of the future may assign to the nameless inventor of the principle of limited liability, as applied to trading corporations, a place of honour with Watt and Stephenson, and other pioneers of the Industrial Revolution. The genius of these men produced the means by which man's command of natural resources has multiplied many times over; the limited liability company [provided] the means by which huge aggregations of capital required to give effect to their discoveries were collected, organized and efficiently administered.”³ To see this, consider the following principles of the public company form: (1) a corporation is a legal entity that holds the firm's assets; (2) the limited liability feature allows shareholders, many of whom are wealth-constrained and risk-averse, to diversify their risks and trade their shares publicly; and (3) corporate law creates centralized management, to which shareholders delegate important control rights to a group of specialists. These principles facilitate the separation of residual control from residual risk-bearing - usually referred to as the separation of ownership and control - and, hence, make it possible to publicly raise capital from a large number of equity investors. Undoubtedly, firms’ decisions to embrace the public company and stockmarket listings have accelerated innovation and industry productivity.

Provocative work on law, finance and development argued that the protection of investors in corporations that were governed by common law rules and institutions were considerably more effective than the rules originating in their civil law counterparts.⁴ The difference in investor

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⁴ See La Porta, Lopez-de-Silanes, Shleifer and Vishny, Legal Determinants of external finance, 52 Journal of Finance 1131 (1997); La Porta, Lopez-de-Silanes, Shleifer and Vishny, Law and finance, 106 Journal of Political Economy 1113 (1998); La Porta, Lopez-de-Silanes, Shleifer, Corporate ownership around the world, 54 Journal of Finance 471 (1999); La Porta, Lopez-de-Silanes, Shleifer and Vishny, Agency problems and dividend policies around the world, 158 Journal of Finance 3 (2000).
protection against expropriation by managers could even explain the divergences in the nature and
effectiveness of financial systems, and hence the innovative capacities on a global scale. A widely
accepted explanation for this is that common law statutes give the judiciary more latitude to fill
gaps in the inherently incomplete statutory company law arrangements that constitute a firm. The
argument is that open-ended fiduciary duty concepts in corporate law invite the judiciary to devise
efficient remedies, hence providing an abundance of case law to guide the adjudicators in their
efforts to resist opportunism within business settings. In this respect, common law statutes are
arguably more conducive to economic and social change than comprehensive and largely
mandatory civil law codes that discourage the adjudicators’ ability to complement and deviate from
statutory law.

However, civil law countries have caught up with common law systems during the past
decade by implementing a vast array of corporate governance reforms and introducing
sophisticated protective measures for passive equity investors. Restoring investors’ confidence in
the integrity of capital markets and addressing deficiencies in the relationship between managers
and shareholders of listed companies are two important factors motivating the constant drive for
corporate governance improvements in the area of listed companies and stock markets in both
common and civil law jurisdictions. This is exemplified by the recent global financial crisis, which
has yet again spurred legislatures into action to address perceived market failures. It is only to be
expected that the recent crisis lead to more mandatory rules and convergence in the corporate
governance systems of listed companies around the world. This observation leads to an
interesting conclusion: the rapid convergence in the legal protection of investors suggests that
legal origin (common law or civil law system) is not a major barrier to change and innovation in the
area of company law.

Breaking with the conventional wisdom on the differences between common law and civil
law systems, this paper argues that the role of the legal industry - in particular the actions and non-
actions of corporate lawyers and other legal practitioners - rather than legislatures and courts,
explains the innovative lawmaking approach in common law systems. It is generally acknowledged
that corporate law in common law countries tend to be more enabling than in civil law countries.
This is particularly true for new company law products that, by combining the corporate feature of
fully-fledged limited liability with the partnership law principles of flexibility and informality,

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5 See, for instance, European Commission, Green paper, The EU corporate governance framework, Brussels,
COM(2011), 164. See also Van der Elst and Vermeulen, Europe’s Corporate Governance Green Paper: Do Institutional
6 See Armour, Doakins, Sarkar, Siems and Singh, Shareholder Protection and Stock Market Development: An Empirical
Test of the Legal Origins Hypothesis, 6 Journal of Empirical Legal Studies 343 (2009). See also Pistor, Keinan,
Kleinheisterkamp and West, Innovation in Corporate Law, 31 Journal of Comparative Economics 676 (2003); Lele and
7 See Ribstein, The Rise of the Unincorporation, Oxford University Press 2010. See als Mendoza, Van der Elst and
Vermeulen, Entrepreneurship and Innovation: The Hidden Costs of Corporate Governance in Europe, 7 South Carolina
completely changed the legal landscape in the United States in the 1990s. The statutes of these “hybrid business forms”, in particular the limited liability company (LLC), were largely a byproduct of practicing corporate lawyers’ drafting and lobbying efforts to better support their clients. The proactive attitude of lawyers can be explained by competitive pressures that encouraged them to push for more flexible rules. Failing to do so could negatively affect the attractiveness of a jurisdiction’s company laws, which, in turn, could hamper potential long-term fee revenue growth for the corporate lawyers and their firms.

Based on our research, corporate lawyers in civil law countries are generally inclined to pursue a reactive, non-competitive strategy. Concerned about legal certainty arguments, corporate lawyers and other legal advisors tend to maneuver within the boundaries set by the statutory company law and case law system in a particular jurisdiction. Interestingly however, and contrary to the regulatory trend of introducing stricter rules and mechanisms for listed firms to comply with, competitive pressures to encourage innovation and economic growth appear to have also opened up opportunities for reform-minded lawmakers and lawyers in civil law jurisdictions. Legal innovators, who were previously blocked in their efforts to simplify and modernize company law, have found ways to successfully promote the contractual nature of their company law business forms. By doing so, the influence of legal transplants from common law jurisdictions is felt more and more in “private company law” reform projects in Asia, Europe and South America. Convinced that more contractual freedom to establish the rights and obligations within an organizational structure not only plays a central role in the emergence of necessary industry partnerships and collaborations, but also attracts foreign investments, a number of civil lawmakers have started to introduce new hybrid business forms in their own jurisdiction. Other civil law jurisdictions, in their efforts to spur entrepreneurship and innovation, pursue a more conservative reform strategy by updating and upgrading the existing company law statutes, thereby staying within the “safety zone” of legal certainty. Still, these reforms seek to promote flexibility and private ordering and allow firms to set up governance structures that best suit their needs.

This essay investigates the hypothesis that common law systems outperform their civil law counterparts in terms of legal innovation and economic development. An analysis of the private

10 As part of a larger research project, we looked at the incorporation and operation procedures of private companies in 77 countries. We also analyzed the flexibility of company laws in restructuring projects in more that 50 countries.
company law reform efforts, more specifically the introduction and acceptance of new company law products in common law and civil law jurisdictions, may challenge or confirm the hypothesis. If a trend towards convergence between the two systems is found, it may be argued that the civil versus common law divide is indeed overstated. Nevertheless, if common law systems innovate at a faster rate than their civil law counterparts, civil lawmakers may at best be viewed as early adopters of “legal innovations” that are generally developed in common law systems.

Our analysis proceeds as follows. Section II will start with briefly discussing studies that challenged the assumption that common law is superior to civil law.\textsuperscript{14} These studies point to the fact that separate private company forms were first successfully introduced in civil law countries. An assessment of the history and development of company law, however, shows that corporate lawyers and other interest groups successfully “lobbied” for more enabling and flexible company law statutes instead, thereby eroding the mandatory nature of company law. Section III analyzes the introduction of new company law products. In particular, the process and impact of the implementation of hybrid business forms in common law countries (the United States, the United Kingdom, India and Singapore) and civil law countries (France, Japan and Colombia) is evaluated. A distinction is made between (1) statutes that were implemented as a result of lobbying activities undertaken by industry groups and reform-minded corporate lawyers and (2) statutes that were proposed by public legislatures to generally encourage entrepreneurship and economic growth.

Evidently, in both cases the provision of new company law is ultimately a decision of public legislatures. Additionally, it is acknowledged that legislatures often involve practicing corporate lawyers in the drafting process of new company law provisions.\textsuperscript{15} On the other hand, if legislatures respond to reform-minded corporate lawyers and interest group pressures, it is shown that the chance of acceptance and success of innovative legal products is increasing significantly, both in common and civil law systems. As will be discussed in Section IV, path dependency factors appear to play an important role in civil law systems when public legislatures initiate legal reform.\textsuperscript{16} In these cases, corporate lawyers in civil law jurisdictions seem to have strong incentives to block innovative legal measures and techniques despite it becoming more and more apparent that there is a growing mismatch between the available legal “products” and the demands of the business world. This would suggest that the existence of a correlation between legal innovation and legal origin. Section V offers concluding remarks.


\textsuperscript{16} Path dependency refers to the fact that the evolution of legal rules and institutions is to a large extent dependent on historical decisions and trends. See Bebchuk and Roe, A Theory of Path Dependency in Corporate Ownership and Governance, 52 Stanford Law Review 127 (1999).
II. The History and Development of Company Law in a Nutshell

The corporate form is a success story. It gained popularity as the economies developed and improved transportation and communication systems led to many larger-scale firms. As discussed in the previous section, these firms were attracted by the corporation-type management and financial structure. With the growth of commercial and industrial activity in the nineteenth century, the pressure from politically influential industrialists to make the corporate form available across the board grew steadily in most industrialized countries. The considerable use of the corporation and the further development of the common law of corporations resulted in increasing demands for codification measures in common law jurisdictions in the nineteenth century. By 1890, all states had adopted statutes that made the corporation - with the limited liability feature - easily accessible by means of a simple registration. These corporate law statutes were mere restatements of the law as developed in practice by the custom of merchants and the courts.

During approximately the same era, civil law countries followed a different codification approach. In the spirit of revolution rather than evolution, judge-made law was viewed with suspicion and as a means of upholding the pre-codification regime. The lawmaking authority shifted from judges to public legislatures established by constitutional documents and principles. These legislatures severed all ties with the past when engaged in their codification efforts. As a result, the corporate law statutes in common law and civil law jurisdictions differed significantly in features dealing with similar issues, reflecting the different codification approaches. More than their common law counterparts, the drafters of corporate law statutes in civil law jurisdictions attempted to mitigate the (potential) governance failures and errors by tightening the rules, giving the statutes a more mandatory character in terms of protection of shareholders' and creditors' rights as well as interests in listed firms.

With the tightening of the rules and regulations for publicly held corporations at the end of the nineteenth century and more generally in the twentieth century, civil law jurisdictions introduced separate and more flexible private company law statutes for non-listed small and medium-sized enterprises. Germany, for instance, is renowned for the enactment of the first private company form. The Gesellschaft mit beschränkter Haftung (GmbH) was introduced on 19 May 1892. The private company form provided active investors in small and medium-sized enterprises with limited

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18 As the economies in the United States and Europe developed, numerous new corporations were chartered for the building of highways, canals, railroads, and telegraph lines. In those days, the corporate form was only available to certain types of businesses because of the formal concession of a sovereign person or government. The formal charter approval procedure disappeared as a result of intensive lobbying by the fast-growing industries. See Vermeulen, The Evolution of Legal Business Forms in Europe and the United States: Venture Capital, Joint Venture and Partnership Structures, Kluwer Law International 2003.
20 See Joseph A. McCahery and Erik P.M. Vermeulen, Corporate Governance of Non-Listed Companies, Oxford University Press 2008.
liability protection without having to abide by the more onerous rules designed to protect passive investors in listed companies. The introduction of the GmbH-form, and its subsequent transplantation throughout the European continent, as well as in Asian and Latin-American civil law jurisdictions, is considered an important development in the history of company law (Table 1).\textsuperscript{21} Arguably, it challenges the superiority of common law systems.\textsuperscript{22} Nonetheless, the introduction of new business forms tailored to the needs of non-listed firms should not be looked at in isolation.\textsuperscript{23}

Table 1: Introduction of Private Companies in civil law jurisdictions

<table>
<thead>
<tr>
<th>Country</th>
<th>Name</th>
<th>Year</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Sociedad de Responsabilidad Limitada (S.R.L)</td>
<td>1932</td>
<td></td>
</tr>
<tr>
<td>Austria</td>
<td>Gesellschaft mit beschränkter Haftung (GmbH)</td>
<td>1906</td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>Besloten vennootschap met beperkte aansprakelijkheid (BVBA)</td>
<td>1935</td>
<td>Modelled on the partnership form</td>
</tr>
<tr>
<td>Bolivia</td>
<td>Sociedad Limitada (S.L.)</td>
<td>1941</td>
<td></td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Druzhestvo z Ogranichenya Otgovornost (OOD)</td>
<td>1924</td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>Sociedades de responsabilidad limitada</td>
<td>1923</td>
<td></td>
</tr>
<tr>
<td>Colombia</td>
<td>Sociedades de responsabilidad limitada</td>
<td>1937</td>
<td></td>
</tr>
<tr>
<td>Denmark</td>
<td>Anpartsselskab (ApS)</td>
<td>1973</td>
<td>Introduced to avoid the application of European Company Law Directives</td>
</tr>
<tr>
<td>France</td>
<td>Société à responsabilité limitée (S.A.R.L.)</td>
<td>1925</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>Gesellschaft mit beschränkter Haftung (GmbH)</td>
<td>1892</td>
<td></td>
</tr>
<tr>
<td>Greece</td>
<td>Eteria Periorismenis Elfinis (E.P.E.)</td>
<td>1955</td>
<td></td>
</tr>
<tr>
<td>Hungary</td>
<td>Körútolt Felelosségü Társaság (Kft)</td>
<td>1930</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>Società a responsabilità limitata (s.r.l.)</td>
<td>1942</td>
<td></td>
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</tbody>
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\textsuperscript{23} See, for instance, Fleckner, Antike Kapitalvereinigungen: Ein Beitrag zu den konzeptionellen und historischen Grundlagen der Aktiengesellschaft, Böhlau (2010) (arguing that the evolution of Roman business law shows that besides economic aspects, social and political factors also a pivotal role in the development of company law)
<table>
<thead>
<tr>
<th>Country</th>
<th>Name</th>
<th>Year</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>Sociedad Anónima de Capital Variable (S.A. de C.V.)</td>
<td>1934</td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td>Besloten vennootschap met beperkte aansprakelijkheid (BV)</td>
<td>1971</td>
<td>Introduced to avoid the application of European Company Law Directives</td>
</tr>
<tr>
<td>Paraguay</td>
<td></td>
<td>1941</td>
<td></td>
</tr>
<tr>
<td>Poland</td>
<td>spółka z ograniczona odpowiedzialnoscia (sp. z o.o)</td>
<td>1934</td>
<td></td>
</tr>
<tr>
<td>Portugal</td>
<td>Sociedade por Quotas (Lda)</td>
<td>1901</td>
<td></td>
</tr>
<tr>
<td>Romania</td>
<td>Societate cu raspundere limitata (SRL)</td>
<td>1990</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>Sociedad Limitada (S.L.)</td>
<td>1953</td>
<td></td>
</tr>
<tr>
<td>Switzerland</td>
<td>Limited liability company (GmbH)</td>
<td>1936</td>
<td>Modelled on the partnership form</td>
</tr>
<tr>
<td>Venezuela</td>
<td>Sociedad de Responsabilidad Limitada (S.R.L)</td>
<td>1955</td>
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Source: Adapted from Lutter, Limited Liability Companies and Private Companies (Chapter 2) in International Encyclopedia of Comparative Law, Business and Private Organizations (Volume XIII)

Referencing just one example, consider the development of corporation law in Delaware, the companies’ choice of state of incorporation for US firms. It is indeed true that Delaware (and the other states) was a laggard in terms of adopting a separate corporate business form for non-listed companies. However, for reasons of flexibility in the incorporation and operation of a business, both listed and non-listed companies started to avail themselves of the corporate form, making the introduction of separate private company legislation superfluous. Contractual deviations from the corporate separation of ownership and control structure were used to tailor the corporate form to the needs of small and medium-sized non-listed companies. The fact that the initial tendency of courts was to treat these contracts with suspicion (by rendering shareholder agreements that provided the parties with partnership-type governance invalid) did not stop corporate lawyers from deviating from the general corporation statutes by opting out of stricter rules that negatively affected the operations of their corporate clients.\(^{24}\) The lawyers’ drafting persistence gradually resulted in (1) courts allowing the use of contractual arrangements despite the possible tension with the corporate structure,\(^{25}\) and (2) corporate statutes becoming more flexible by explicitly permitting to contract around statutory provisions.

As entrepreneurs intend to start up a high-tech company in the United States, for example, their lawyers, attentive to the specific needs and aspirations of fast-growing high-tech firms, are usually very much inclined to incorporate in Delaware.\(^\text{26}\) Delaware’s statutory law and case law permits the lawyers to contract around irrelevant and inconvenient default rules and tailor rights and duties that are more consistent with their organizational priorities.\(^\text{27}\) Research shows that these contractual arrangements, set forth in the articles of association, stock purchase agreement, investor rights agreement and other legal documents, offer an effective solution to the challenges of investing in high-tech companies. It appears that venture capital investments in start-up companies are optimally made against the issuance of convertible preferred stock. It allows for significant ex post flexibility in the determination of control rights and the conditions upon which venture capitalists are allowed to exit their investment. Convertible preferred stock is considered optimal because it, firstly, secures downside protection for venture capitalists and secondly, gives entrepreneurs incentives to take significant risks in order to obtain a higher final firm value in the event of success. In this respect, there is little doubt that the flexibility of Delaware’s General Corporation Law - in that it allowed corporate lawyers to experiment with innovative contractual provisions that encouraged venture capitalists to actually invest in start-up firms and at the same time stimulated a steady supply of entrepreneurs - has also been a key input to the development of the venture capital industry in the United States.\(^\text{28}\)

In contrast, statutory corporate law in civil law jurisdictions usually lacks the flexibility of Delaware law.\(^\text{29}\) Private company law in Europe, for instance, in many respects a mirror-image of the law for public corporations, was generally characterized by its mandatory nature and inflexibility, leaving little room for legal experimentation. Nevertheless, path-breaking decisions of the European Court of Justice in the previous decade, resulting in the improvement of the so-called ‘incorporation mobility’, have dramatically altered the Continental company law landscape.\(^\text{30}\) The court decisions allowed start-up firms to incorporate under the laws of other Member States if the foreign business form better serves the start-ups’ needs. The pressures of losing “business” to neighboring jurisdictions gave rise to a large number of company law reforms to offer firms a more flexible and adaptable regulatory framework similar to Delaware’s corporate law statute.\(^\text{31}\) It should be noted here that company law reforms are not limited to Europe. Stimulation of entrepreneurship,
attraction of foreign investments and the facilitation of investor participation in local companies are all driving forces behind reform initiatives worldwide.\textsuperscript{32}

In short, company law of the twenty-first century offers a spectrum of incorporation and operation options to firms. On one end, there is the traditional public company form that becomes more and more regulated and controlled in order to restore investor confidence and prevent a next financial crisis.\textsuperscript{33} On the other end, lawmakers endeavor to provide firms with one or more flexible business forms that allow them to innovate and pursue entrepreneurial activities. Illustrations of recent company law developments allow us to see how the reforms tend to map on the spectrum of company law options. Please find some of the key findings below:

- Policymakers and lawmakers around the world are actively discussing the further regulation and control of listed firms. Some examples of this trend include the rules that are meant to promote the involvement of independent directors and long-term shareholders in the decision-making process of firms. In addition, certain policymakers have argued that changing the composition and compensation of corporate boards will deter fraud and abuse in the boardroom and, at the same time, foster firm performance.

- Lawmakers are considering and introducing legal upgrades to their private company law forms leaving the core of the company law system untouched. These reforms are characterized by compromise legislation that mainly focuses on the simplification of formation requirements. Proponents of this view are of the opinion that legal certainty arguments prevent a more ambitious reform which offers business parties an environment of private ordering and contractual flexibility. The private company law reforms in the European Member States are examples of compromise reforms.

- Company law reforms are also moved by interest group pressures with the effect of the promulgation of new hybrid business vehicles that combine the best features of the traditional partnership and corporate forms. The key drivers behind the development of new business forms are the benefits of maximum flexibility and autonomy of business parties to structure the firm’s internal organization free from historically determined rules and doctrines. It is to be observed that the introduction of new hybrid business forms has the potential drawback of being a relatively untested entity that has not generated a large body of case law and academic research. But, the statutory incompleteness is often mitigated by (1) developing improved statutory default rules to provide enhanced certainty and guidance to the business parties, (2) initiating regularly updates of the business law statutes and (3) providing model articles of association on a ‘think small first’ basis that offer, particularly, smaller firms ‘off-the-rack’ provisions reflecting the preferences of the majority of users of the business form, thereby reducing transaction costs. The Limited Liability


\textsuperscript{33} See Mendoza, Van der Elst and Vermeulen, Entrepreneurship and Innovation: The Hidden Costs of Corporate Governance in Europe, 7 South Carolina Journal of International Law & Business (2011).
Company in the United States, the Limited Liability Partnership in the United Kingdom, the French Société par Actions Simplifiée (SAS), and the Colombian Sociedad por Acciones Simplificada (SAS) are examples of these innovative hybrid business forms.34

- Hybrid business forms are also inspired by the success of these forms in the United States and the United Kingdom, as limited liability partnerships were introduced in other common law jurisdictions, such as Singapore and India, to expand the governance options to be considered by small and medium-sized businesses and professionals. Importantly, Japan, which has a tradition to follow Germany’s civil law system, introduced two new hybrid business forms in 2005 and 2006. The rationale behind this was to supply Japanese firms with more contractual flexibility, thereby encouraging the establishment of multinational joint ventures in the human capital-intensive and financial services sector. The developments described here can be distinguished from the introduction of hybrid business forms in the United States, France and Colombia in that the lawmaking initiatives were undertaken by public legislatures or groups affiliated to public state actors.

Important observations can be distilled from these developments. In general, lawmakers are reactive, rather than proactive. They are reluctant to take action before an actual problem has arisen, tending to respond to competitive or interest group pressures. The question arises whether the reforms and modernizations of company law can better inform us about the efficiencies and inefficiencies of common law and civil law systems. To analyze this question, the focus lies on the hybrid business forms that facilitate freedom of contract and organization. The acceptance and impact of these business forms arguably give us more insights in the innovative strengths of the legal systems as well as the willingness of corporate lawyers to experiment with new business forms. In the next section, the developments of the hybrid business forms are elaborated upon further.

III. The Evolution of Hybrid Business Forms

Traditionally, the features of legal business forms – i.e., whether it is viewed as a legal entity, providing parties with limited liability protection or offering beneficial tax treatment – has dictated the selection of business form process. Due to the fact that this decision is made before the actual outcome of the venture is clear, the participants must engage in a comparative ex ante search for the organizational structure that maximizes the value of their investment. They tend to bargain over four fundamental elements – risk of losses, return, control and duration – subject to three major

constraints: conflict of interest, government regulation and limits on specifying in complete detail all the terms of the relationship ex ante.\textsuperscript{35}

Rational business parties that decide to operate as a firm should agree upon the business form that best matches their legal status with their organizational needs. Three questions, which follow the bargaining elements and constraints, are crucial to choice-of-business-form decisions.\textsuperscript{36} Firstly, what is the relationship between the participants inside the firm? This choice relates to the function of the governance structure, break-up provisions and incentive mechanisms. Secondly, what is the relationship between the firm and outsiders? The latter focuses on limited liability regimes. Thirdly, what is the relationship between the government and the firm? This question primarily concerns the incorporation requirements and tax treatment of the business form. It goes without saying that the hybrid business forms offer significant inherent benefits in terms of increased flexibility. Cheaply available and combining the best of the partnership and corporate world, these flexible business forms contain features that make them better suited to professional, start-up and family firms as well as for joint ventures, in which there is no strict separation of ownership and control. Even so, this does not necessarily entail a widespread use of the relatively new business forms. Firstly, these new entities do not have the tried and tested status of the older and more common public and private company forms and are therefore more prone to legal uncertainties and disputes. Secondly, sunk costs and learning effects often prevent corporate lawyers to adopt legal innovations. Finally, reputation and commercial image concerns may complicate the decision to opt into the new business form.

Turning to the development of hybrid business forms in several common and civil law jurisdictions, the following questions shall be answered: (1) Is the hybrid business form accepted by businesses across the board? (2) Is the hybrid business form recommended by corporate lawyers despite the possible legal uncertainties? and (3) What are the distinctive features of the hybrid business form and how does it fit in the existing company law framework? Part A evaluates the development of hybrid business forms that were introduced as a response to interest group pressures. In Part B, hybrid business forms that were introduced as a result of competitive pressures without the influence of high-powered, reform-minded interest groups are discussed.

A. The Introduction of Hybrid Business Forms as Response to Interest Group Pressure

The Limited Liability Company in the United States

In 1975, corporate lawyers advising Hamilton Brothers Oil Company lobbied for the introduction of a new business form, the LLC. This business form bundled together limited liability, a flexible governance structure and preferential tax treatment. The hybrid business form required less ongoing paperwork than corporations. Also, it provided its members with an almost total shield against personal liability without cumbersome formation and capital maintenance rules. After a failed legislative effort in Alaska, corporate lawyers lobbied successfully for the enactment of the LLC statute in Wyoming, another state with significant gas and petroleum production facilities, in 1977. In 1980, the Internal Revenue Service (IRS) issued a private letter ruling to the Oil Company securing the favourable partnership taxation for its Wyoming LLC structure.

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

The success of the LLC in all states forced the tax authorities to explain in more detail the distinction between partnership and corporate tax treatment, which eventually led to a new federal ‘check-the-box’ tax rule. Under the Internal Revenue Service’s ‘check-the-box’ regulations, which became effective on 1 January 1997, hybrid business forms are taxed as partnerships unless they affirmatively elect to be taxed as corporations. The partnership taxation – pass-through tax treatment – is based on the assumption that a partnership is a mere aggregate of individual partners who re-distribute profits among themselves. Consequently, LLC income is treated as if it were personal income realized by the members, and is taxed to the members as individuals. In contrast, corporate income is taxed first to the corporation and later, if it is distributed as dividend, to the shareholders individually.
The LLC is a separate legal entity that attempts to take proper account of the concerns of economic actors in an increasingly competitive and litigious business environment. The most important feature is that it offers contractual flexibility. The Operating Agreement even overrides the Articles of Association in the event of a conflict. By doing so, the LLC keeps the price of limited liability down by not only providing for flexible tax rules, but also by giving the business planner the chance to opt into the most optimal governance structure. Due to the over-regulatory nature of the marketplace, it should come as no surprise that clear and flexible business forms that shun formation and operation formalities, such as LLCs, were heralded in the United States. The LLC is most popular in states which included the principle of maximum contractual flexibility in their statutes. The fact that businesses, apparently, put so much emphasis on organizational flexibility explains why Delaware is the preferred destination particularly for large firms. Delaware’s specialized Chancery Court, which tends to respect the parties’ contractual arrangements, is

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arguably one of the determining factors in the choice of formation state decisions.\textsuperscript{38} Indeed, the Delaware court is very supportive of the dominance of “freedom of contract”.\textsuperscript{39} “The LLC is a relatively new entity that has emerged in recent years as an attractive vehicle to facilitate business relationships and transactions. The wording and architecture of the Act is somewhat complicated, but it is designed to achieve what is seemingly a simple concept — to permit persons or entities ("members") to join together in an environment of private ordering to form and operate the enterprise under an LLC agreement with tax benefits akin to a partnership and limited liability akin to the corporate form.” It is therefore not surprising that the market share of the LLC is still increasing in Delaware (Figure 1).

The Limited Liability Partnership in the United Kingdom
The introduction of the limited liability partnership (LLP) in the United Kingdom (UK) in 2001 was motivated by a myriad of factors, including election politics, which contributed to its speedy passage. The Department of Trade and Industry (DTI) was directly involved in the establishment of the LLP. Prompted by competition from offshore LLP statutes, particularly that of Jersey, the UK legislature, lobbied by British accountants, decided to promulgate a Limited Liability Partnership Act.\textsuperscript{40} The LLP has legal personality, a partnership governance structure, limited liability, and partnership tax treatment. In drafting this legislation, DTI responded to the pent-up demand from existing professional partnerships wishing to transfer to LLP status. Although the LLP act was initially drafted to address the liability concerns of large accounting and other service providers in England, the statutory provisions, as enacted, cover all types of businesses.

Firms that opt into the LLP form are required to comply with provisions of the Companies Act 2006 concerning the preparation of audits and publication of accounts; some provisions of the Companies Act relating to the registration of charges, the delivery of accounts, and the investigation of companies and their affairs; and some provisions of the Insolvency Act relating to voluntary agreements, administrative orders, and the winding-up of the business. In other respects, and chiefly its decision-making rules, the LLP is closer to a partnership, offering parties, to a large extent, freedom of contract in the context of internal organization and the governance structures.

As mentioned, the United Kingdom has responded to the demands of a particular class of firms (i.e., multinational professional service firms) that possess the resources and capacity to draft a comprehensive operational agreement that meets their special requirements. The outcome is


\textsuperscript{40} Limited Liability (Jersey) Law, 1996. Motivated by liability and tax considerations, British accountants (in particular Ernst & Young and Price Waterhouse) provided a wholly crafted statute to the Jersey legislature, a largely passive and accessible body that decided to enact the statute. In speedily adopting the LLP, Jersey signalled its commitment to a comprehensive set of business forms for foreign organizations. However, high switching costs and doubts about the prospective benefits of incorporating as a Jersey LLP may explain Jersey’s failure to capture a share of the UK partnership market.
that, while the UK LLP extends limited liability to all types of firms, the effect of high transaction costs will arguably limit its suitability for most SMEs. While there are significant, unanticipated drawbacks during the pioneering development of the LLP statute, corporate lawyers have already taken steps to avoid the most costly aspects of the Act by experimenting with key provisions within the LLP agreement for the benefit of the mixture of large and small firms that have contracted into this form. The result is that the UK LLP has become a practical and useful vehicle for a variety of small and larger businesses, such as professional firms and joint ventures for property development. Particularly, the LLP gained popularity during the recent economic downturn as it offers a simple and flexible business form with better protection for its members if the business runs into trouble (see Table 2).

### Table 2: LLPs in the UK

<table>
<thead>
<tr>
<th>March (Year)</th>
<th>Total LLP Registrations</th>
<th>Yearly Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>2002</td>
<td>1845</td>
<td>1845</td>
</tr>
<tr>
<td>2003</td>
<td>4442</td>
<td>2597</td>
</tr>
<tr>
<td>2004</td>
<td>7396</td>
<td>4799</td>
</tr>
<tr>
<td>2005</td>
<td>11924</td>
<td>4528</td>
</tr>
<tr>
<td>2006</td>
<td>17499</td>
<td>5575</td>
</tr>
<tr>
<td>2007</td>
<td>24555</td>
<td>7056</td>
</tr>
<tr>
<td>2008</td>
<td>32066</td>
<td>7511</td>
</tr>
<tr>
<td>2009</td>
<td>38443</td>
<td>6377</td>
</tr>
<tr>
<td>2010</td>
<td>40604</td>
<td>2161</td>
</tr>
<tr>
<td>2011</td>
<td>45376</td>
<td>4772</td>
</tr>
</tbody>
</table>

Source: Companies House

### The Société par Actions Simplifiée in France

The pressure of competition from businesses in other Member States, which were viewed as having more suitable closely held business forms, stimulated the French business community to lobby the legislature for the adoption a new organization structure for firms in the early nineties. The 1994 introduction of the Société par Actions Simplifiée (SAS) and its subsequent modification in 1999 is thus an example of responsive lawmaking in a civil law country. The SAS is a limited liability vehicle that provides for a flexible organization and administrative structure, but restricts free transferability of shares. The vehicle allows parties to choose the firm’s management and decision-making structure and the contents of its by-laws. As conceived the SAS creates the
opportunity for partners in a joint venture to contractually arrange for the most effective organization and control mechanisms inside the firm. The 1999 modification proved highly successful in attracting large numbers of foreign firms to France for investment purposes. Subsequently, the legislature set out to improve the competitive environment for investment through the introduction of a series of company law and fiscal reforms. In particular, Law n° 2008-776, Le Roi de modernisation de l'économie dated August 4th 2008 (loi LME), was promulgated to streamline and simplify the code, offering firms, for example, with easy access to the SAS, more contractual flexibility, and a more beneficial fiscal regime for SMEs.

Turning to accessibility, the French legislature succumbed to pressures to reduce the minimum capital requirements for the SAS. As from 2009, the legislation requires that an SAS must have a minimum authorized and paid up capital of EUR 1.00. Together with the SARL, the SAS can now compete, on cost terms, with the UK private limited company for attracting newly incorporating firms. At the same time, entrepreneurs and foreign investors have greater possibilities to invest their human capital and services in start up and investment oriented vehicles. Specifically, under article L. 227-1 of the French Commercial Code, a shareholder is permitted to make contributions in kind, as well as their experience, skills and knowledge. This measure is fashioned on the US LLC statute that permits shareholders to invest their experience and sweat equity in exchange for financial interests in the firm. However, unlike its US counterpart, the French SAS, can only permit the issuance of non-transferable shares. Despite this limitation, the legislature has taken a significant step forward by introducing partnership-like principles in the core of French company law.

Even the appointment of a statutory auditor, a traditional French corporate law principle, has been abandoned under certain circumstances. The remaining two circumstances under which the shareholders of an SAS are required to appoint a statutory auditor are if the SAS is part of a group of companies and if the statutes require that an auditor must be appointed if a company exceeds, at the end of the fiscal year, two of the following three thresholds (i.e., total sales of EUR 2,000,000 (excluding VAT), a total balance sheet of EUR 1,000,000 or more than 20 employees).

Thus, the SAS, already in 1999, created the opportunity for partners in a joint venture – and for other purposes – to adopt a legal structure that is sufficiently flexible in the organization and control of the firm. This vehicle allows parties to choose the firm’s decision-making structure and the contents of its bylaws. 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 reducing barriers to incorporation, it is likely that the French government will indirectly increase the number of new domestic businesses and perhaps attract a larger number of foreign firms seeking a productive investment or joint venture.
As shown, the recent SAS reforms were fashioned on the US LLC. While the effect has been to create a more accessible legal business form for investors, some features of the SAS may require further attention by lawmakers. For example, the requirement to appoint a President to represent and bind the company sets a clear limit on the degree of organizational flexibility for the SAS. Moreover, unlike the US LLC, the SAS does not provide a detailed set of default rules that could easily fill the contractual gaps for the parties’ omissions. Despite these shortcomings, the SAS is perhaps the most entrepreneur-friendly hybrid business form in Europe today that is also available to individuals. It should therefore come as no surprise that slowly but surely the SAS increasingly attracted high-tech start-ups and venture capital pioneers in France, which used to employ the public corporation (société anonyme) (see Figure 2).41

The Sociedad por Acciones Simplificada in Colombia
The promulgation of hybrid business forms in civil law jurisdictions is not only restricted to France. In December of 2008, the Congress of the Republic of Colombia enacted a new law introducing a

new form of hybrid-business entity: the Simplified Stock Corporation (SAS). The reform was initiated by local corporate lawyers who, inspired by the Delaware LLC, drafted the SAS legislation in an effort to introduce legal tools to better serve the business community in Colombia. The result was astonishing. The SAS ushered in a new way of doing business. Interestingly, its flexibility and easy and cheap access to limited liability not only eclipsed the sole proprietorship as a form of doing business, but also gained substantial market share compared to the traditional company law forms, such as the private company and the stock corporation (see Figure 3).

Figure 3: The Growing Market Shares of the SAS in Colombia

Business parties can establish an SAS by filing a simple registration before the Chamber of Commerce (without going through the complicated and time-consuming incorporation requirements that apply to the traditional business forms, such as the mandatory rule to have a multiple number of shareholders and the appointment of fiscal auditors). The Act made it clear that shareholders would be shielded from any liability concerning any obligations arising from the business activities of the corporation. Furthermore, it removed obsolete prohibitions regarding the activity of shareholders and managers and, most importantly, adopted the straightforward principle of

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42 Law 1258 of 2008.
freedom of contract. It is now, for instance, possible for shareholders to manage the company directly and/or obtain different classes of shares. The new law even introduced an innovative and alternative enforcement mechanism, which referred conflicting parties to an arbitration or administrative adjudication procedure. The simplified incorporation procedure allowed the Chamber of Commerce to design an online system that facilitated the electronic filing of new SAS registrations. Currently, the incorporation process can take less than two hours. This is because the website of the Chamber of Commerce of Bogota, for instance, provides for a six step process: (1) the creation of an account, including the application for a corporate name and tax ID-number, (2) the filing of the articles of incorporation (in order to expedite the process, model articles of association are made available), (3) the online payment, (4) the request to issue a digital signature, (5) digitally signing the incorporation documents and (6) review of the documents by the Chamber of Commerce.

A wide range of businesses employ the SAS. Besides the smallest companies and family firms benefitting from the dual class shares, international corporate groups, looking for cost-saving opportunities, rushed to convert their previous subsidiaries into the new flexible business form. In only 4 months the SAS was the preferred business entity, as measured by the number of new business formations and the market share of business forms in Colombia. In May 2010, a total of 31,856 SASs were registered.

B. The Introduction of Hybrid Business Forms Initiated by Public Legislatures

The Limited Liability Company and Limited Liability Partnership in Japan

Traditionally following Germany’s company model, Japan has also, inspired by the success of legal innovation in the United States and the United Kingdom, introduced two new legal forms: the J-LLP (Yigensekinin-jigyo-kumiai) and J-LLC (Godo-kaisha). These hybrid entities, which are intended to supply Japanese firms with more contractual flexibility, are arguably more suitable for firms involved in the human capital intensive technology sectors, such as software development companies.43

There are numerous indications that the Japanese legislature has devoted considerable attention to the concerns of the largest and most established companies seeking to develop new technology, spin-off new opportunities and intellectual property, which can form the basis of joint ventures and alliances. Thus, by 2003, the Ministry of Justice had established a number of priorities involving the amendment of the Commercial Code. The end result was a package of legislative reform measures, comprised in The New Company Law, which were submitted to the Diet (Japanese legislature) in March 2005. The Japanese New Company Law (Kaisha Ho)

43 Japan is slowly but surely shifting to software. It is therefore important to encourage the establishment of these companies by offering a suitable legal infrastructure. See Economist, Innovation in Japan, Samurai go soft, 16 July 2011.
abolishes the Yugen Kaisha (YK), the private company form, but leaves a modernized Kabushiki Kaisha (KK), the public corporation, in place (grandfathering the existing YKs). The New Company Law provides for the introduction of a new company form, the Japanese Limited Liability Company (J-LLC) or Godo Kaisha. The J-LLC is a flexible business form that bundles together limited liability, decentralized management by default, unanimous consent to transferability of members’ interests, fiduciary duties and no requirement to audit and disclose financial records. The Japanese vehicle bears a strong resemblance to the US LLC (e.g., voting and distribution rights are by default proportionate to the members’ contributions), but diverges in a number of important respects, including: (1) contributions to the J-LLC will be limited to cash or property, but no services, know-how or other agreements are permitted; and (2) the J-LLC will receive corporate, and not pass-through, tax treatment.

Table 3: Total Number of Registrations of Limited Liability Entities

<table>
<thead>
<tr>
<th>Entity</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
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<tr>
<td>KK</td>
<td>1212503</td>
<td>1191680</td>
<td>1235720</td>
<td>1171114</td>
<td>1310520</td>
<td>1210010</td>
<td>1215015</td>
<td>1369953</td>
<td>1250514</td>
<td>1055543</td>
<td>992293</td>
<td>931967</td>
</tr>
<tr>
<td>YuGen</td>
<td>386486</td>
<td>413519</td>
<td>420626</td>
<td>431879</td>
<td>449401</td>
<td>470455</td>
<td>475298</td>
<td>452389</td>
<td>374410</td>
<td>331056</td>
<td>293880</td>
<td>270191</td>
</tr>
<tr>
<td>J-LLC</td>
<td>- - - -</td>
<td>- - - -</td>
<td>- - - -</td>
<td>- - - -</td>
<td>- - - -</td>
<td>- - - -</td>
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<td>- - - -</td>
<td>- - - -</td>
<td>- - - -</td>
<td>- - - -</td>
</tr>
<tr>
<td>J-LLP</td>
<td>- - - -</td>
<td>- - - -</td>
<td>- - - -</td>
<td>- - - -</td>
<td>- - - -</td>
<td>- - - -</td>
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<td>- - - -</td>
<td>- - - -</td>
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</tr>
</tbody>
</table>

Source: Government of Japan, Ministry of Justice

The Japanese legislature had not been able to adopt a hybrid business form that also provided for pass-through taxation due to doctrinal factors and principles. This encouraged the Ministry of Economy, Trade and Industry (METI) to step in and submit, subsequent to the introduction of the Godo Kaisha, the Limited Liability Partnership Bill to the Diet in February 2005. As a consequence, the J-LLP or Yugen Sekinin Jigyou Kumiai came into effect on 1 August 2005 to encourage the creation of new business ventures, joint ventures and other strategic partnerships between high tech companies and research institutions. The J-LLP provides for the introduction of a vehicle that is characterized by limited liability, a flexible organization structure, pass-through taxation, and restrictions to the free transferability of partners’ interests. Despite these attractive features, the legislation mandates a number of highly restrictive and costly features including: 1) registration of the J-LLP agreement; 2) disclosure of financial information including the profit and loss statements and the balance sheet upon the request of creditors; 3) the mandatory obligation of partners to participate in J-LLP management and its operation; and 4) the right of partners to exit at will. These shortcomings, which reflect political compromises to obtain partnership tax treatment, have arguably led to the slow start as well as the already declining use of the J-LLP. Indeed, with

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44 This is surprising since Table 3 shows that the private company form (Yugen Kaisha) was gaining popularity in the business and legal community.
respect to incorporations, the J-LLC has proved the more popular and enduring structure, partly due to the possible preferable tax treatment in international transactions: The J-LLC (in contrast to the traditional KK) could opt for a pass-through tax treatment in the United States. This pattern, which undoubtedly will improve the image and reputation of the J-LLC in the future, is revealed in Table 3 below, showing the increasing number of registrations from 2006 to 2010.

The Limited Liability Partnership in Singapore

Turning to Singapore, it has been observed that the public legislature, in order to respond to increased competition in Asia and the rapid development of China, has also enacted an LLP statute (which came into effect on 11 April 2005). The Company Legislation and Regulatory Framework Committee (CFRFC) spurred the introduction of an LLP in Singapore. The LLP reflects “the acute awareness of the need to recognize and accommodate current international business and commercial practices”\(^{45}\). The Singapore LLP (S-LLP) is a new type of hybrid form in Singapore fashioned on the Delaware LLC and the UK LLP. It is a legal entity that can sue and be sued and acquire and hold property. Like the Japanese counterpart, it offers a flexible management structure and pass-through taxation. The partners are not personally liable for the firm’s debts and obligations. Yet, the partners are personally liable in tort for their own wrongful act or omission. The internal relationship between the partners is governed by the limited liability partnership agreement. In the absence of an agreement or when the agreement is silent on a matter, the First Schedule, acting as a model agreement, will apply. Although the S-LLP is required to keep accounts and other records, it is not necessary to prepare profit and loss accounts or balance sheets nor to have them audited and disclosed.

Initially, the implementation of the S-LLP was greeted enthusiastically by investors. In fact, the evidence shows that from 2006-2008 there were 5,234 LLPs incorporated, which was approximately eight percent of the newly established private firms registered in Singapore each year from 2006-2008. Even though this figure may appear small in absolute terms, the diffusion rate is considered a partial success due to the limitations of and limited experience with the new business form in Singapore. The continuing effects of the credit crunch on start-ups and other shareholders resulted only in a slight decline in the use of the S-LLP measured by the number of new formations (Figure 4). The dominant business form in Singapore is the Exempt Private Limited Company. Especially small and medium-sized enterprises are attracted by this business form, given its reputation, legal entity status and limited liability protection whilst simultaneously not subject to comply with cumbersome formational and operational procedures. Exempt private limited companies are, for example, not required to appoint an auditor and file audited accounts if their annual turnover is less than S$ 5,000,000. Another advantage compared to the S-LLP is that

\(^{45}\) Please see: www.singaporelaw.sg

21
it is possible to establish sole shareholder exempt private limited companies. The S-LLP needs at least two members upon its inception.

**Figure 4: Current Market Share LLP in Singapore**

![Current Market Share LLP in Singapore](source)

Source: Janus Corporate Solutions/Guide me Singapore

**The Limited Liability Partnership in India**

The economy is growing and flourishing in India. The country is known for its highly-trained professionals and technicians. Western companies and firms are increasingly outsourcing their IT and legal services to India. Yet, the government in India is faced with a complex problem. The small and medium-sized enterprises are underdeveloped and provide only 10% of the number of available jobs in India. Against this background, the need has arisen for the modernization of the legal infrastructure. In particular the introduction of a hybrid business form, based on the UK LLP model and its separate LLP rules, should make it easier for entrepreneurs to start a business.

Although the first limited liability partnership bill was introduced in 2006, the LLP Act 2008 came only into effect on 1 April 2009. The delay seems to have provided opportunities for lawmakers to learn from the experiences in the United Kingdom.

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46 See Financial Times, Up in the army, 6 September 2010.
47 Interestingly, the LLP in India is introduced before discussions on a more general company law review were started. It is only to be expected that the new private company law will be more flexible and contractual in nature.
The LLP is a legal entity with two or more partners, who, if not otherwise agreed upon, are also involved in dealing with the daily affairs of the business. Similar to the US LLC and UK LLP, the internal relationship among the partners is mainly governed by the LLP agreement. The 2009 Finance Bill has brought the taxation in line with a general partnership. This entails that the profits will be taxed at firm level. The distribution of profits is tax exempt. The LLP has at least two designated partners who are responsible for the registrations with the respective authorities. One of these partners must be resident in India. There are hardly any mandatory rules, except that the designated partners must file financial statements. An interesting feature of the India LLP is that,
like in Colombia, it may be established through the Internet: the designated partners must apply for a Designated Partner Identification Number (DPIN) and a Digital Signature Certificate (DSC). The DPIN and DSC are necessary to register the LLP. After registration a trade name check will be conducted. The incorporation process is completed upon the payment of the registration fee by credit card. The website\textsuperscript{48}, which was set-up by the Indian government, also offers assistance in drafting the LLP agreement and registering the LLP (within 30 days of the incorporation). The website contains tutorials and information about the number of LLP registrations. After sixteen months, 2265 were established. One year later (on 1 August 2011), the number of registered LLPs was 5788. The simplicity of the legislation, one of the advantages of the LLP, captured the attention of not only professionals, but also many other businesses across different sectors (Figure 5).

IV. Common Law or Civil Law: The Changing Role of Corporate Lawyers

Are firms made better off by choosing to organize as a hybrid business form? As demonstrated, in making the choice for a particular legal entity, three questions are relevant: (1) How does the statute govern the relationship between the parties inside the firm? (2) How does the statute govern the relationship between the firm and outsiders (third parties)? (3) How is the relationship between the government (society) and the firm governed? Table 4, providing a comparative overview of the hybrid business forms discussed in the previous section, reflects the answers to these questions. As for the last two questions, it is clear that limited liability protection is a common feature of the hybrid business forms. However, the accessibility, i.e., the incorporation and disclosure requirements, differs slightly among the hybrids. For instance, the business forms that carry the partnership name usually require two or more partners to set up the business, whereas the “corporate-type” hybrid business forms acknowledge sole ownership structures. These variations partly explain the differences in popularity.

It is widely acknowledged that choice of entity decisions are often based on tax considerations. Consider the LLC in the United States, which became very popular very quickly due to its pass-through tax treatment. Yet, Table 4 seems to cast doubt on taxation being the most important driver behind the success of hybrid business forms. Clearly, the French and Colombian SAS, which are both treated as corporations for fiscal purposes, have become the most favourable choice of entity for non-listed firms for other considerations than a more beneficial tax status. Indeed, it follows from Table 4 that the driving force behind the hybrid business forms is the concept of maximum flexibility and autonomy of the business parties (and their corporate lawyers) to structure the firm’s internal affairs as much as possible free from the established legal principles.

\textsuperscript{48} Please see: www.llp.gov.in
and doctrines. For instance, the fact that parties may be subject to broad fiduciary duties and partnership-type sharing principles, possibly requiring a party to forgo personal interests, could very well act as a deterrent to the establishment of international joint ventures. Also, recall that venture capitalists prefer to use convertible preferred stock in their transactions. Start-up businesses in need of equity capital cannot be expected to be tied up with business forms that only offer mandatory and burdensome statutory measures, such as strict predefined management and shareholding structures. This is especially true if the business form statutes - explicitly - fail to allow for the possibility to contract around its provisions by opting into a more effective organizational regime. An example as follows; if venture capitalists are not allowed to enforce their rights under a preferred stock agreement, it could severely restrict entrepreneurs’ access to risk financing and other services necessary to start- and grow a company. Ironically, these latter situations show that, particularly for firms involved in multinational joint ventures or in human capital intensive sectors, the lack of contractual flexibility could significantly increase legal uncertainty (and transaction costs) due to statutory obsolescence and ambiguity.

Table 4: Comparison: Hybrid Business Forms in Common Law and Civil Law Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>US LLC Delaware</th>
<th>UK LLP</th>
<th>SAS France</th>
<th>SAS Colombia</th>
<th>J-LLC</th>
<th>J-LLP</th>
<th>S-LLP</th>
<th>LLP India</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Governance</strong></td>
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<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Relationship</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Flexible</td>
<td>Flexible, but mandatory participation in management by all the partners</td>
<td>Member-managers, unless otherwise provided in the agreement</td>
<td>Member-managers, unless otherwise provided in the agreement</td>
</tr>
<tr>
<td>between parties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Flexible</td>
<td>Flexible, but mandatory participation in management by all the partners</td>
<td>Member-managers, unless otherwise provided in the agreement</td>
<td>Member-managers, unless otherwise provided in the agreement</td>
</tr>
<tr>
<td>inside the firm</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Flexible</td>
<td>Flexible, but mandatory participation in management by all the partners</td>
<td>Member-managers, unless otherwise provided in the agreement</td>
<td>Member-managers, unless otherwise provided in the agreement</td>
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<tr>
<td><strong>Number of</strong></td>
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<tr>
<td><strong>members</strong></td>
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<tr>
<td>1 or more</td>
<td>2 or more</td>
<td>1 or more</td>
<td>1 or more</td>
<td>1 or more</td>
<td>2 or more</td>
<td>2 or more, but it is possible to have one partner for two years</td>
<td>2 or more, but it is possible to have one partner for 6 months</td>
<td></td>
</tr>
<tr>
<td><strong>Fiduciary</strong></td>
<td></td>
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<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>duties</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Access to</td>
<td>Specific</td>
<td>Good faith - Articles of association could contain more detailed duties</td>
<td><em>Abuse of rights</em> provision</td>
<td>Good faith</td>
<td>Defined by agreement</td>
<td>Defined by agreement - default provision in First Schedule: disclosure and non-compete</td>
<td>Defined by agreement - default provision in First Schedule: non-compete</td>
<td></td>
</tr>
<tr>
<td>information and</td>
<td>default duties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>records</td>
<td>in Regulations</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

51 See Lerner, Boulevard of Broken Dreams, Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed - and What to Do about It, Princeton University Press 2009 (noting that in many jurisdictions corporate lawyers were suspicious to convertible preferred stock transactions).
<table>
<thead>
<tr>
<th>Country</th>
<th>US LLC Delaware</th>
<th>UK LLP</th>
<th>SAS France</th>
<th>SAS Colombia</th>
<th>J-LLC</th>
<th>J-LLP</th>
<th>S-LLP</th>
<th>LLP India</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial rights</td>
<td>If no agreement, profits and losses allocated on the basis of the agreed value of the contribution</td>
<td>In absence of agreement equal sharing rights</td>
<td>If no agreement, sharing in proportion to members’ contributions</td>
<td>If no agreement, sharing in proportion to the equity participation</td>
<td>Partners’ unanimous approval required</td>
<td>If no agreement, sharing in proportion to the equity participation</td>
<td>In absence of agreement equal sharing rights</td>
<td></td>
</tr>
<tr>
<td>Freedom of contract</td>
<td>Yes, complete freedom</td>
<td>Yes, but some mandatory rules</td>
<td>Yes, but some mandatory rules</td>
<td>Yes, but some mandatory rules</td>
<td>Yes, but several mandatory rules</td>
<td>Yes</td>
<td>Yes, but some mandatory rules</td>
<td></td>
</tr>
<tr>
<td>Transferable interest</td>
<td>Yes, restrictions could be imposed by the agreement</td>
<td>No public offerings allowed</td>
<td>Yes, restrictions could be contractually imposed</td>
<td>Members’ unanimous approval required</td>
<td>Members’ unanimous approval required (mandatory rule)</td>
<td>LLP agreement - default: assignment of financial rights</td>
<td>LLP agreement - default: assignment of financial rights</td>
<td></td>
</tr>
</tbody>
</table>

**Relationship between the firm and outsiders**

| Legal entity | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| Limited Liability | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes, but clawback provision before insolvency | Yes |
| Financial statements | Members have access / no public disclosure | An annual return and annual statutory accounts must be filed | Parties are required to disclose annual accounts | Shareholders must approve financial statements and annual accounts | Members have access | Members have access / creditors have access upon request | Accounts and other records must be kept for seven years | An annual return must be filed |

**Relationship between government (society) and the firm**

| Formation | Simple certificate of formation (filed at the Secretary of State) | Registration at Companies House | Registration at the Commercial Court | Incorporation document filed at the Mercantile Registry (online registration) | Registration at the Legal Affairs Bureau | Registration at the Legal Affairs Bureau | Online registration | Online registration |
| Notarization of charter | No | No | No | No | No | No | No | No |
| Taxation | Check-the-box | Pass-through | Corporate | Corporate | Corporate | Pass-through | Pass-through | Pass-through |

**Practical relevance**

| Familiarity | Dominant choice of business form | Growing in popularity after recent economic downturn | Most popular business form | Most popular business form | Relatively unknown business form | Unknown business form | Business form for professionals | A tax efficient vehicle |
| Experimenting by corporate lawyers | Yes | More sophisticated users after recent economic downturn | Erosion of mandatory rules took 15 years | Increased use of different classes of shares presupposes experimentation | J-LLC could be treated as a pass-through entity for US tax purposes, more experimentation expected in the future | No, not used | No | Tax planning |
That is not to say that contractual flexibility will automatically lead to efficiency.\textsuperscript{52} As noted, the new hybrid business forms have the potential drawback of being relatively new and untested entities. The fact that their statutes are inherently incomplete necessitates the involvement of corporate lawyers. Here a conundrum arises. Corporate lawyers are generally considered to be conservative, risk averse and fearful of legal change and innovation. They tend to recommend boilerplate standardized agreements and arrangements rather than customized and more optimal contractual solutions. It could therefore very well be argued that corporate lawyers contribute significantly to a “lock-in” effect in the context of the evolution of business forms. There are several reasons for this. Firstly, a network of court cases, legal opinions and precedents, standard articles of association and other legal materials have usually been created around existing legal business forms, providing corporate lawyers with a feeling of alleged legal certainty and comfort. Consequently, corporate lawyers tend to recommend the “standardized” legal business forms when advising their clients about incorporation decisions even if a new legal product could lead to a cheaper and more valuable business solution. Secondly, and related to this, a particular lawyer or law firm has usually invested considerable time and money in becoming familiar with an existing legal business form and its network. Obviously, “switching” from a standardized form to a new and innovative business form is costly in terms of developing a new legal network - even if it is cost-effective for clients - as it will most probably also benefit other competing lawyers and law firms generally.\textsuperscript{53} Thirdly, and even more important than the potential free-rider problem, promoting a new legal innovative product could, if it is later successfully challenged in court, damage the professional reputation of lawyers. This explains why lawyers tend to be risk averse.\textsuperscript{54} The risk-averseness, in turn, confines corporate lawyers to a reactive “wait-and-see” strategy. Finally, and ironically, in the traditional legal environment, corporate lawyers are able to capture most benefits by recommending a sub-optimal business form to their clients. Simply consider the mismatch between the private company form in the books - with its statutory separation of managers and investors - and the usually active involvement of shareholders in non-listed companies in practice.


In order to bridge the gap between the “law-in-the-books” and the “law-in-practice”, lawyers tend to generate complicated and, sometimes even, academic legal documents and provisions that hardly add any value to their clients or the business environment in general. Fortunately there are signs that corporate lawyers are in the process of altering their business models, thereby adapting to a more pro-active strategy. The upshot is that as corporate lawyers adopt a new strategy, they are becoming more likely to recommend hybrid business forms. There are two examples to substantiate this statement.

The recent economic downturn shows that the “business model” that is traditionally followed by corporate lawyers/law firms is vulnerable in today’s fast-changing and international business environment. Clearly, new players, like online service providers, are rapidly entering the market for legal services that was until recently destined solely to law firms. Consider the following facts. LegalZoom is an online legal document provider, headquartered in California, that was established by Brian Lu, Brian Lee, Eddie Hartman and Robert Shapiro in 2001. The mission behind the online provider is improving and simplifying the process of providing legal services, in particular the drafting of legal documents. LegalZoom also assist businesses in making choice of entity decisions. For instance, LegalZoom offers an LLC or Corporation Package for US$ 99.00. Since a corporation imposes specific incorporation and operation requirements on business parties, the LLC is probably better tailored to be sold as an online product. The LLC package not only includes assistance with the standard “incorporation” formalities, such as the clearance of the LLC name and the filing of the Articles of Association with the Secretary of State, but also with the customization of the Operating Agreement. LegalZoom developed a three-step process to assist their clients: (1) the client has to complete a relatively simple questionnaire, (2) LegalZoom will review the answers and create the Operating Agreement, while at the same time the Articles of Association will be filed with the Secretary of State, and (3) the client will receive the formation documents. The questionnaire contains questions (and assistance) about the preferred state of incorporation, the company name, dissolution requirements, management structure, transfer of ownership interests, and taxation (check-the-box). The cheaper legal services are certainly

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55 See Economist, The price of legal services, How to curb your legal bills, 7 May 2011. See also Hadfield, Legal Barriers to Innovation: The Growing Economic Cost of Professional Control Over Corporate Legal Markets, 60 Stanford Law Review 1689, 2008. Here is some data: Approximately, 40% of in-house counsel are of the opinion that the work performed by corporate lawyers declined during 2010 (see Serengeti Managing Outside Counsel Survey (2010)). Interestingly, in-house lawyers, who also had a tendency to be risk-averse, appear to change their attitude (see Wall Street Journal, Company Lawyers Sniff Out Revenue, 13 May 2011.
57 Apparently, lawyers feel threatened by the increased competition from online legal service providers. Recently, two private individuals represented by plaintiffs’ lawyers filed a lawsuit against LegalZoom charging that LegalZoom is illegally practicing law in the state of Missouri. Ironically, the documents “drafted” by LegalZoom were not deemed ineffective or invalid..See Wall Street Journal Law Blog, Class Action Claims Online Legal Forms Pose Threat To Consumers, 27 July 2011. See also Larry Ribstein’s entry to the weblog “Truth on the Market”. See www.truthonthemarket.com.
58 See www.legalzoom.com.
attractive to smaller enterprises in that they can now forgo a visit to a more expensive and time-consuming corporate lawyer, which charges approximately US$ 1000 for a less accessible and time-consuming service.

Evidently, it could be argued that legal services providers, such as LegalZoom, will only contribute to the popularity of LLCs among the smallest and simplest firms. Medium-sized and large enterprises, which usually retain a lawyer to assist in business planning activities, may still be more attracted to the traditional corporate form. Having a reputation of being the preferred choice of business entity for small firms could even have a detrimental effect on a wider use of LLCs in more complicated and sophisticated business transactions. The reputation of a business form is an aspect that often dominates choice of business form decisions. The employment of the traditional corporate form radiates seriousness and confidence to the business parties. Particularly in complicated international or financial engineering transactions, the familiarity with a business form is considered to be of utmost importance. Oftentimes, these transactions are surrounded with issues that were not anticipated upon. The parties and, especially their corporate lawyers, need an understanding how these issues will be handled. Being familiar and having experience with corporations, which present many similarities in the various jurisdictions, tend to make corporate lawyers more confident not only in their understanding of the used business form, but also in their discussions with local colleagues. However, as corporate clients increasingly complain about the value of legal work, it becomes clear that it will be more difficult to justify choice of business form decisions by quoting the familiarity argument in the future.

Now, onto the second example: there is growing criticism about the legal tools and assistance available to businesses to support their efforts to innovate in the fast-changing business environment. This is largely due to a widening “DNA-gap” between corporate lawyers and the businesses they support. Of course, it could be argued that corporate lawyers should function as “transaction costs engineers”. In practice, however, it does not always turn out this way. Corporate lawyers increasingly view themselves as necessary (evil) to defend their clients against lawsuits and to lead them through the maze of cumbersome government regulations that they have to comply with. Generally, corporate lawyers do not think that the design of innovative and highly productive business models needs a visit to the legal department. Yet, there is a growing demand

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59 This could also change in the near future. Consider LawPivot (www.lawpivot.com), a legal Q&A site in which high tech start-up businesses can receive confidential - and customized - legal answers from relevant lawyers. See Bloomberg Businessweek, Innovator: Startup Counsel, 11 July 2011.

60 The reputation of the business form is one of the reasons why the public corporate form is more popular than it private company counterpart in Switzerland. Almost 65% of the total incorporated businesses employ the public form. Clearly, the fact that the public form is more developed and predictable than the private company in terms of the legal impact of various corporate actions. See Wymeersch, Comparative Study of the Company Types in Selected EU States, 6 European Company and Financial Law Review 71 (2009).


62 See Hadfield, Legal Services Wanted; Lawyers Need Not Apply, Miller-McCune, 2011.

for lawyers who support businesses, faced with an ever-growing fierce and global competition, in their efforts to become more creative and competitive.

In this context, hybrid business forms could become an important tool for lawyers who are confronted with the technological advances and the internationalization of the economy. As we have seen, Delaware’s LLC statute gives maximum effect to the principle of freedom of contract. There is something to the introduction of an all-purpose contractual entity that can be tailored to the business needs and expectations of firms in particular circumstances. Parties in joint ventures, for instance, are likely to reduce agency problems by contracting into the preferred governance regime without necessarily taking the statutory regime into account. To give a more specific example, consider the following restructuring project: a company that contains two business units intends to sell and transfer one business unit to a third party. Business registrations and fiscal benefits do not allow the company to immediately split-off one of its business units to a separate legal entity. Fortunately, Delaware’s LLC statute offers a solution.\(^{64}\) In 1996, Delaware became the first state to introduce the Series Limited Liability Company (Series LLC). A Series LLC offers a unique structure in which it is possible to partition the assets and liabilities between two business units. Each Series has its own assets, economic structure, members, and managers. Also, the profits, losses, and liabilities of the units are “contractually” separated, thereby creating a virtual “firewall” between the two units. Even though the Series LLC is a still-evolving business form (and the total number of Series LLC filings is relatively low) (see Table 5),\(^{65}\) its use is slowly but surely gaining prominence.\(^{66}\)

Table 5: Series LLC Filings in Three States from 2006 to 2010

<table>
<thead>
<tr>
<th>State</th>
<th>LLCs filed</th>
<th>Series LLCs filed</th>
<th>% Series LLCs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nevada</td>
<td>201109</td>
<td>13721</td>
<td>6.82</td>
</tr>
<tr>
<td>Illinois</td>
<td>137984</td>
<td>5184</td>
<td>3.76</td>
</tr>
<tr>
<td>Utah</td>
<td>114983</td>
<td>485</td>
<td>0.42</td>
</tr>
</tbody>
</table>

Source: Adapted from Bradley and Vattamala, Series LLCs in Real Estate Transactions, 46 Real Property, Trust & Estate Law Journal (forthcoming 2011)

It follows from the above discussion that (1) the implementation of hybrid business forms and (2) pro-active corporate lawyers that embrace them to better serve their clients' business planning activities determine the quality of the legal infrastructure available in a jurisdiction in the future. The acceptance and use of hybrid business forms are thus an indication of the innovative

\(^{64}\) Del. Code Ann. tit. 6, §18-215.


\(^{66}\) See Borden and Vattamala, Series LLCs in Real Estate Transactions, 46 Real Property, Trust & Estate Law Journal (forthcoming 2011).
quality of a legal system, i.e., a legal system that is up to the challenge of satisfying the demands of the current and future business environment. Of course, new hybrid business forms can only be disruptive to the traditional legal framework (with its established doctrines and principles), if the corporate lawyers are able to capture enough benefits to justify coping with the “legal uncertainty” surrounding the untested legal novelty. This corresponds to the findings in this paper. The history of the introduction and development of hybrid business forms indicates that if a new form is introduced and implemented at the behest of interest groups, innovative corporate lawyers promptly start establishing new networks of expertise and services around the “new legal product” (see Figure 6). This is most likely explained by the existing pent-up demand for the product, which will provide at least some economic return on the lawyers’ investment. But there is even an more interesting finding. Even if the accepted hybrid business form is still evolving, its use tend to spread rapidly across a wide range of business activities. This trend could even mark the beginning of the end of the life cycle of the traditional company forms as we know them. For instance, the UK LLP was designed to offer professional firms protection against excessive liabilities, but it is also largely employed by small and medium-sized enterprises and international joint ventures. The French SAS, as we have seen, is predominantly used by new start-up companies that require equity investors, while the first version of the SAS focused on international joint ventures.

This brings us back to the question of which legal system, common law or civil law, offers the most flexible legal infrastructure. It has been shown that the US LLC and, to a lesser extent, the UK LLP awakened the law reformers’ interest in other countries. The Delaware LLC has even extended the statutory flexibility to give maximum effect to the freedom of contract concept, thereby enhancing the ability of corporate lawyers to experiment with the business form. While there is a growing acceptance of hybrid business forms in common law jurisdictions, such as Singapore and India, the evolution of hybrid business forms in the civil law French and Colombian systems suggests that the legal origin effect is overrated. As demonstrated, the SAS in France is currently widely considered to be an extremely business-friendly hybrid business form in Europe. In Colombia, the SAS has been a real legal revolution. It not only became the preferred business form in the first year of its existence, but it also started to erode the mandatory nature of company law in Colombia in general, offering online registration similar to LegalZoom and other websites that offer incorporation assistance. However, hybrid business forms in civil law jurisdictions are less accepted when their introduction is not the direct result of interest group pressures. Apparently, the lack of an immediate market for hybrid business forms prevents the emergence of a new network of expertise and services. Without market opportunities, corporate lawyers are inclined to discourage legal reform and hence favour adhering to the traditional legal business forms. The developments in Japan show that even if the legislature decides to abolish one of the existing

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67 See Economist, The eclipse of the public company, Traditional listed firms are facing competition, 19 August 2010.
business forms, corporate lawyers, captured by legal doctrine and other path dependence factors, tend to be slow in accepting new business forms. It is therefore fair to say that common law systems are quicker to adapt their legal infrastructure to changing market circumstances and increased global competition.\footnote{This is also exemplified by the design of contractual “innovations” in the construction industry (partnership-type arrangements in construction contracts in Australia and England, which were later also introduced in civil law countries). Other common law innovations that slowly but surely found their way to civil law countries emerged in the venture capital industry and the mergers and acquisitions/joint ventures practices.}

Figure 6: The Life Cycle of Hybrid Business Forms and the Role of Corporate Lawyers

V. Conclusion

It would be too simple and naive to suggest that the introduction of hybrid business forms alone would spur innovation and economic growth. But hybrid business forms can become an important tool in the legal infrastructure of the future. If public legislatures give maximum freedom in the choice of governance arrangements, these new business forms will allow corporate lawyers to provide legal services that better match the needs of the business community to innovate and embrace the changing global market place.
In the United States, state legislatures have embraced hybrid business forms to improve the legal infrastructure and business environment. Interest group pressures and the competitive incentives of not losing local filings to other states have moved legislatures into hasty action. The expansion of new business forms appears to be based on compelling logic: it allows firms easy access to a range of governance structures designed to provide limited liability, reduce complexity and limit transaction costs. Recently, public legislatures in other jurisdictions have also, inspired by the success of the LLC in the United States, introduced hybrid business forms. Generally, these business forms seek to facilitate the emergence of innovative contractual arrangements to efficiently structure the internal relationship between parties inside a wide range of firms as well as the relationship between these firms and their outsiders. Increased pressures of competition make it likely that similar reforms will, sooner or later, be introduced in other slow-reform countries.

Let us conclude with our broader point. One of the goals in this paper was to assess whether common law systems outperform their civil law counterparts in terms of legal innovation. To test this hypothesis, we have attempted to strengthen our understanding of the introduction and acceptance of new hybrid business forms in both common law and civil law jurisdictions. As a result, it has been found that interest group pressures do indeed play a pivotal role in the success of hybrid business entities in both common law and civil law jurisdictions. Without these pressures, the chance of successfully introducing new business forms outside the established company law framework and doctrines decreases more significantly in civil law countries. The reason for this is that, in general, common law corporate lawyers appear to be more pro-active in terms of anticipating the clients’ needs. It is therefore fair to say that they tend to be more open to legal change and innovation.