The Requirement of Consent for the Transfer of Shares and Freedoms of Movement: Toward the Liberalization of Private Limited Liability Companies.

A comparative study of the laws of Portugal, France, Italy, Spain, the United Kingdom and the United States and its interplay with EU law.

Lécia Vicente

Thesis submitted for assessment with a view to obtaining the degree of Doctor of Laws of the European University Institute

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Department of Law

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Examing Board

Professor Hans-W. Micklitz (EUI/ Supervisor)
Professor Stefan Grundmann (EUI)
Professor Martin Gelter (Fordham University Law School / External Supervisor)
Professor Luca Enriques (LUISS/University of Oxford)

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This thesis has benefited from language correction, generously sponsored by the European University Institute
To my Mom,
Mãezinha
Acknowledgements

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This research was conducted over a long period. It was filled with solitary moments travelling or spent in archives where my thoughts were my only company. The kindness, understanding, warmth and help of dear friends who did not hesitate to host me and just be present for me turned this into an even more rewarding task. Last, but not least, I thank my family for their love and encouragement. I thank you, O, for the light and joy of being.
Extracts and legal provisions in Portuguese, Italian, Spanish, French, and German were freely translated to provide clear and idiomatic English. Except where referred to otherwise, their translation is the responsibility of the author. Very specific terminology and Latin expressions are left in the original.
Summary

In the ‘Requirement of Consent for the Transfer of Shares and Freedoms of Movement: Toward the Liberalization of Private Limited Companies – A comparative study of the laws of Portugal, France, Italy, Spain, the United Kingdom and the United States and its interplay with EU law’, I try to shed light on the dynamics of private limited liability companies (PLLCs), and how they can be legally designed to become efficient units of economic development in Europe and the United States. I take a social sciences approach to the legal question: How does the design of clauses establishing restrictions on transfer of shares of private limited liability companies affect investment made in these companies and their consequent development? To answer this question, I develop two parallel lines of investigation. First, I undertake an embedded historical study to trace the evolutionary patterns of PLLCs in six countries. Furthermore, I longitudinally track the standards of behavior of market agents in the selected jurisdictions. Second, I develop my legal research by looking at an anomaly regarding the transfer of shares and changes in the ownership structure of these business organizations. Transfer of shares in PLLCs is, for the most part, regulated by default rules which impose restrictions on transfers. Typically, the parties do not contract around these default rules. The anomaly lies in the fact that, even though shareholders of these companies do not opt out of these rules, shareholders often ignore them and/or breach them at a later stage. To understand this phenomenon, I collected data to learn how often these rules are included in the companies’ articles of association, their content and the allocation of decision-making power in the company. My empirical work was based on the analysis of more than 200 articles of association of companies in Portugal, France, Italy, Spain, and the United Kingdom and operating agreements of limited liability companies (LLCs) in the United States. I also analyzed almost 100 court decisions in the selected jurisdictions. My findings tend to confirm the hypothesis that shareholders of these companies normally do not contract around default rules, but they ignore them or breach them in order to maintain an engrained status quo in the company. My findings also show that there is a phenomenon of cross-over of the same contractual provisions to the articles of association of other companies in the same jurisdiction and to the ‘constitutional’ documents of companies in other jurisdictions. Sometimes, this happens over a time span of 100 years.

Theoretically, I try to bridge the gap between natural sciences and social sciences and frame my investigation by applying evolutionary theory to law. Methodologically, I use
comparative law, and law and economics. Given the context provided by the historical research, I compare market agents to *selfish genes*. I try to explain how PLLC’s law has been primarily designed at the market level through a process of coordination and competition between market agents favored by a principle of natural selection. PLLC law was created at the lowest level through experimentation and a network of lawyers, who acted like legal engineers, notaries and courts. Under these circumstances, only optimal legal solutions were preserved and reproduced. The legislation came after. Thus, I define law as a byproduct of private ordering manifestations. Richard Dawkins, for his part, might well define it as an ‘extended phenotype’.

However, a delicate balance exists between cooperation and coordination among market agents at the lowest level in these business organizations. Evolution at the market level is limited particularly by the weak enforceability of the default rules that market agents do not contract around, and the bargaining failures these rules do not prevent. Hence, I normatively compare the role of lawyers, legislatures, regulators (or politicians) and courts to that of the scientist who uses biology as a cognitive tool to tame the silver fox through a process of artificial selection. By drawing this analogy, I dwell upon the concept of path-dependence in law and how it can be broken through legal engineering and experimentation. Most importantly, I make use of the biological notion of *pleiotropy* (the capacity of one gene to widely affect different phenotypic traits), which does not have a corresponding normative concept in law. Pleiotropy in this setting would refer to inheritance of legal solutions. Thus applied, fields of corporate law, contract law, and property law are shown to be related in unexpected ways. Further, the application of the notion highlights unintended consequences stemming not only from market dynamics, where lawyers arguably play an important role, but also from the way legislatures design law. The effects of restrictions on share transfer on the 'physiology' and 'morphology' of property rights in shares is illustrative, and a banner of this dissertation. In addition, because the concept of evolution has its own limitations, I suggest that law should be seen as a commodity that can be designed at the institutional level to overcome such limitations at the market level. In terms of my paradigm, this window of opportunity for new legal policies has much to do with the fact that the genetic traits of markets tend to be preserved, but the biological process does not. Accordingly, by playing the role of the *scientist* that tames the *fox*, legislatures are in a position to design the best default rules and lawyers are able to engineer the best legal solutions for these companies. They have the opportunity to promote ‘cross-fostering’ of PLLCs to advance their reproduction and longstanding development. This may lead to the hybridization of these business organizations
for specific rules of partnership law (e.g., dissolution at will) or corporation law (e.g., put
rights) may be used to surpass bargaining failures and strengthen property rights of
shareholders, especially minority shareholders in cases of deadlock or bilateral monopolies.
At the policy level, this is undertaken through a model legal policy that interconnects society,
legislatures, courts and regulators (politicians), and the market at a point where law is created
from the bottom-up. At the economic level, I am calling for the liberalization of private
limited liability companies which, I argue, may be potentiated by market integration and the
promise of jurisdictional competition in Europe as a form to press for change in legal policy.
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Law is ‘social engineering’ and legal science is a social science.¹

“What is law?” (a question that has little practical significance if, indeed, it is a meaningful question at all).²

Corporate law is inherently a messy business.³

INTRODUCTION

This study has a fourfold purpose. First, it returns to basics and emphasizes contractual aspects of corporate law. In fact, this research puts small businesses in the spotlight: it looks at their history, at the essential elements of the market structure in which they operate, and at their governance and ownership structures in order to test the efficiency of and reasons for default rules on transfer of shares. Second, this research aims to show how the law fails to keep up with practice, and why it may be the case that we need more or less law. Third, it proposes a theory of incentive default rules framed by an evolutionary approach (evolutionary theory of incentive corporate default rules) which conceptualizes default rules as commodities with a contractual purpose which is primarily created at a lower level than legislatures – the market. Fourth, as a comparative law study it tries to provide an answer to two sub-questions: Do the above-noted default rules vary across jurisdictions, and if the selected jurisdictions have similar problems of parties ignoring the default rules, what might explain the differences and/or similarities of the rules across jurisdictions?; and, Does the law lag behind or stay current with practice in the various jurisdictions, which might say something about the efficiency of lawmaking across countries?

Law, perceived more and more within the context of global phenomena, lacks a universally accepted definition. Thus, the question What is law today? awaits a comprehensive answer. Crucial to this inquiry is a thorough consideration of the normative foundations of law, or more technically speaking, of the sources of law. But it requires a great deal more: the main discourses fleshing out the law must be kept in mind (culture, economics, rational choice theory, evolutionary theory). Moreover, a choice must be made as to the nature of the arguments necessary to explain the meaning of law.

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4 The term ‘company law’ is mostly used in the United Kingdom, whilst ‘corporate law’ is widely used by American scholars and in American jurisprudence. I use it here interchangeably.
7 See Case, Mary Anne, ‘Is There a Lingua Franca for the American Legal Academy?’, in Mertz, Elizabeth (ed.), The New Legal Realism, Cambridge University Press, 2013. University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 647, Available at SSRN: http://ssrn.com/abstract=2296602 (accessed on 19 August 2013), p. 4 (arguing that ‘… whether or not there is a lingua franca in the legal academy, there is a vernacular, the language of doctrine’. Referring in particular to the American case she submits that ‘Doctrine is the vernacular of American law along a variety of dimensions: It is not import from another discipline, but indigenous. While some of its characteristic words and phrases originated elsewhere and some have penetrated to broader American society, it is spoken fluently only by lawyers’. Focusing on the American example, this author resists accepting law and economics as the dominant language of legal academy.
This study takes an evolutionary approach to law and asks: How does the design of clauses establishing restrictions on transfer of shares of private limited liability companies affect investment made in these companies and their consequent development?\(^8\) This is the research question driving this comparative study.\(^9\) The underlying idea is that as long as these business associations have an adequate legal structure, they can become relevant players in the market, with the ability to attract investment, and lock in capital. In this way, such associations find themselves in the position of being able, if necessary, to draw the attention of legislatures and courts to the need for reform.\(^10\) Given the above, the following sub-questions may be asked: Are PLLCs capable of overthrowing public limited companies? Are they able to overcome the policy trends that have been aligned for so long in favor of public limited companies? The answer, at least in the United States, seems to be ‘yes’.\(^11\) Moreover, one can ask, would it be beneficial for firms to mix corporate and uncorporate features, thereby blurring the distinctions between the two categories of firms?\(^12\) For example, in Part


\(^9\) See Davies, Paul L., Introduction to Company Law, Oxford, Oxford University Press, 2002, p. 283 (stating that ‘Providing a legal framework which facilitates the growth of small companies is particularly important in public policy terms’).

\(^10\) This idea calls to mind the literature on law and finance. This literature, which is best substantiated by the work of La Porta et al., seeks to empirically demonstrate the connection between the qualitative features of legal systems and the nature of capital markets and corporate governance structures in different countries. See, for instance, La Porta, Rafael et al., ‘Law and Finance’, Journal of Political Economy, vol 106, No 6, 1998, pp. 1113-1155. My work, as described in the text, focuses on private companies and on the type of market there is or can be for their shares. In order to understand the macroeconomic impact these companies can have through the design of efficient rules included in their articles of association, my work thinks small first. It tries to explain the micro-level dynamics of these business associations’ ownership structures. Additionally, it looks at relevant articles of association and operating agreements to clarify if and how these business associations and their constituencies can be at the top of their game when it comes to developing new and efficient governance structures. This common tendency to link law and development has a long history: it was pioneered by classical social theorists such as Marx, Durkheim and Weber. On one hand, the challenge now in the twenty-first century is offered by globalization of markets and legal institutions, and on the other hand by legal pluralism at the national and transnational levels.


\(^12\) See Ribstein, Larry E., ‘Limited Liability Unlimited’, 24 Delaware Journal of Corporate Law, 1999, pp. 407-450 (proposing an alternative to business association status – the ‘Contractual Entity’). Also see Ribstein, Larry E., ‘Uncorporating the Large Firm’, in idem, The Rise of the Uncorporation, cit., pp. 193-246; and Williamson. Oliver E., The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting, New York, The Free Press, 1985, p. 159 (in trying to provide an answer to the question ‘why can’t a large firm do everything that a collection of small firms can do and more?’ Ribstein states that ‘…at least for many projects that do not require an enormous research commitment, large companies are becoming increasingly aware that the bureaucratic apparatus they use to manage mature products is less well-suited to supporting early stage entrepreneurial activity. Hybrid forms of organization result’).
III, Chapter 1, I propose dissolution at will as a mechanism of governance of contractual relations between corporate constituencies. When would that be beneficial, especially bearing in mind that uncorporations (partnerships, limited partnerships and LLCs), allow shareholders to choose their level of autonomy? How much autonomy do shareholders really need?  

This study is inspired by a number of default rules regulating the transfer of shares in private limited liability companies (PLLCs) in Europe and the United States. These rules are Article 228(2) of the Portuguese Commercial Companies Code (Código das sociedades Comerciais) referring to the Portuguese sociedade por quotas, Article 2469 of the Italian Civil Code (Codice Civil) regarding the società a responsabilità limitata, s. 544 (1) of the United Kingdom Companies Act 2006 regulating the private limited company, § 18-702 of the Delaware Limited Liability Company Act and § 603 of the New York Limited Liability Company Law regulating the limited liability company (LLC) in Delaware and New York, respectively. Except s. 544 (1) of the Companies Act 2006 and Article 2469 of the Italian Civil Code, which establish a default principle of free transferability, all the other rules provide restrictions on transfer of shares. These are not restrictions on access to capital markets. These restrictions impose an obligation not to transfer the shares of PLLCs. In many circumstances, if transfers are not consented to under these rules, they have no effects vis-a-vis the company and other non-transferring shareholders. However, they still have effects between the parties to the share sale and purchase agreement. These restrictions, besides being provided by default rules, also are introduced by the parties into the companies’ articles of association. In the case of France, the respective rule is a default regarding the majority requirement to consent to a transfer, but the imposition of restrictions on transfers is mandatory.

These rules and the procedures that they invoke yield different approaches to transfer of shares in PLLCs. I am interested in the exogenous effects of these rules: I wish to determine how they affect PLLCs’ development. By inquiring about the sources of development of PLLCs, I am not necessarily advocating access to capital markets for these companies. Indeed, the companies may wish to grow without becoming public. In addition to the analysis

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13 The terms shareholder and member are used interchangeably in this dissertation.
14 For a different, but also interesting approach see Mösllein, Florian, Dispositives Recht: Zwecke, Strukturen und Methoden, Tübingen, Mohr Siebeck, 2011.
15 An investigation of their endogenous effects alone would be very difficult to assess by means of a cross-country observation whether they matter and have a causal effect on these business associations.
of default rules, I pay close attention to selected case law regarding disputes over the transfer of shares of PLLCs.\textsuperscript{16}

Despite the research question upon which this study is based, I do not assume the utility function of law for the development of PLLCs. I am instead interested in understanding why it is that their members would care about the effect of ‘jural principles’ on their company’s development. (A crucial point that I will develop is exactly which members would care.) I want to discover how their interests and goals are shaped by their membership. Therefore, to show the importance of the legal framework of PLLCs in each jurisdiction and why it is worth studying how their shares are transferred as well as the complexity of their ownership structures, Part 1 presents an introductory historical account of their legal regime and the above-mentioned rules. This task is undertaken by analysing the minutes of parliamentary debates, operating agreements of LLCs\textsuperscript{17} and articles of association published in the country’s Official Gazette, the Companies House, UK\textsuperscript{18} or treated in WestlawNext and Bureau van Dijks databases such as Amadeus, Astree, in France, Aida in Italy, Orbis, in the United States, and Fame in the United Kingdom. With this introductory account of the history of PLLCs, Part 1 explains why these business associations exist. I also hope to shed light on the rationale behind the creation of restrictions on transfer of shares, and to explain why these governance techniques are designed as they presently are. Ultimately, this embedded historical analysis seeks to show what the existence of default rules implies about the historical development of business association law in the selected jurisdictions.\textsuperscript{19}

An in-depth analysis of samples of case law in the selected jurisdictions disclosed four pivotal elements: shareholders’ opportunistic behavior; bargaining failures; difficulties in combining action among shareholders, and among shareholders and other non-shareholder constituencies such as creditors; shareholders holding-up others; and, finally, situations of

\textsuperscript{16} See Poteete, Amy R. et al., \textit{Working Together: Collective Action, the Commons, and Multiple Methods in Practice}, Princeton and Oxford, Princeton University Press, 2010, p. 46 (‘The more lawlike and specific a theory, the more readily it can be tested through carefully selected case studies...’).

\textsuperscript{17} These agreements contain specific requirements regarding the transfer of shares or sale of membership interests. In this context, see Romano, Roberta, ‘Corporate Governance in the Aftermath of the Insurance Crisis’, \textit{Emory Law Journal}, vol. 39, 1990, pp. 1155-1189 (1160-1161) (stating she collected a random sample of 180 Delaware publicly held companies which adopted in their charters a limited liability provision following the enactment in this state of a statute limiting directors’ liability).

\textsuperscript{18} The Companies House is an Executive Agency of the Department for Business, Innovation and Skills (BIS), where all limited companies in England, Wales, Northern Ireland and Scotland are registered.

\textsuperscript{19} See Martino, Paolo Di, ‘Lobbying, Institutional Inertia, and the Efficiency Issue in State Regulation: Evidence from the Evolution of Bankruptcy Laws and Procedures in Italy, England, and the United States (c. 1870-1939)’ in Batilossi, Stefano; and Reis, Jaime (eds.), \textit{State and Financial Systems in Europe and the USA: Historical Perspectives on Regulation and Supervision in the Nineteenth and Twentieth Centuries}, Farnham, Surrey, Burlington, Ashgate, 2010, pp. 41-54 (51) (asserting that ‘…the past is important in shaping the availability of present options.’ This is how he defines path-dependency).
deadlock which resemble bilateral monopolies within the company, and for which articles of association do not provide efficient exit mechanisms or other relevant provisions. These problems tend to overlap and are likely to be mentioned in the literature in respect to the publicly held company. Interestingly, however, they also appear in the PLLC. For instance, cases adjudicated by courts in Portugal suggest that there is a downside to the freedom of contract enjoyed by shareholders in these companies. Shareholders introduce restrictions on the transfer of shares to protect their status quo (or to maintain the status quo provided by the law), ownership structure and control of the company. At a certain point, however, they face difficulties in acting together in their common interest and in the interest of the company. Furthermore, conflicts between these companies’ constituencies are normally and more easily internalized by contract. Therefore, Part II, Chapter 1 examines potential agency problems and problems of private governance as they appear in the context of the environment framing the relationships among shareholders and between them and directors / managers in these business associations. In particular, it provides an account of the purpose of establishing

20 See Easterbrook, Frank H. and Fischel, Daniel R., ‘Close Corporations and Agency Costs, Stanford Law Review, vol. 38, N,” 2, 1986, pp. 271-301 (279) (arguing that ‘The more power minority shareholders have, the more likely is deadlock. The possibility of deadlock also exists where the number of shareholders is small and shares are distributed so that votes can be evenly split’. These two authors link deadlocks to opportunistic behavior and rent seeking). Also see Posner, Richard, Economic Analysis of the Law, 3rd. ed., 1985 (dwelling on the problems of bilateral monopolies in closely held corporations).

21 My initial intuition was confirmed by the literature after a thorough analysis of case law. See Whincop, Michael J., ‘Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law’, Oxford Journal of Legal Studies, vol. 19, 1999, p. 30 (claiming that ‘A great deal of work remains to be done in analysing how the protection of entitlements in corporate law doctrine affects this process of coalitional bargaining’). Also see Miller, Sandra K., ‘Fiduciary Duties in the LLC: Mandatory Core Duties to Protect the Interests of Others Beyond the Contracting Parties’, American Business Law Journal, vol. 46, 2, pp 243-278 (259) (apropos the lack of considered negotiation in LLCs noting that her ‘…preliminary findings point to the possibility of significant differences in legal representation between controlling and noncontrolling investors. The evidence also points to the fact that LLC investors may well enter into LLC agreements without having carefully reviewed and/or negotiated terms. Under such circumstances, it is unlikely that such investors would end up being well protected under a statutory regime that permitted the elimination of fiduciary duties or which required the express adoption of duties’).

22 I am here referring to economic control.

23 Regarding the case of the United Kingdom under a historical perspective, see Harris, Ron, Industrializing English Law: Entrepreneurship and Business Organization 1720-1844, Cambridge, Cambridge University Press, p. 92 (mentioning that within the taking by individuals instead of municipal corporations of river navigation projects in England in the early eighteenth century, there was growing need to share the burden of financing such projects. Harris, although referring to the corporate form, explains that ‘…a standard act named undertakers and, in so doing, in fact prohibited transferability of their interests to individuals not named in the act. A problem occurred when the financial resources of the undertakers ran out before construction was completed. Original undertakers may then have wanted to desert, to be replaced by new undertakers, or to add more undertakers to share the financial burden with them. A formal solution could be to amend each act when new individuals joined, but this solution was not very practical. A more practical solution was to ignore the authorizing status on this point and to transfer shares by agreement between the outgoing and incoming undertakers’. Further historical examples of this kind are presented by Harris in his book.

24 Agency problems between shareholders and managers / directors of the companies are more frequently referred to in the United Kingdom and United States literatures. These countries, at least regarding the public company, are characterized by dispersed ownership and very strong securities markets. The situation is different.
restrictions on transfers, considering that often these restrictions are ignored and shares are transferred in breach of the company’s articles.\(^{25}\)

My hypothesis is that when legislators select default rules the substantive preferences of parties may change, but they do not necessarily do so, even when, for the sake of competition in the market and according to an evolutionary pattern, that change would be desirable. Parties prefer to preserve the status quo in their contractual arrangements. They seem to want to keep this status quo regardless of the purpose of the default rule. Why does this status quo exist? To what extent does it affect the development of business associations? Is there a relationship between the development of PLLCs and the type of defaults selected by legislators and courts? These are the questions I am trying to answer.

Notwithstanding the hypothesis I have ventured above, I view defaults as neither useless nor redundant.\(^{26}\) On the contrary, I want to ‘test’ whether and to what extent their nudging effect can be used to induce the development of these business associations.\(^{27}\) From an...
evolutionary point of view, I endorse the understanding that law, including common law, is not a spontaneous order. I call it a 'byproduct of informal manifestations of private ordering'. Richard Dawkins would probably call it an 'extended phenotype'. A short biographical note is in order. A recent visit to the American Museum of Natural History called my attention to experiments regarding the domesticated silver fox. The experiments undertaken in the former Soviet Union and later in Russia showed that as a consequence of a selective breeding process, foxes bred in a peculiar environment of domestication developed dog-like morphological and behavioral traits including color of fur, size of ears and skull, barking and submission. These experiments suggest two things. First, there is a natural response and evolutionary process of adaptation of living beings to purposeful actions of tameability. The analogy with law boils down to the idea that the 'morphology' of law is likely to be conditional upon the context and environment in which it is applied and on the stimulus to which it is subjected. Second, sometimes things are linked in a way we do not expect, and this linkage is likely to change the environs as a result of new traits they develop. Thus, there are unintended consequences in this process of path-dependence or pleiotropy in law. I derive from this idea in Part II, Chapter 1 a new conceptualization of property rights. Restrictions on transfer of shares are likely to change the 'morphology' and 'physiognomy' of property rights in shares. Their absolute nature is modified. Like the silver fox, they are ‘tamed’. This notion of pleiotropy in corporate law based upon the drawing of contractual clauses restricting transfers of shares of PLLCs is further extended in Part II, Chapter 2. Here, I try to understand how restrictions on transfers affect the share sale and purchase agreement and the implications of these restrictions for the definition of shares. The pleiotropy idea is also extended in Part II,

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28 By considering that law is not a spontaneous order I am referring to legislation and legal solutions adopted by legislatures. The idea is that legislation and legal solutions always come afterwards. See Ratnapala, Suri, ‘The Trident Case and the Evolutionary Theory of F.A. Hayek’, Oxford Journal of Legal Studies, vol. 13, 2, 1993, pp. 201-226 (referring to ‘deliberate law making’ as a relatively recent human activity). Also see Ratnapala, Suri, ‘The Trident Case and the Evolutionary Theory of F.A. Hayek’, cit. p. 211 (claiming that Hayek does not deny the need for legislation. Legislation is sometimes required in relation to tasks for which the rules of a spontaneous order are inappropriate. Legislation is also required to correct the sometimes unsatisfactorily directions in which the common law develops. But Hayek insists that if liberty is to be preserved, legislation which affects rules of just conduct should themselves imitate nomos. That is to say, they should be general, end-independent and applicable to an indefinite number of unknown future situations. They should not be calculated to achieve particular material results). Additionally, see Benson, Bruce L., ‘The Spontaneous Evolution of Commercial Law’, Southern Economic Journal, vol. 55, 3, 1989, pp. 644-661 (644-45) (arguing that ‘…rules of property and contract necessary for a market economy, which most economists and legal scholars feel must be “imposed”, have evolved without the design of any absolute authority’).

29 See Whitman, Douglas Glen, ‘Hayek contra Pangloss on Evolutionary Systems’, Constitutional Political Economy, vol. 9, 1, 1998, pp. 45-66 (50) (arguing that ‘If changes in the traits of an organism can shape the environment as well as be shaped by it, the very idea of optimal adaptation gets murky because it is unclear that a steady-state relationship between organism and environment will always occur’). See Whitman, Douglas, ‘Hayek contra Pangloss on Evolutionary Systems, cit. pp. 52-53 (referring to pleiotropism in the context of cultural evolution).
Chapter 3 where I try to demonstrate that restrictions not only affect property rights in shares, but also are likely to affect the governance of the company to the point that it is necessary to pierce the ownership veil of the company to understand who really is in control of the decision-making. This knowledge is important because it sheds light on how consent to transfer is executed, and how that can affect the exercising by shareholders of property rights in their shares. Moreover, the act of piercing would serve to unveil agency problems and conflicts between majority and minority shareholders in the PLLC. The blurred lines separating ownership from control in the PLLC make frequency of occurrence of these problems and/or conflicts difficult to determine. A third extension of the pleiotropy notion is undertaken in Part III, Chapter 1 where, after I demonstrate the superiority of property rules to liability rules and inalienability in Part II, Chapter 4, I suggest forms to contractually design the company’s articles of association to strengthen property rights in shares and prevent bargaining failures.

In my view, the problem of path-dependence in biology and, to a certain extent pleiotropy in law, echoes political economy path-dependence and doctrinal path-dependence.\(^{30}\) On one hand, there may be interest groups that lobby for a prevailing status quo.\(^{31}\) On the other hand, there may be an entrenched legal system which is not able to regenerate itself completely. Nothing new develops. Rather, there is an adaptation of existing legal solutions, which are in fact changed with the least possible effort. New legal solutions are often constructed upon the bits and bytes of the existing law. Some concepts and legal institutions tend to be coupled even when they generate suboptimal results. The question is: Can they ever be separated, and, if so, how? I suggest that path-dependence patterns and pleiotropy in law and legal doctrine can be broken by experimentation undertaken at a structurally lower level where lawyers, notaries, bar associations, non-governmental organizations, and law consumers in general are able to network and set rules before the legislator does.\(^{32}\) For instance, an attempt at strengthening property rights by drafting the

\(^{30}\) See Dawkins, Richard, *The Selfish Gene*, Oxford, Oxford University Press, 1976 p. 12 (arguing that ‘...the best way to look at evolution is in terms of selection occurring at the lowest level of all’. And he goes on saying that ‘...the fundamental unit of selection, and therefore, of self-interest, is not the species, nor the group, nor even strictly, the individual. It is the gene, the unit of heredity’.).

\(^{31}\) See Ratnapala, Suri, cit, pp. 225-226 (advocating that nowadays judges are not immune to political lobbying. Unlike in former times, they are no longer insulated in their task of adjudicating. So, she submits that if common law is to be maintained, judges should justify the continuing relevance and value of the tradition of judicial restraint. This justification should be drawn upon a general political theory able to claim its autonomy in face of the pressure of political groups).

\(^{32}\) The French case, for instance, is illustrative. The legislator, whilst reforming the legal regime of the SARL, has been inspired by and has drawn upon some of the solutions for professional organizations. The hope of some scholars is that if changes to the SARL follow the recommendations of representatives of these professional
company’s contract fosters this kind of experimentation. Following this point of view, I look at law and legal solutions from a bottom-up perspective to see which legal solutions work best. I illustrate this with a three-level model of legal policy in Part II, Chapter 1. The first level is the level of the society. Level 2 is the level of legislatures, regulators (politicians) and courts. The third level is the level of the market where we can find ‘genetic traits’ of corporate default rules. This model highlights, for the most part, how the second and third levels are interwoven. It suggests that this interconnection is likely to affect the first level. The way it affects the level of the society (i.e., the aggregate), especially when it comes to define the use of resources to maximize benefits with the least cost, may imply that a decision must be taken as to whether one places greater value on the market or the society. It is a knotty issue. This model delineates my idea of a bottom-up approach to law and is meant to be a point of departure for legal policy.

However, historical records I collected during this study show that in many instances law is contingent upon the influence of interest groups and unexpected circumstances that render it incapable of reflecting about the conditions of its own application and evolution. Hence, this study rebuts assumptions of the type labeled by Korobkin as a ‘preference exogeneity assumption’ as well as theoretical models based on pronouncements of rational choice theory. This particular assumption is criticized by Korobkin, who considers it organizations, they should find a favorable echo in practice and thus enhance the use of SARL. See Saintourens, Bernard, ‘L’attractivité renforcée de la SARL après l’ordonnance n° 2004-274 du 25 mars 2004’, Revue des sociétés, 2004 p. 207–(…). In the case of the United States, see Ribstein, Larry E., ‘The Evolution of the Modern Uncorporation’, in idem, The Rise of the Uncorporation, New York, Oxford University Press, 2010, pp. 131 (affirming that ‘…the main force driving the evolution of the LLC statutes appears to be lawyers who have an interest in promoting their individual reputation as experts in the area and in ensuring that the law of their home state was attractive to business formation’). Also see Ribstein, Larry E., ‘Statutory forms for Closely Held Firms’, 73 Wash. U. L. Q., pp. 369-432 (400) (stressing the central role of the practicing bar in both demanding and supplying legislation); and Ribstein, Larry E, ‘The Emergence of the Limited Liability Company’, The Business Lawyer, vol. 51, 1, 1995-1996, pp. 1-49 (4) (arguing that ‘The growth of the LLC has been spurred largely by state bar committees rather than by independent legislative initiatives’).

33 I am not endorsing a self-regenerating evolutionary legal system precisely because I believe the situations of path-dependence I refer to in the text lead to suboptimal results. I am arguing that law can have a corrective effect when legislatures are able to stay connected with this network of stakeholders (lawyers, notaries and corporate law consumers) and the market, and draw the legislative process accordingly. For instance, there are historical and anthropological data revealing how far law can go in developing family enterprise. See Yanagisako, Sylvia Junko, Producing Culture and Capital: Family Firms in Italy, Princeton and Oxford, Princeton University Press, 2002, pp. 170-173 (referring to the reform of the Italian Civil Code in 1975 and to the introduction of changes to inheritance law. These changes enabled women – mothers, daughters and sisters - to champion a new position in the company’s ownership structure).

34 I thank Roberta Romano for her comments and for having discussed some of these ideas with me. Naturally, all mistakes and omissions are mine.

35 This view differs from those suggested by proponents of ‘reflexive law’.

36 See Korobkin, Russell ‘The Status Quo Bias and Contract Default Rules’, Cornell Law Review, vol. 83, 3, 1997-1998, pp. 608-687 (The assumption referred to by Korobkin is based on the idea that ‘...contracting parties’ preferences for the substantive terms of their contracts remain the same regardless of the choice of default rules’. For law and economics advocates parties’ preferences for substantive contract terms change most likely as a
dubious. His thesis is that ‘...contract default rules affect preferences, not because the law places its imprimatur on certain contract terms, but because people prefer the status quo to alternative states, all other things being equal’. He maintains that in order to overcome contractual inefficiencies lawmakers should create majoritarian rather than penalty default rules and tailored or nonenforcement default rules instead of untailored defaults in general. I disagree, however, with this normative conclusion. In my view, a status quo bias would not be neutralized simply by the introduction of majoritarian, tailored or nonenforcement defaults. If that were the case, courts, legislatures and lawmakers in general are not themselves affected by any status quo bias. My research thus far demonstrates they are. I think that the effects of jurisdictional competition on the development of systems of contract law, corporate law and property law in Europe is promising in this regard.

This research is mainly supported by doctrinal sources, case law and empirical data collected through archival work. The purpose of using this sort of method in a legal investigation is to rethink companies’ evolution from a legal standpoint. Additionally, it inspires refinements of fundamental concepts such as property rights, ownership, and contract, as well as methods for comparison. In addition, sources accessed at multiple archives and libraries described in Part 1, Chapter 1 shed light on the relationship between corporate constituencies and the governance structures in these business associations. We shall see that shareholders do not perform in one-man shows, and that their relationships with one another and with other constituencies shape their behavior. The intricacies of the private sphere (e.g., asymmetries of information, trust, reputation, and expectations and how they are fulfilled by the law) will be illustrated by the case studies I have selected.

This background work is germane to the kind of bargaining I am describing with reference to these companies. It is also relevant to clarifying the problems I am trying to ‘diagnose’ in Part II. It may help explain how different bargaining processes inhere to these companies and are different from other types of institutional bargaining. Moreover, considering that disputes between members of these companies typically do not even reach the courts, case studies and archival material help to expose different microsituational result of transaction costs and strategies to withhold private information and not so much because of a particular default term).

37 See Korobkin, Russell, cit., p. 623.
contexts. Matters are dealt with privately, and alternative dispute resolutions are found. Using rational choice theories is good for some groups. There may indeed be cases where people really behave strategically. This, however, is not always the case. It can be difficult to predict where and when we should expect certain types of behavior.

I started my empirical research in September 2010 by collecting information on companies with registered offices in Portugal. In the second stage of my research – as of September 2011 to February 2012 – I went to historical archives in Italy and the United Kingdom. In the third stage of my research – as of May to July 2012 - I refined the data I had already collected and turned to companies located in France and Spain. Finally, as of September to December 2012, I concentrated on LLCs in the United States. In the cases of Spain and the United States it was very difficult to obtain the originals of articles of association and operating agreements of Srls and LLCs, respectively. In the US, for example, certificates of formation are public documents, but the relevant information may be lodged in non-filed operating agreements. Also, a voluminous number of operating agreements are not collected in any organized way. Moreover, these companies, unlike publicly held companies, do not benefit from a market for their shares, and their members often enter into other sort of agreements which are not public. Corporate behavior in the PLLC is not constrained by arranged markets such as financial and employment markets, at least to the same extent it is in public companies. Therefore, their profile has been established with the help of the data that have been possible to collect.

While collecting material provided by historical and legal sources, and consulting newspapers of massive circulation such as the New York Times and the Wall Street Journal, I came to realize that this study boils down to a discussion (perhaps today a bit less mainstream than before) about sources of law. Sources of law are and always have been influenced by political choices in the implementation of law, by moments of war and peace in the history of nations, by economic trends, and moral values, even when these values were not so evident when normative claims were made. Today, the old discussion must be held with new arguments made in the context of a global market and legal pluralism. The normative conceptualization of a global market and legal pluralism as well as the normative understanding of their effects at the national and transnational levels cannot be undertaken.

39 See Poteete, Amy R. et al., ‘Small-N Case Studies: Putting the Commons under a Magnifying Glass’, in idem, cit., pp. 31-63 (making an account of case study contributions for theory developing and testing).
40 See Poteete, Amy R. et al., cit. pp. 220-221 (arguing that ‘It is particularly upsetting to have one theory – rational choice theory – that explains how individuals achieve close-to-optimal outcomes in competitive market settings, but fails to explain how individuals will or will not cope with social dilemmas’).
41 See the Delaware Limited Liability Company Act §18-201.
without considering phenomena of ‘cross-fertilization’ and fluidity in the law, and the existence of different types and layers of ordering to which the concept of ‘law’ may be ill-fitting. Cultural patterns of behavior and the understanding of how markets and institutions (should) work, and forms of institutionalized power (disclosed by empirical data) cast a shadow over the construction of models for which my ultimate goal is ‘internal validity’. I kept this in mind while developing the ideas I present hereto.

This dissertation presents a theoretical framework that is based upon evolutionary theory in law. It provides new theoretical arguments which are embedded in the empirical data collected. Every new thought stems from these data. They have been strategically compiled into annexes to this dissertation so that the robustness of the ideas can be confirmed. The purpose of framing the investigation with evolutionary theory is to yield solutions liable to reflect better the preferences of the overall consumer of corporate laws, in particular those who desire to invest in PLLCs. This framework shows how, according to different concepts of efficiency (i.e., Pareto efficiency and dynamic efficiency), it is possible to create default rules that overcome internal corporate deadlocks, and promote combined action and informed interaction, trust and binding reciprocity among company’s constituencies, competition, and therefore institutional evolution.

Additionally, I propose legal policies, and take into account the model of regulation at the EU level. I compare it with the United States market design. This market is not necessarily based on an a priori principle of regulation. In fact, I try to overcome the bias Europeans are often said to depart from, which is that (more) regulation is needed. This may not be the case. This begs the question which I pose from an evolutionary platform: Is it time to

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43 This term is mostly used by literature on experimental methods dealing in particular with validity and causality. See Adcock, Robert and Collier, David, ‘Measurement Validity: A Shared Standard for Qualitative and Quantitative Research’, *American Political Science Review*, vol. 95, No 3, September 2001, pp. 529-546; and McDermott, Rose, ‘Internal and External Validity’ in Druckman, James N. et al (eds.), *Cambridge Handbook of Experimental Political Science*, New York, Cambridge University Press, 2011, pp. 27-40. By using the expression ‘internal validity’ in the text I want to call attention to the fact that broad generalizations based on the empirical results found in this study should be avoided. Data presented here point in a certain direction, but are not intended to be a platform for external validity.

44 The word ‘coordination’ has been more recently used by mainstream literature. This, however, is not the only problem one has to deal with, at least when it comes to the assessment of the type of relationships putting together different corporate constituencies.


46 This can be historically illustrated by the closed family firm, for which legal conceptions such as separate legal personality, managerial structure, transferable shares or membership interests, and the separation of ownership and control were not so relevant, but rather the values shared by the members of the family and long-standing traditions. The case of the unincorporated company is equally interesting. This corporate form (if one can fairly name it as such due to the convergence in it of partnership law, contract law, trust, agency, company law and
liberalize the PLLC, the most frequently used corporate form to invest and create capital? This question inevitably leads one to consider the potential role of markets, the political process, the courts, and the society in setting standards of legal evolution.\(^{47}\) It is also important to think about whether models enabling jurisdictional competition and the creation of a market for law better serve the evolutionary principle.\(^{48}\)

As a comparative study, this research will more efficiently reveal the preferences of consumers of corporate law than if it was reduced to a narrow methodological approach. To this end, the work is driven by a comparative matrix wherein I introduce elements for comparison in the six countries. This matrix is designed at an early stage in its empty form to be completed at a later stage upon the comparative synthesis. Moreover, the comparison between the United States and the selected jurisdictions in Europe is based upon the judgments adjudicated by national courts and the European Court of Justice (ECJ) on company law cases and on freedoms of movement.\(^{49}\) These judgments paved the way for jurisdictional competition in Europe. The purpose of this comparison is to evaluate whether national courts and the ECJ can play a role when it comes to breaking a prevailing status quo and can, thus, take the cognitive burden off the shoulders of members of PLLCs with regard to the choice of the best rules to govern their deals. The comparison I undertake herein does not include the study of tax and labor laws in the six jurisdictions; it does not scrutinize the role of stakeholders such as employees and creditors; it does not dwell upon the definition of public good, it does not compare the EU to the United States, and it does not engage in a

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\(^{48}\) See O’Hara Erin A., and Ribstein Larry E., *The Law Market*, New York, Oxford University Press, 2009. Also see Butler, Henry N. and Larry E. Ribstein, ‘Fiduciary Duties and Residual Claims: Obligations to Non-Shareholder Constituencies from a Theory of the Firm Perspective’, 65 *Washington Law Review*, vol. 1, 1990, pp. 1-72 (58) (arguing that ‘...there is substantial reason to believe that a process of evolution of corporate rules through private ordering is preferable to a system of mandatory rules’). It is important to note that the terms in which the discussion about default and mandatory rules has been held in the United States and Europe is different.

\(^{49}\) *Centros* (Case C-212/97, 9 March 1999), Überseering (Case C-208/00, 5 November 2002), and Inspire Art (Case C-167/01, 30 September 2003).
debate about the best methods of comparative law. By taking a social sciences approach to a legal question, however, it does introduce a wider debate about methodology in law.

In sum, examining rules on transfer of shares creates a 'laboratory' in which to study significant jurisprudential issues, including the factors that result in differences or cause convergence among different legal systems, the effect of jurisdictional competition for the development of better rules (e.g., Do we need mandatory rules, different default rules, or no rules at all?) and fundamental policies of contract and business association laws across jurisdictions.50

This dissertation is divided into three main parts. They correspond to the three different stages of comparative work. The first part is descriptive. It tries to look the PLLC in the face to unveil the profile of these business organizations in the six jurisdictions. This is accomplished by embedding into the legal research a parallel historical inquiry. The second part is an explanatory part wherein I evaluate the problems deriving from a potential scenario of un-consented transfer of shares. In the third part, I 'connect the dots' and relate the systems to each other. This is where the real work of comparison is undertaken, through the comparative synthesis. The comparative synthesis entails the cross-checking of results. I do this by answering the questions listed at the left column of the comparative matrix in respect to each of the six countries listed at its top row. The fourth part concludes and yields my thesis.

PART I

DOWNLOADING THE PRIVATE LIMITED LIABILITY COMPANY:
A CROSS-COUNTRY HISTORICAL AND LEGAL OVERVIEW AND EMPIRICAL EVIDENCE

(Description phase)
CHAPTER I

METHODOLOGY: THE COMPARATIVE MATRIX AS A LABORATORY FOR RESEARCH

‘The empirical basis of objective science has thus nothing ‘absolute’ about it. Science does not rest upon solid bedrock. The bold structure of its theories rises, as it were, above a swamp. It is like a building erected on piles. The piles are driven down from above into the swamp, but not down to any natural or ‘given’ base; and if we stop driving the piles deeper, it is not because we have reached firm ground. We simply stop when we are satisfied that the piles are firm enough to carry the structure, at least for the time being’.


Introduction

This chapter develops a method based on the construction of a comparative matrix to link each problem under investigation with the respective jurisdiction in which that problem is being observed and studied. Borrowing from the field of engineering, I call it a comparative matrix. To date, there exists no standardized method for comparison of legal systems or elements of different legal systems. This matrix is an analytical space, and functions as a laboratory that is designed to be used both as a starting point and as an instrument for the comparative synthesis at the end of the work of comparison. At this point, the comparative matrix not only streamlines the research, but also organizes the ways in which problems are examined in the context of my laboratory.

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51 This chapter is based on the presentation I gave at the British Association of Comparative Law (BACL) Postgraduate Workshop on Comparative Law, Kent Center for European and Comparative Law, Kent Law School, Canterbury, United Kingdom on 19 and 20 June 2012. I thank the participants for their comments.

52 See Part III, chapter 3.

53 Relevant questions regarding which and how legal systems and topics for comparison should be selected must be answered before the endeavour of comparison starts. But when it comes to the method, the researcher enjoys considerable leeway to implement it. See Kamba, W. J., ‘Comparative Law: A Theoretical Framework,’ *The International and Comparative Law Quaterly*, vol. 23, 3, 1974, pp. 485-519 (517) (saying that ‘It seems plain … that systematic comparison consists of a combination of a number of techniques or approaches which leave considerable room for individual judgment’). Also see Gerber, David J., ‘System Dynamics: Toward a Language
The comparison follows a functional principle. However, I attempt to harmonize the focus on the purpose of specific rules with the context within which they were designed. The use of comparative law to analyze and describe the law within a context creates a bridge to an interdisciplinary avenue in the field of comparative studies.\(^\text{54}\) I do this by taking a social sciences approach to legal research in order to explain why law is how it is.\(^\text{55}\) This task is additionally complemented by the evolutionary theoretical framework that tries to clarify what law is (or it can be) alongside the legal categories that inform the standardized knowledge of it.

Finally, the comparative work and the creation of a method is meant to provide tools to test the falsifiability of the following hypothesis: When legislators select default rules the substantive preferences of parties may change, but do not necessarily do so, even when, for the sake of competition in the market and according to an evolutionary pattern this change would be desirable. Parties prefer to preserve the status quo in their contractual arrangements. Importantly, they seem to want to hold onto this status quo regardless of the nature of the default rule. Given this hypothesis, I scrutinize case law regarding transfer of shares, which are mostly un-consented. My goal is to provide a sense of the number of disputes regarding transfer of shares that actually reveal the intention of corporate constituencies to maintain a status quo in the company regardless of the ‘legal infrastructure’ they have selected. Also, the comparison allows for an explanation of the collected data, and to understand the differences and similarities across the jurisdictions selected.

Section 1 presents the comparative framework. It explains the object of the comparative research and the problems that are investigated. In addition, it clarifies the methodology for the comparison and introduces as well as extends the concept of comparative matrix as a laboratory for research. Section 2 dwells on the empirical method and elucidates the choices of Comparative Law?’, \textit{The American Journal of Comparative Law}, vol. 46, 4, 1998, pp 719-737 (claiming for a theoretical framework for corporate law). See Reimann, Mathias, ‘The Progress and Failure of Comparative Law in the Second Half of the Twentieth Century’, \textit{The American Journal of Comparative Law}, vol. 50, 4, 2002, pp. 671 – 700 (686) (arguing that ‘The most embarrassing theoretical weakness is the continuing lack of an understanding of what it really means to compare’). This naturally raises very difficult questions as to the method of comparison, which to this date has not fully developed in doctrine.


and challenges faced with respect to it. Section 3 makes clear the larger theoretical framework of the thesis, that is, evolutionary theory in law. Section 4 concludes.

1. The comparative framework

i. The object of the comparative research and illustration of the problems under investigation

This is a comparative study. As explained in the introduction to this dissertation, it aims to understand whether the design of default rules establishing restrictions on transfer of shares is likely to affect investment in PLLCs and their development. The following chapters can only be fully understood if a model of comparison is objectively presented beforehand and the object of the research is reflected therein. So that this can be easily grasped I shall give an overview of the problems which are addressed throughout the research.

a. The public / private companies divide: Where does the PLLC stand?

Business organizations are differently designed in the laws of the selected jurisdictions. However, there also are similarities that cut across the legal forms of these business organizations. Importantly, there is a line in all these jurisdictions dividing public and private companies. In the case of the United Kingdom, as it shall be described, this line is blurred, mostly for historical reasons. This distinction would only become apparent in the 1980s

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58 See Part I, Chapter 3.
The definition of private and public companies may be undertaken through the following variables: (i) limited liability, (ii) minimum number of shareholders, (iii) share capital (including minimum authorized capital and minimum paid up capital), (iv) transferability of shares, (v) and management or ultimate decision-making body.

(i) The public company, PLC or corporation

Public companies (also referred to in modern corporate law as publicly held companies or PLCs) were historically preceded by joint stock companies. They are typically limited liability companies. In other words, shareholders’ liability is limited to their contributions and only the assets of the company are liable for the company’s debts. Their shares are publicly traded in stock markets or, put differently, the value of their shares is subject to the scrutiny of a public market. Despite being categorized as public, these companies are not state-owned. Their securities are normally held by a large number of shareholders (or investors) which, but for very few exceptions, do not face any restrictions on their transferring of shares. Their share capital is disseminated and, for this reason, these business organizations are great sources of liquidity. Thus, unlike private companies, publicly held companies do not have to bear the heavy weight of borrowing. They are the legal form of big businesses and large corporations. The management of these companies is undertaken by a board of directors and is not diffused by the members. That is to say, generally, shareholders are not directors. The separation of ownership and control, that is distinctive of publicly held companies, has motivated extensive literature on ‘agency problems’ effected by the lack of incentives of managers. In spite of the advantages of limited liability and free transferability of shares, public companies are not flexible business organizations. In principle, they are not controlled by governments, but are subject to a considerable amount of state regulation and international

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60 One of the famous early joint stock companies was the Portuguese East India Company, created in the seventeenth century.

principles of corporate social responsibility. They are constrained by corseting legal and regulatory provisions that implement strict rules of corporate governance, monitoring and financial disclosure. The legislation of each selected jurisdiction provides specific requirements regarding each of the above-specified five variables.

In Portugal, shareholders of the Portuguese version of the PLC – sociedade anónima – enjoy limited liability. The minimum number of shareholders required is five. The minimum required share capital is €50,000.00. At least 30% of the share capital should be paid-up. Shares may be transferred freely, without prejudice of minor exceptions. The management or ultimate decision-making body is the board of directors (conselho de administração). In a similar way, the investors of the French PLC – sociétés anonymes – enjoy limited liability. The company may not number fewer than seven members. The minimum share capital is €37,000.00 and should be fully paid-up. Shares can be freely transferred. The management of the company is held by a board of directors (conseil d’administration). In Italy, investors of the Italian version of the PLC – the società per azioni – enjoy limited liability. The company may be founded with even one member. The minimum required share capital is €120,000.00 and the minimum paid up capital is set at a threshold of 25%. Shares can be freely transferred. The management or ultimate decision-making body consists of a sole director or board of directors. In Spain, the shareholders of the PLC or sociedad anónima enjoy limited liability. The minimum required share capital is €60,000.00 and the minimum paid-up capital is €15,000.00. Generally, restrictions on transfer of shares are not provided. The management and representation of the company is in the hands of a board of directors (consejo de administración), but the general meeting of shareholders holds the ultimate decision-making power. In the United Kingdom investors of the PLC enjoy limited liability. The company must be incorporated with a minimum of two shareholders. The minimum required share capital is €57,100 or £50,000. Normally, no restrictions on transfer of shares are imposed. The management and ultimate decision-making power belong to directors working in the best interest of shareholders. In the United States, the PLC is also referred to as a ‘corporation’. For example, investors of Delaware corporations enjoy limited liability. The minimum number of founder members is one. There is no required minimum share capital or minimum paid-up share capital. Shares are freely transferable. However, it is important to stress that members of these business organizations may choose to restrict the transfer of shares or limit the admission of new members. In these circumstances, the corporation is referred to in

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American literature as a ‘closely held corporation’. \(^{63}\) In the corporation, the ultimate decision-making body is the board of directors.

(ii) The private company or ‘uncorporation’

Private companies (also referred to as privately held companies) are business organizations whose shares are not publicly traded. Their articles of association often include restrictions on transfer of shares. The absence of a market for their shares explains the illiquidity of these companies’ shares. There are fewer shareholders, and these also frequently function as managers or directors. Hence, the separation of ownership and control in these companies is less evident than in publicly held companies. Sometimes, it is nonexistent. Often, the management of the company is attributed to all shareholders or to the majority shareholder(s). However, agency costs which in publicly held companies are, for the most part, caused by the split of ownership and control are not marginal in private companies. The samples of case law collected in all six countries suggest that it is likely that there be not only clashes of interests between majority and minority shareholders, but also between shareholders and managers. Given that there are fewer shareholders, it is understandable that as a rule these companies are less of a stage for problems of collective action than publicly held companies. \(^{64}\) However, these problems exist in private companies, especially when their distinctive contractual framework gives more power to certain constituencies than others and bargaining failures are difficult to overcome. Generally, private companies are less hampered by financial regulations and legal provisions of corporate governance. In many cases, they also are subject to beneficial tax treatment. This legal form includes the general partnership, the limited partnership, the private limited liability company (PLLC) and other variations of these entities. In American legislation and literature they have been clustered into the concept of ‘uncorporation’ to signify they are not corporations. \(^{65}\) This dissertation investigates the PLLC. Like the public company, the legislation of each jurisdiction foresees specific requirements for the PLLC which are distinctive features of this form.

In Portugal, shareholders of the Portuguese version of PLLC – *sociedade por quotas* – enjoy limited liability, unless otherwise established in the articles of association. If


\(^{65}\) See Ribstein, Larry E., *The Rise of the Uncorporation*, New York, Oxford University Press, 2010 (providing an insightful description of these business organizations).
shareholders are liable for corporate debts they will hold a right to be paid back by the company. The company must be incorporated with two or more shareholders. The minimum share capital of a Portuguese PLLC is freely established in the articles of association. It should be equivalent to the total membership contributions, which should not be less than the symbolic amount of €1. If the share capital is higher than the minimum required, at least 50% should be paid-up. In principle, shares must not be transferred to third parties other than spouses, ascendants, descendants and other shareholders without the consent of the company, unless articles of association establish otherwise. The company is managed by one manager or a management board. Managers are responsible for directing the company on all subjects that are not exclusively dependent upon on shareholders’ decisions. French PLLCs are also known as sociétés à responsabilité limitées. Shareholders enjoy limited liability. PLLCs may have even a single founding member (l’associé unique). The share capital is freely established in the articles of association. Transfer of shares is subject to restrictions. The management is undertaken by one or several managers who may or may not be shareholders. They decide on all matters that do not fall within the exclusive competence of shareholders. In the SARL there is no fully-fledged management board. Managers hold separate powers to represent and act on behalf of the company in accordance with the articles of association. In Italy, shareholders of the Italian PLLC – società a responsabilità limitata – enjoy limited liability. PLLCs must be incorporated with at least one shareholder. The minimum required share capital is €1 and the requirement of 25% of minimum paid-up capital applies. Shares are freely transferable, unless otherwise established in the articles of association. The management of the company rests on a sole director or board of directors who may or may not be shareholders. In Spain, the shareholders of the PLLC or sociedad de responsabilidad limitada also enjoy limited liability. The company may be incorporated by one or more shareholders. The minimum required share capital is €3,000.00, which should be fully paid-up. Transfer of shares is subject to restrictions, unless otherwise provided by the articles of association. The management and representation of the company is undertaken by managers or a management board (consejo de administracion), but the general meeting of shareholders is the ultimate decision-making body. The United Kingdom private company grants its members limited liability. It may be founded with a single member. The minimum required share capital is £ 0,01. Shares are freely transferable, unless otherwise established in the articles of association. The ultimate decision-making power is held by directors who, as in the

66 In Portuguese literature, a distinction is made between ‘managers’ of PLLCs and ‘directors’ of PLCs.
public company, are bound to act in the best interests of shareholders. The American version of the PLLC is the limited liability company (LLC). It is also referred to as a type of unincorporation. Taking, once more, the example of Delaware, LLC shareholder liability is limited to the amount of their contributions. LLCs may be incorporated by one shareholder. According to the law of the state of Delaware, no minimum share capital is required. Generally, LLCs’ shares or interests are assignable in whole or in part, except if the LLC agreement provides differently. The representation and ultimate decision-making body are defined by the LLC agreement.

(iii) Hybrid entities

In spite of the line dividing public and private companies, the traditional legal forms of business organizations are currently dealing with serious challenges effected by the emergence of alternative and hybrid entities. There are publicly traded limited liability companies as well as publicly traded partnerships. In 2010, The Economist reported that publicly traded partnerships and real-estate investment trusts were merging, and in the process were combining traits of publicly held companies or corporations and private companies such as partnerships. This same column provided the following passage:

The most fashionable investment vehicles—leveraged buy-out firms, hedge funds and venture-capital funds—are spearheading the “uncorporate” revolution. These firms are usually organized as partnerships, though some, such as the Blackstone Group, are also listed. Corporate raiders often raise money by creating funds in the form of partnerships. Their targets are often restructured as partnerships. This makes managers behave like owners rather than hired hands: they can lose money as well as making it and they have years to turn their companies around rather than answering to the stockmarket every quarter. Hedge funds can make money by buying companies and selling underperforming assets. Venture capitalists make money in the long term by lending their names and expertise to start-ups. Hedge funds and venture-capital firms also make money in their different ways by getting fund managers to behave more like partners, with “skin in the game”, as the modish phrase puts it.68

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67 This rule has specificities deriving from the decomposition of LLCs’ shares into economic and management rights. They will be further explained in Part I, Chapter 3 apropos the United States case.
I faced the hybridity of these legal forms while collecting a sample of LLC agreements on WestlawNexis to study the United States case. Many of these companies are contractually structured like equity funds. Their ownership and governance structures reflect this. For example, and as it is pointed out in the excerpt above, managers who are not owners behave like it. LLCs are structured more like corporations / publicly held companies perhaps because they are being used as business vehicles to enter the stock market at a later stage.

In sum, the PLLC, which is the object of this study, is a private company whose shareholders enjoy limited liability. Its ownership and governance structures are not diffused, at least not as much as in publicly held companies. Its shares are often subject to transfer restrictions. However, this type of business organization is flexible in nature. They are mostly used by small businesses, but also are adaptable to big businesses. This fact has compelled some authors to forecast the ‘uncorporation’ of large firms as a form to overcome governance problems deriving from centralized management in publicly held firms.

b. Why are there restrictions on transfers?

The transferability of shares, the company’s legal personality, the principle of limited liability, the management form (i.e., undertaken under a board structure or through collective decisions of shareholders), and the question of ownership of investors constitute the basic features of a company. This is especially the case for companies incorporated in the selected jurisdictions. I highlight the transferability of shares and the deviation from this principle with

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69 I have noticed that one of the reasons that LLC members introduce restrictions on transfers has to do with the fact that they want to prevent any portion of the assets of the company to become ‘plan assets’ of any ‘benefit plan investor’ within the meaning of regulations issued by the US Department of Labor at Section 2510.3-101 of Part 2510 of Chapter XXV, Title 29 of the Code of Federal Regulations as modified by Section 3(42) of the Employee Retirement Income Security Act of 1974. Paragraph b(4) of this regulation provides a definition of freely-transferable publicly traded securities. It also clarifies that the question of whether a security is freely transferable is a factual question to be determined on the basis of relevant facts and circumstances. However, if a security is part of an offering in which the minimum investment is $ 10,000 or less, the factors described in the several subparagraphs ordinarily will not, alone or in combination, affect a finding that such securities are freely transferable. Among those factors are different sorts of restrictions on transfers.


regard to the PLLC. Frequently, restrictions on transfer of shares in these companies are by default established by the law and subsequently introduced in their articles of association by their members. (Sometimes these restrictions are not provided by the law, but members of the company prefer to introduce them). The problem with transfer of shares in private companies is that restrictions on transfers, such as the requirement of consent of the company, managers or other shareholders, render more cumbersome the resolution of acrimonious behavior between shareholders and of situations of opportunistic behavior. This is true even in situations in which the law and the articles of association provide mechanisms to prevent shareholders from being locked-in to the company.

I maintain that criteria of economic rationality determine the inclusion of restrictions in the companies’ articles. When partners incorporate these business associations they attribute a greater value to those restrictions than to the right to freely resign from the company. They attribute a greater value to restrictions on transfers than to the attainment of immediate gains as a result of the sale of shares in a public market. They view these restrictions as more valuable than the possibility of decreasing investment risks by means of a greater dispersal of the share capital. This is so because the value of human capital should be added to the share

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72 See Kalss, Susanne, ‘The Transfer of Shares of Private Companies’, European Company Law and Financial Law Review, vol. 1, 3, 2004, pp. 340-367 (352) (stating that the ‘The greater difficulty of trading shares in a private company and the fact that the consent of the other shareholders may be required for a sale makes solving a potential conflict by selling one’s shares more difficult for the shareholders in a private company’). Also see Thompson, Robert B., ‘Corporate Dissolution and Shareholders’ Reasonable Expectations’, Washington University Law Quarterly, vol. 66, N.º2, 1988, pp. 193-238 (196) (saying that ‘In a close corporation setting, the norm of free transferability of shares is illusory. Because of the size of the business and the small number of participants there is no ready market for interests in the enterprise’). He explains this more clearly in note 10 by asserting that ‘The lack of a ready market (1) makes valuation of shares uncertain, increasing the transaction costs of any participant seeking to sell; (2) precludes some participants from using the secondary market to provide ‘home-made dividends’ if the corporation itself does not declare dividends, (3) precludes reliance on the stock market to monitor managers; and (4) precludes the ability of uninformed investors to rely upon the efficient market to set price instead of engaging in their own costly search for information’).

73 The term lock-in is used differently in the text from the way it is used in Part III, Chapter 1. Here, by referring to ‘lock-in’ I mean a situation in which members become ‘prisoners of the company’, to use an expression propagated in French and Portuguese literature. For example, Article 231(1) of the Portuguese Commercial Companies Code regulates the refusal of consent and determines that if the company refuses to consent, it must make a proposal of redemption or acquisition of the share.

value of the corporation. It is important for a member to maintain a close relationship with her or his peers. Kinship, loyalty and trust are three other reasons for the inclusion of restrictions. PLLCs often emerge from family relationships. So, when a shareholder sells his or her shares without the company’s prior consent they are inevitably depriving other shareholders of that accrued value. Furthermore, shareholders normally agree on the division of profits, the exclusion or entry of new shareholders, and the acquisition of shares in other corporations to guarantee that the integrity of the ownership structure and control of the company stay as they were initially envisioned. Finally, sometimes members just want to operate with anonymity and avoid regulatory restrictions which otherwise would be imposed if it was a publicly held company. Therefore, they opt for ‘…keeping the partnership “close and tight”’. The PLLC structure tends to insulate the controlling members from passive investors and leaves the former with control over company investments.

c. Transfer of shares and agency problems in PLLCs

Transfers of shares – especially un-consented transfers of shares - are liable to trigger ‘agency problems’. These problems vary according to the governance and ownership structures of the corporation. At this point, I shall emphasize that I question whether shareholders can properly be called owners of the company. A great deal of research has shown that they face considerable restrictions on their ability to control the corporation and its assets. Even taking into account that shareholders enjoy property rights in their shares or units

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75 I refer to the human capital of both shareholders and employees. I believe the former is more important in PLLCs. The latter is more relevant in publicly held companies.


78 See Easterbrook, Frank H. and Fischel, Daniel R., *The Economic Structure of Corporate Law*, Cambridge, Massachusetts; London, England, Harvard University Press, pp. 228-243 (refering to agency costs in closely held corporations). See also Armour, John; Hansmann, Henry; and Kraakman, Reinier, ‘Agency Problems and Legal Strategies’ in Kraakman et al, *The Anatomy of Corporate Law*, cit., pp. 35-53; and Pratt, John W., and Zeckhauser, Richard J., ‘Principals and Agents: An Overview’ in idem (eds.), *Principals and Agents: The Structure of Business*, Boston, Harvard Business School Press, 1985, p. 10 (mentioning that information asymmetries can create agency loss or agency costs for capital (e.g. money and machines). For example, ‘… the owner of the capital, such as the outside shareholder in a closely held corporation, may have difficulty determining what his capital has produced’). The same may be true of the PLLC.
and that they hold residual claims to profits, they are not necessarily agents of the firm. Nonetheless, I refer to agency problems to illustrate that the same questions posed by the law of agency (e.g., Do shareholders owe fiduciary duties to other shareholders and the company?) may be asked in corporate law. The answers, however, are necessarily different because corporate law provides specific rules to determine shareholders’ rights and duties toward the corporation and other shareholders. The analogy is particularly apt when shareholders are simultaneously managers of the company. These companies, which are small and closely held by their shareholders, are often based on unwritten articles of association and operating agreements. Many of them are not even filed. Thus, what non-transferring shareholders and third parties actually know, or are able to know, about the company is a highly significant question. In sum, my reference to agency problems is meant to account for situations in which the relationship that shareholders have with each other and with other corporate constituencies do not live up to expectations.

With regard to these problems, the following is stressed. Although in PLLCs shareholders are often managers, they are not necessarily experts in a particular field. In practical terms, the management infrequently works under a complex board structure as it typically does in publicly held companies. Decisions are instead taken collectively (sometimes informally), but voiced in and outside the company by an activist or group of activist shareholders who lead the business activity of the company. Moreover, PLLCs are

79 See Bruner, Christopher M., ‘The Enduring Ambivalence of Corporate Law’, Ala. L. Rev., 59, pp. 1385 – 1449 (describing three theories of corporate governance: the nexus-of-contracts theory, the team production theory and the shareholder centric theory. He also explains how they fall into two different doctrinal views. I quote: ‘…those premised on the board’s authority to manage the business and affairs of the corporation and those premised on the board’s accountability to the shareholders who elect them’). As Bruner clarifies choosing one of these sides brings on different normative framework. The first understanding tends to emphasize the importance of governance structures such as the board of directors whilst the second understanding gives scant attention to claims related to shareholder ‘ownership’ and to their vulnerability to ‘agency’ problems.


81 This can be nicely illustrated by what parties to the articles of association of a company establish content-wise in those articles. For instance, while establishing the methodological approach to the research, I have analysed numerous articles of companies in which registered offices were or still are located at the selected jurisdictions. The articles of the company Henry Bath & Sons, Limited - an old company incorporated in 1920 in England, and still active - provides that the parties to the agreement are simultaneously directors and managers of the company’s business and therefore are entitled in that capacity to participate in the profits of the company. Moreover, the articles say that it shall be no objection to the arrangements to be given effect under the articles that they – directors / managers - are in a fiduciary relation to the company, or that they participate as managers or otherwise in the profits of the company. Further, the articles do not foresee an independent board of directors. [italicized by the author]

82 The text refers to a number of rules that the members end up agreeing on aside from the formal contract of the company. However, it is important to note that Article 2 of the First EU Company Law Directive requires the disclosure of the ‘instrument of constitution, and the statutes if they are contained in a separate instrument’. Moreover, at least in German-speaking countries and some of those which follow the French legal system, articles of association should be made in writing before a notary public.
mostly contract-based. Hence, I discuss the contracting inefficiencies that accompany the features of these business associations. For instance, the assumption that shareholder-managers necessarily hold an encompassing interest in the company and for that reason would not behave opportunistically is unwarranted. Often, in addition to not being experts, they are also not subject to external monitoring.

I also hope to clarify whether agency problems can be triggered by restrictions on transfers. If these restrictions indeed trigger agency problems, I try to determine whether they increase the likelihood that corporations will lag behind, diminish in value, and turn into undertakings in which it is neither attractive nor wise to invest.

d. The research object

In light of the above, I examine bargaining failures and risk of opportunism when ownership interests are transferred and different governance mechanisms are established in the articles of association. To this end, I adopt a functional standard to underscore similarities and differences between the selected jurisdictions.\(^83\) My goal is to show how different approaches and governance mechanisms set up by legislators and corporate constituencies are used to balance the exit and retaining of shareholders in the company.\(^84\)

Problems previously described are assessed as they appear in different settings of the selected jurisdictions. They are addressed within an overarching comparative scheme. This scheme is described in the next section.

ii. Methodology for the comparison and comparative matrix for the laboratory

I explore the transfer of shares in Portugal, Spain, Italy, France, the United Kingdom and the United States. The criteria used for selecting these countries were that they should be representative of the Southern peripheral Europe (Portugal, Spain and Italy) and they should stand for bigger economies closer to global markets (France, the United Kingdom and the United States). These countries are rich sources of policy examples both because of the size of their markets and level of competition therein, and also due to the fact they have different

\(^{83}\) See Michaels, Ralf, ‘The functional Method of Comparative Law’, in Reimann, Mathias, and Zimmermann, Reinhard (eds.), The Oxford Handbook of Comparative Law, New York, Oxford University Press, 2006, pp. 339–382 (Referring to the principle of functionality); Zweigert, Konrad; and Kötz, Hein, cit, p. 34 (stating that ‘The basic methodological principle of all comparative law is that of functionality’). Additionally, see Kraakman et al., The Anatomy of Corporate Law, cit. (also adopting a functional principle).

\(^{84}\) See Part III, chapter 1.
legal systems. Portugal, Spain, Italy and France have a civil law system, whilst the United Kingdom and the United States are bastions of the common law system. Nonetheless, the real work of comparison is developed at a later stage.\textsuperscript{85} It is undertaken by cross-checking the information introduced in a comparative matrix (Table 1) which synthesizes the results of the macrocomparison and microcomparison.\textsuperscript{86} This comparative matrix, however, also serves as a starting point of the comparative work.\textsuperscript{87} This essential instrument of the comparative research is based on a table with two entries.\textsuperscript{88} One of the entries contains the elements that I consider relevant for the comparison. These are listed in the form of questions. The other entry is comprised of the selected jurisdictions. I will register the variations of each element in the respective jurisdiction and subsequently cross-check the outcomes. This will help me carry out the comparative synthesis later on in Part III.

The elements of comparison were selected on the basis of preliminary research on the topic and on the assessment of the relevant default rules in each jurisdiction. Additionally, I analyzed rule books on PLLCs yielding standard terms of articles of association\textsuperscript{89} as well as standard articles of association provided by notaries who customized them to specific clients. This preliminary research led me to conclude that legal rules, although different from one another, are not markedly so.\textsuperscript{90} This becomes clearer with the evolutionary approach I take herein, which puts forward an explanation for the crossover of legal solutions and the diffusion of corporate law.

\textsuperscript{85}See Part III, chapter 3 providing a comparative synthesis that gives the whole picture of the comparative work.
\textsuperscript{86}See Zweigert, Konrad; and Kötz, Hein, cit, pp. 4-5 (defining macrocomparison and microcomparison).
\textsuperscript{87}See Zweigert, Konrad, and Kötz, cit., p. 44. (referring to the need to build a system. They say that ‘…one needs to develop a special syntax and vocabulary, which are also in fact necessary for comparative researches on particular topics’).
\textsuperscript{88}The adoption of a comparative table for the development of the method of comparison has been attributed to Isabel Magalhães Colaço – the first Portuguese female doctorate in law. Her degree was awarded in 1954. I call it ‘comparative matrix’ because this term better captures the anatomy of the comparison – the establishment of a network of intersections between the elements / questions listed in two different entries leading to the comparative synthesis at the end.
\textsuperscript{90}See K. Zweigert e H. Kötz, cit., p. 34 (stating that the ‘…legal system of every society faces essentially the same problems, and solves these problems by quite different means though very often with similar results’).
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<tr>
<th>Question</th>
<th>Portugal</th>
<th>Spain</th>
<th>Italy</th>
<th>France (England &amp; Wales)</th>
<th>US</th>
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<td>1 - When and why was the law adopted?</td>
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<td>2 - What kind of restrictions on transfer of shares does the law foresee?</td>
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<td>3 - What is the purpose of restrictions on transfer of shares foreseen by the law?</td>
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<td>4 - Do these restrictions constitute a source of inefficiency (unenforceability) of the legal framework of transfer of shares?</td>
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<td>5 - How do legislators approach the transfer of shares and protect entitlements (inalienability rules, property rules, or liability rules)?</td>
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<td>6 - What kinds of costs result from the transfer of shares according to the approach taken by legislators?</td>
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<td>7 - What kinds of agency problems derive from the transfer of shares according to the approach taken by the legislators?</td>
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<td>8 - In practice, do defaults reduce bargaining failures?</td>
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<td>9 - Is there a demand for efficient company (corporate) law rules?</td>
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<td>10 - What kind of ownership structure do these business organizations have?</td>
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<td>11 - On average, how big is the PLLC (i.e., how many shareholders do these business organizations have)?</td>
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<td>12 - What kind of control structure do PLLCs have (e.g., (i) one controlling shareholder; (ii) many controlling shareholders through a shareholder agreement or through occasional coalitions; (iii) no controlling shareholder)?</td>
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<td>13 - Which constituency is most likely to efficiently assess the transfer of shares (e.g., shareholders, managers, creditors, employees, consumers/customers)?</td>
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<td>14 - Are the company's and shareholders' interests well protected considering the constituencies intervening in the transaction process?</td>
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<td>15 - Is the choice of the constituencies which are competent for the assessment of the transaction liable to be affected by the environment in which the company operates (e.g., financial context, taxes, links with hedge funds, and with the uncorporation of larger dimensions)?</td>
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<td>16 - Is the (competitive) context in which the company operates likely to be a source of efficiencies which may lead to: (i) containment of bargaining failures; and (ii) allowing the evaluation of the right amount of benefits which should be granted to the shareholder who wants to leave the company?</td>
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<td>17 - Do default rules adopted by legislatures allow any single corporation to submit transaction costs to the constituencies which are more likely to correctly assess its commercial value?</td>
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2. The empirical method

i. Data set

This project includes data of different sources I collected in all six jurisdictions. I collected copies of manuscripts, private documents (e.g. letters, opinions), and correspondence between members of the Board of Trade in the United Kingdom as of the second half to late nineteenth century, constitutional documents of corporations in all six jurisdictions (e.g. minute books of board of directors, company ledgers, etc.), and newspaper articles (e.g. The Wall Street Journal and The New York Times) as of mid nineteen century to the second half of the twentieth century. For the purpose of collecting this data I visited the archives of the Portuguese National Library, the Newspaper Library of Lisbon, the Library of the Faculty of Law of the University of Lisbon, the National Archive of the Tower of the Tomb in Lisbon, the Central National Library of Florence, the Library of the Italian Parliament in Rome, the Camera di Commercio di Firenze, the Library of the European University Institute, the Università Commerciale Luigi Bocconi, the Business and IP Center and the Asian and African Studies department of the British Library, the National Archives, United Kingdom, the Guildhall Library, The London Metropolitan Archives, the Albert E. Jenner, Jr. Library of the University of Illinois College of Law, The Leo T. Kissam Memorial Library (Fordham Law Library), The Arthur W. Diamond Law Library (Columbia Law School), The New York Public Library, the Bibliothèque Nationale François Mitterand, the Archives Nationales (France), the Centre Georges Pompidou in Paris, the Archivo Histórico de Protocolos de Madrid, the Biblioteca Nacional de España, the Archivo General de la Administración, and Archivo Regional de la Comunidad de Madrid.

I also collected data from electronic databases. For the most part, the search included the terms: ‘private companies’, ‘private limited liability companies’, ‘transfer of shares’, and ‘restrictions’. The earliest data varied according to the breadth of the various research engines (ex. Westlawnext, LexisNexis, Bureau van Dijk). I collected from these databases legislation, opinions, LLC agreements (Westlawnext), company information (BvD), and case-law (LexisNexis). Regarding the LLC agreements I found, however, that they are not widely available through Westlawnext. I realized that the best way to obtain these documents was through public companies Securities and Exchange Commission filings. Larger companies amend their operating agreements considerably. So where possible, I tried to gather all the
interactions of the agreement that I could find.⁹¹ Those collected from Westlawnext in their amended and restated versions often contain an ‘entire agreement’ clause providing that the respective agreement constitutes the entire agreement among the members relating to the company and supersedes all prior contracts or agreements with respect to the company and the matters addressed or governed thereby, whether oral or written. Therefore, I used them as events of my sample. For several reasons, usually related to capital market transactions, American companies file a high amount of LLC agreements for subsidiaries. These documents are tremendously extensive.⁹² Nevertheless, the operating agreements are only a small portion and normally attached as exhibits which can be found more easily by searching for ‘operating agreement’. This sort of documents normally yields three, four, five or even more LLC agreements. The agreements are often very similar to each other. The interesting fact is that the similarity in the wording of the agreements is not exclusive to the United States. It is a cross-country phenomenon. It also happens in Portugal, France, Italy, and Spain which are countries with a civil law system. For example, while treating the events included in the samples of articles of association of Portuguese and French companies it was interesting to note that the wording of the clauses of articles of association of Portuguese companies, in particular those regarding the management, was very similar to those of French companies. The articles of association of French companies are dated as of 2000 onwards whilst in respect to the Portuguese case it was possible to find articles dated as of the beginning of the twentieth century until the decade of 2000s. What is more striking is the fact that this similarity in wording is apparent in different generations of articles of association. This not only hints something about path-dependence of legal solutions in the respective jurisdiction, but also the cross-over of legal solutions through imitation for centuries.

In respect to case-law, the cases that did not address the keywords, such as the several forms of PLLCs in each country, transfer of shares, and restrictions were eliminated from the initial set of events. The analysis of the cases in my pool was complemented with factual scrutiny. The factual data compiled from each case included the court, date of the judgment, number of the sentence, the parties to the dispute, source, and the respective description of the case. Additionally, I have also listed the reasons courts put forward to justify the decision they upheld. I ranged the reasons which I have grouped in different categories while treating each

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⁹¹ This was the case for Chrysler LLC’s operating agreements included in my sample of American LLCs.
⁹² A good example is the Form S-4 (Registration Statement under the Securities Act of 1933) for the Delaware company Huntsman International LLC which I analysed. Given that this was an exchange offer, I examined the prospectus which contained information about its ‘parent’ company – Huntsman Corporation – and Huntsman International LLC’s subsidiaries, including the respective operating agreements. This document is about 800 pages long.
jurisdiction. Sometimes courts give more than one reason, and to the extent this was clear in the decision, I enunciated them where appropriate. I also created samples of articles of association of companies in all six jurisdictions. The articles of Portuguese companies were collected from the *Diário do Governo*. The respective companies were incorporated throughout the country. Articles of Spanish companies were sent to me by the Commercial Registry of Madrid. Articles of association of the French SARL were collected from the database *infogreffe.fr*, which makes publicly available data regarding commercial companies deposited at French Commercial Courts (*greffes des Tribunaux de Commerce*). Most of the articles of association of French companies in the sample are *statuts constitutifs* deposited at the Commercial Tribunal of Paris (*Greffe du Tribunal de Commerce de Paris*). The articles of the Italian SrL were collected from *Gazzeta Ufficiale* and *Camera di Commercio di Firenze*. The targeted companies were incorporated in the Tuscany and Florence regions. The articles of association of United Kingdom private companies were collected from the Companies House Webcheck. All the companies were incorporated in England and a great part of them in the city of London. Finally, LLC agreements were collected from Westlawnext and LiveEDGAR. Most LLCs scrutinized were incorporated in the state of Delaware.

ii. Methodological challenges and the one view of the Cathedral

I borrow the expression ‘the one view of the Cathedral’ from Calabresi and Melamed. My data vary both qualitatively and quantitatively, and my sources were differentially available. In some cases they do not even exist in all six jurisdictions. I turned this challenge into a tool of my comparative work. Putting it differently, the fact that some documents exist and others do not in certain jurisdictions helped me to trace the legislative and market profile of that particular jurisdiction. For instance, whilst documents in the United Kingdom are filed and readily accessible, in Spain most of the constitutional documents of the company are

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93 Often the language used by courts is extremely intricate and phrasal constructions are confused.
94 I thank Don Manuel Casero and his assistant, Alicia Martin for sending to me more than 100 articles of association.
95 I thank Fabrizio Vanni and his assistant Antonella Stecchi for their help at the Camera di Commercio di Firenze.
97 LiveEDGAR is a database that makes EDGAR text searchable. EDGAR is the Securities and Exchange Commission’s online site that allows investors to access annual reports (SEC Form 10-k), quarterly reports (SEC Form 10-Q), and other sort of documents. I thank then-graduate student Erik Krusch at Fordham University Law School for invaluable help on this task.
private, which makes difficult the task of sketching these companies’ profile. It also indicates that the Spanish PLLC is likely to be more private and closed than the average United Kingdom private company in terms of the publicity of the articles of association and possibly regarding the shareholder structure. In the United States, it is difficult to find operating agreements because they are private and are not filed in an organized way. Furthermore, in the process of screening documents that are not uniformly available, I noticed policy similarities across countries. Further, I noted instances in which measures and policies could have been implemented, but were not. Cultural nuances engrained in the law, the availability of business forms other than the PLLC, and the importance of the banking system and bankruptcy law may all figure into the choices made.  

From a general perspective regarding the methodological challenges I faced to a more particular one, I note that the results of my research are based on reported cases that may not be a representative sample of all cases regarding un-consented transfer of shares actually decided. I am mostly doing a qualitative research based on case study. Furthermore, I hold information that many opinions are not included in the databases I had access to. It may also be the case that they are not even reported. So, results are also not representative of all cases of un-consented transfer of shares actually filed. As many cases are settled or do not even go to court, samples are not representative of the total number of transactions involving transfers of shares in which the problem of un-consented transfers of shares comes up. Due to the contractual nature of these business associations it is often the case that disputes are shuffled off before even getting to trial. Therefore, these limitations make it inappropriate to draw general conclusions as to the number of corporations in which the problems deriving from or leading to un-consented transfers in reality occur. Further, with respect to case law, data are not broken down between trial and appellate courts. There is, however, a noticeable tendency

99 A treatment of these issues is beyond the scope of this dissertation.
100 George L. Priest & Benjamin Klein, ‘The Selection of Disputes for Litigation’, 13 J. Legal Studies 1, 4 (1984) (developing a model suggesting that disputes selected for litigation (as opposed to settlement) will constitute neither a random nor a representative sample of the set of all disputes); George L. Priest ‘Selective Characteristics of Litigation’, 9 J. Legal Stu. 399 (1980), and George L. Priest, ‘Measuring Legal Change’ (1987) (Yale Law School Working Paper, Program in Civil Liability). These papers suggest that disputes selected for litigation will constitute neither a random nor a representative sample of the set of all disputes. Despite this, the bias is not great enough to hinder meaningful results based on the samples collected. This is so because case law is used as part of qualitative method to tell different narratives.
to include in the sample appellate cases. There are two reasons for this. First, the interesting aspect of courts of appeal is their systematic interpretation, following and encompassing what other lower courts have done.\(^{102}\) There are institutional rules that interfere with the interpretation of the law and the reading of a particular case, and this sometimes shows up in the judgments.\(^{103}\) Second, the respective research engines mostly provided decisions of appellate courts.

Another aspect of the methodological challenges I faced is related to the selection of my samples of articles of association. My selection is not random, a term that denotes that each unit has an equal chance of being selected. The paucity of available information in some countries, as well as other resource constraints forced me to forfeit this valuable research principle. Notwithstanding, I have used a qualitative method, and I have made sure to cast a wide net for sources of articles of association and LLC agreements. Moreover, I have selected variables that are important for tracing the profile of the PLLC in each jurisdiction. These variables are the business name, the registered office, the commercial registry, the date of the articles of association, the number of shareholders and votes they hold in the company’s general meeting, the number of managers, the share capital, the business object and the transfer clause. I then checked my sample to see if it was representative on these particular variables, that is to say, if it was representative of the population of the companies in the jurisdictions in terms of size, earnings, ownership and governance structure. This task is undertaken with the help of statistical data for individual countries where information by years in respect to the variables I have chosen is available as of 2007 to 2012. These statistical data are provided by the European Commerce Registers’ Forum (ECRF) that has been sponsoring the ECRF ‘Benchmarking Survey’ as of 2012.\(^ {104}\) This survey, which is informed by the European Commerce Register’s Forum Report 2013, aims at tracing trends in companies’ register at a regional level based upon data its authors collected in each country.

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\(^{103}\) At this point, I am not making a positive or a negative judgment of possible path-dependence issues.

\(^{104}\) I thank Vito Giannella for providing me with statistical data, including the amount of share capital and number of shareholders of private limited companies, and the operation of business registries in all countries that participated in the survey such as Italy, the United Kingdom, Spain, and several states of the United States, namely Delaware. Portugal and France are not participant countries, but the survey has managed to collect data from another Portuguese speaking country-Brazil- and Jersey, whose legal system has been greatly influenced by French law due to its geographic and historical proximity to France.
It yields statistical information in respect to the variables I have selected regarding public and private limited companies. I focus on private companies. The graphics below treat these data regarding the operation of the business registry, the average share capital, the average minimum number of founders, shareholders and members of the management board, and the overall types of firms created in each region.


Source: Figure 14 (p.33) ‘Average Minimum Number of Founders, Shareholders and Board Members per Company Type’ from *European Commerce Registers’ FORUM Report*, 2013. Global benchmarking of business registration - ECRF, CRF and IACA Business registers survey by Staffan Larsson (ed.), Hayley E. Clarke, Julia Fatemi, Monica Grahn, Tanja Kothes, Magdalena Norberg Schönfeldt, Stacey-Jo Smith.
Finally, I am careful not to fall into the main trap that comparative and empirical work are likely to place in the way even of the most experienced researcher. That is, I avoid the hermeneutical risk of reading too much into the data I collected. Nevertheless, I do not always take a positive approach. I take a normative approach to law based on the data I found. This is illustrated by the structure of the dissertation. The objective of Part 1 is primarily positive. I try to explain the reasons that defaults were designed as they were, and why restrictions on shares are provided on the articles of association of all six jurisdictions. In Parts 2 and 3 my objective is, for the most part, normative. In these parts I clearly make a normative statement.

3. The theoretical framework: Darwin’s Principle of Natural Selection, the Law and Economics

This dissertation links in a dialectic way three fields: biology, law and economics.\textsuperscript{106} It is framed by an evolutionary principle, Darwin’s principle of natural selection, to explain that

\textsuperscript{106} See O’ Connor, Erin O’ Hara, and Stake, Jeffrey Evans, ‘Economics, Behavioral Biology, and the Law’, \textit{Supreme Court Economic Review}, vol. 19, 2011, pp. 103-141 (explaining similarities and differences between economics and biology on one hand, and the similarities between law and biology, in particular behavioral biology, on the other hand. Regarding economics and biology, both disciplines surprisingly lie on similar
law is not a given, but rather a construction. I try to give a sense of this by writing in an integrated fashion about doctrinal, comparative, and empirical works. The writing is held together by a comparative matrix (Table 1) that prevents theoretical diffusion and steers the effort of comparison. The link with the evolutionary principle that frames this dissertation rests on the idea that writing in an integrated fashion does not provide immediate definite results while research is ongoing, as would most likely be the case if the doctrinal, comparative and empirical parts were written separately. I have chosen this expositional style to show how the treatment of the hypothesis evolves throughout the chapters until the very end, where the reader will find the comparative synthesis.\textsuperscript{107}

This dissertation offers a theory of defaults by which it tries to submit a set of coherent statements and / or principles to explain how defaults can be designed to potentially induce market agents’ behavior, especially the ‘consumer’ of corporate law. Central to this theory of defaults is the principle of Pareto optimality and the idea of ‘pleiotropy’ in law. Whenever reference to efficiency is made, it should be understood as Pareto efficiency. I am interested in creating mechanisms for designing the best possible corporate default rules. Pleiotropy implies that we live in an interconnected world. In economics and social and political science literature, this idea has been developed through the concept of path-dependence.\textsuperscript{108} Pleiotropy in law also echoes the idea of path-dependence. I suggest that there may be a doctrinal, socio-economic status quo that needs to be broken. Breaking the status quo means breaking any path-dependent behavior which is by itself an anomaly. The challenge is to determine whether law can do this by looking at the market and at what market agents are doing, and understand how they select the laws they are actually using.\textsuperscript{109} Additionally, legal pleiotropy implies that there are unintended consequences for legal rules and legal institutes stemming from the interaction between market and law. This thought does not follow the theory of systems and the construction of law as an ‘operationally closed autopoietic system’\textsuperscript{110}. It could not be underlying concepts. In this triangle, law has a different face since it is more often positively and normatively explained through concepts closer to economics than to biology. This dissertation tries to challenge preconceived ideas that law and its evolution cannot be explained through the lens of natural sciences. Additionally, Zumbansen, Peer, and Calliess, Graff-Peter (eds.), \textit{Law, Economics and Evolutionary Theory}, Cheltenham, United Kingdom; Northampton, MA, USA, 2011.

\textsuperscript{107} See Part III, chapter 3.


\textsuperscript{109} Refer to part III of this dissertation where I dwell on the concept of market while creating a bridge to the European internal market and the promise of jurisdictional competition in Europe.

otherwise, for I use idiosyncratic language to illustrate how law, economics and biology are connected in surprising ways.

4. Conclusions

This is a comparative study which uses a qualitative method of research. However, it casts its net over a wide range of documents such as articles of association and case-law to complement the profiling of PLLCs in the selected jurisdictions. These data were compiled in an annex to the dissertation that contains the analysis of more than two hundred articles of associations of PLLCs and nearly one hundred cases decided by courts in the selected jurisdictions. The comparative work is driven by a comparative matrix that yields the variables for the comparison. At this point, the comparative matrix is an empty table. It is meant to be filled, by the end of this dissertation, with the answers to the analytical questions it poses. I use a dynamic language which mirrors an interdisciplinary approach to law and the legal problems debated herein. Law is treated from the point of view of law and economics. The analogy with biology serves a descriptive purpose. Context-wise, history itself is used as a case study to illustrate the contingency of law and legal practices, and the path-dependence of legal solutions. I link method to epistemology. The method serves as a means to comprehend a social phenomenon (the status quo found within PLLCs) by way of legal knowledge. For example, the systematic interpretation of technical documents sheds light on phenomena of legal imitation, the role of lawyers in developing corporate forms, the behavior of certain corporate constituencies, and the ownership and governance structures of companies. Moreover, lawyers, who draft and are accustomed to reading legal documents, are at an advantage in understanding their structure and socio-economic significance. Methodologically, this dissertation embarks on a dialectic journey that starts with a hypothesis. I then try to falsify that hypothesis mainly through the six countries comparison and case studies. In the end, I arrive at a synthesis. On the one hand, I attempt to demonstrate, with reference to the legal concept of ‘due diligence’, that law can have its own method. On the other hand, I also show the permeability of law vis-à-vis other social sciences. Appreciating the extent of this permeability is a major challenge not only at the methodological, but also the substantive level.
CHAPTER II

DISCLOSING THE PLLC’S LEGAL REGIME THROUGH A HISTORICAL OVERVIEW AND EMPIRICAL EVIDENCE:
THE CASES OF PORTUGAL, FRANCE, ITALY AND SPAIN

An inspired theoretician might do as well without such empirical work, but my own feeling is that inspiration is most likely to come through the stimulus provided by the patterns, puzzles, and anomalies revealed by the systematic gathering of data, particularly when the prime need is to break our existing habits of thought.


Introduction

This chapter looks PLLCs in the face to understand their basic principles and main lines of ownership and governance structure. I present a historical account of the legal regime of these business associations in four out of the six jurisdictions I have selected: Portugal, France, Italy and Spain. Parenthetically, the German case may be ranked high among the possibilities for treatment, given that Germany is the motherland of the Gesellschaft mit beschränkter Haftung (GmbH) – the German form of the PLLC. It was created in 1892 and it is frequently described in the literature as pioneering. However, while designing the laboratory for this investigation several factors were considered to establish the comparative matrix and the empirical research. One of these factors was the proficiency in the German language required to scrutinize historical documents and manuscripts. These documents are likely to disclose whether a form similar to the GmbH existed before 1892 in Germany and the reasons that led German legislators to formally adopt it at that point given that, as we shall see below, the PLLC existed in other jurisdictions before 1892 even if not legally accepted. To the best of my knowledge, there still is space in German literature to develop this issue.\textsuperscript{111}

\textsuperscript{111} For recent literature on the subject see, for example, Völker, Bastian, Die Vinkulierung von GmbH-Geschäftsanteilen, Schriften zum Handels- und Gesellschaftsrecht, Band 124, Hamburg, Verlag Dr. Kovač, 2013
In order to understand the PLLC’s legal regime I first try to strip it from any preconceived idea that spontaneity of the law is a given fact. I consider the law a byproduct of private ordering and subjective considerations individuals have about a particular rule-setting. The approach I take is based on the reading of parliamentary debates and specialized literature, and on the collection of empirical data. The case studies I present are narratives of the PLLC, and they were chosen to illustrate the profile of the PLLC throughout the second half of the nineteenth century until today. Their profile is given through the story-telling of the influence interest-groups have in shaping the law and their shadowed intervention with respect to legal options taken by legislators. Some of these legal options are frozen in time and in force today. The outcome is the creation of a platform of understanding of legal institutions and their natural contingency. This is done in the face of the PLLC in the sense that I try to lift the veil covering its private sphere. Moreover, in this chapter, I hope to make clear the reasons why some jurisdictions lag behind regarding the adoption of new forms of business organizations. I also strive to make apparent the main role state policies play with respect to the development of these business organizations. This chapter also provides an account of the means used by shareholders to protect the integrity of the share capital, of the governance structure and of shareholders’ interests by introducing restrictions on transfers. In fact, transfer of shares constitutes a laboratory which is in itself contingent, and which in itself creates a context.

I have selected Portugal, France, Italy, and Spain as the jurisdictions whose elements I am comparing in this chapter. They have in common the fact of being countries with a civil law system. However, dealing with these countries not only means that I am comparing different legal systems, but also that I am bringing an international perspective to this dissertation. To talk about the laws of Portugal means talking about the laws of former colonies such as Brazil, Angola, Mozambique, Cape Verde, Guinea Bissau and Easter Timor. To talk about the laws of Spain, means redirecting the heart of the matter to the laws of Latin America’s countries (which, as we shall see, are presumed in the literature to have influenced the adoption of the LLC in the United States). To talk about the laws of France means talking about the laws in force in French former colonies. To talk about the laws of the UK\textsuperscript{112} means

\textsuperscript{112} See Part I, chapter 3.
not only thinking about the nature and purpose of United States laws, but also of other former British colonies such as those currently forming the Commonwealth.\textsuperscript{113}

History establishes the baseline for understanding current legal solutions in these jurisdictions. Lessons from the past will, hopefully, shed light on evolutionary trends, their similarities and differences over time in the selected jurisdictions, and will make it possible for new evolutionary schemes to be considered. In this chapter, I am telling three stories. First, I am telling a story of interests groups interfering with the outcomes of legislative policies. Second, I am telling a story of how the law is a byproduct of private ordering manifestations. Finally, I am telling a story of legal evolution of business organizations. These stories are informed in the text by three parameters: courts and legislatures (state), actors (equated with the society), and the market (economy). The special aspect of these stories is that I am looking at small businesses and at the variations of their ownership and governance structures in time through case studies and considerable archival work which serve as a qualitative platform for theoretical constructions.\textsuperscript{114} These theoretical constructions are highlighted in Parts II and III. This chapter proceeds as follows. Section 1 provides a historical account of restrictions on transfer of shares. It treats individually the cases of Portugal, France, Italy and Spain. Section 2 concludes.

1. Restrictions on transfers of shares of private limited liability companies: An introductory historical account

This section presents an introductory historical account of PLLCs and of rules on transfer of shares. My main goal is to demonstrate the importance of these companies and why it is worth studying their legal regime in the jurisdictions I have selected. There are elements that cannot be ignored such as the size of the country, its cultural homogeneity or diversity, its geographical features and its political culture. For the purposes of this study, however, I will try to answer the following questions: (1) What were the reasons for the

\textsuperscript{113} Part II of this dissertation was partially written in South Africa (Johannesburg) while I was invited to talk about my work to promising young African leaders. In that context, it was inspiring to see how small businesses operate, and how the design of the law is liable to facilitate the investment of market agents who, in this case, come from very different backgrounds and are in great number women. Also, in this context, it made sense to talk about the creation of an enabling environment for businesses with a focus on the role of law.

\textsuperscript{114} In these countries the historical discussion has focused, for example, on whether the PLLC should be structured rather in a ‘personalistic’ or ‘capitalist’ way, that is to say, rather like a partnership or a corporation. This debate has also been held in Germany, for instance, which is considered by many as the country that provided the model PLLC – the GmbH, created in 1892. Here the GmbH looks much more like a corporation than the American LLC that is closer to a partnership. In general, the ‘capitalist’ view is largely dominant. The transferability of shares and the default rule for such transfer is relevant to the debate.
introduction of the PLLC in a given legal system?\textsuperscript{115}; and (2) What is the historical nature of transfer clauses introduced in the articles of association? My research focuses on the analysis of the parliamentary debates in Portugal, France, Italy, and Spain that led to the implementation of the laws on PLLCs in these countries. Other documents were observed, for example, in the case of Spain I had access at the General Archive of the Administration (Archivo General de la Administración) to letters and statements of the General Direction of Industry (Dirección General de Industria), of the Delegation of Industry of Valencia (Delegación de Industria de Valencia), and of the Superior Council of Industries as of 1954 and 1955.\textsuperscript{116} Additionally, I have analyzed articles of association published in the Portuguese Official Gazette (Diário do Governo) between 1905 and 2006, the articles of association filled with the Archivo Historico de Protocolos de Madrid and entered into between 1871 and 1887, and the articles of association deposited at the Commercial Registry of Madrid and the Regional Archive of the Community of Madrid (Archivo Regional de la Comunidad de Madrid) between 1961 and 2012.\textsuperscript{117} I also analyzed the articles of association published in the Italian Official Gazette (Bollettino Ufficiale delle Società per Azioni e delle Società a Responsabilità Limitata), deposited with the Chamber of Commerce, Industry, Handicraft and Agriculture of Florence (Camera di Commercio Industria Artigianato Agricoltura di Firenze) and deposited at the Registry of the Tribunal of Florence (Cancelleria del Tribunale di Firenze) between 1958 and 2009, and the articles of association of French SARLs deposited at the Greffe du Tribunal de Commerce de Paris the between 2000 and 2012.

This was a slow-motion process of selection and reconstruction, which depended greatly on available time, resources and data. In addition, samples collected from each jurisdiction do not constitute representative samples of the entire universe of corporations.\textsuperscript{118} Yet, they give a


\textsuperscript{116} Archivo General de la Administración, Petition No. 973, Seccion 13, Box 71/6324. The archive did not provide a classification of PLLC (sociedades de responsabilidad limitada or SL). While developing the research I considered two possibilities. One of the possibilities was to analyze single companies. Yet most of them were publicly held companies (sociedades anónimas or SAs). The other possibility was to analyze documentation deposited with different ministries, and which conserved documents that revealed the relationship that a specific company had with the respective ministry. This company would be a Spanish SrL, and its documents would be filed along with other documents.

\textsuperscript{117} Archivo Regional de la Comunidad de Madrid, Signature 136484. This box contained the Agreement of Mercantile Colaboration between Limac Producciones, S.L and Galerias Preciados as of 1995. In this context, the notarial deed of incorporation of Limac Producciones, SL was also included. I analyzed at the Archive the box with signature 21539 with documents as of 1953 of the Ministry of Industry / Provincial Delegation of Madrid with certificates of register of companies in the Industrial Registry. For the purpose of registration, the articles of association of the companies should be provided. Finally, I also scrutinized the box with the signature 34640 with documents from the Regional Ministry of Economy and Labor, where articles of association of PLLCs were also included.

\textsuperscript{118} Refer to Chapter 1, Section 2 above.
sense of the heterogeneity of the variables I am studying. I provide a snapshot of the main historical lines of these business associations and transfer clauses included in their articles.\textsuperscript{119}

1.1 PORTUGAL

I. State

i. Parliamentary debates, the reasons for the adoption of the ‘sociedade por quotas’ and the Law of 11 April 1901

Why did the Portuguese legislators create the PLLC or \textit{sociedade por quotas} especially long before their creation in countries such as the United Kingdom, France, Italy, Spain and the US?\textsuperscript{120} Some of the reasons underlying the proposal of the law of private companies for discussion in parliament were presented by the Commission of Civil Legislation of the Chamber of Deputies, on 23 February 1901.\textsuperscript{121} First, it was stressed that the proposal and implementation of the private company’s legal framework aimed at satisfying the claims of the Portuguese business class. Already in 1896, the Chamber of Commerce and Industry of Lisbon suggested that a law similar to the \textit{Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbHG)}, published in Germany in 1892, be enacted. Subsequently, the Industrial Association of Porto and a commission consisting of some of the most distinguished entrepreneurs of that city made the same claims. Second, examples of systems of limited liability implemented in what were considered by then the ‘biggest commercial nations in the world’ were given. For instance, some states of the United States of America had implemented the \textit{homestead exemption}. This was a legal regime of limited liability which prevented certain assets of the debtor from becoming a guarantee for the payment of his or her debts.\textsuperscript{122} Among such assets were the house or the capital deemed necessary for the sustenance of the family of the debtor. The English case was also mentioned. It established a system of limited liability allowing shareholders to create private or family companies, under

\textsuperscript{119} The analysis of minute books of PLLCs, letters, and other sorts of communications between shareholders, between shareholders and directors/ managers of the company, between directors, solicitors and accountants suggests that often agreements are entered into on the side of what is actually established in the articles of association. I will make reference to this point further on in the dissertation.

\textsuperscript{120} In the Portuguese former colony Brazil the PLLC was adopted in 1919.

\textsuperscript{121} For the access to the minutes of the parliamentary debates during the period of the Constitutional Democracy in Portugal (1821-1910), see URL: \url{http://debates.parlamento.pt/page.aspx?cid=mc_cd} (accessed on 15 August 2011). For a special account of parliamentary debates on economic and financial issues, from 1821 to 1910, see URL: \url{http://www.ics.ul.pt/debatesparlamentares/} (accessed on 15 August 2011).

\textsuperscript{122} This applies to situations such as forced sales and bankruptcy.
the legal regime of joint stock companies. Their share capital should not exceed £100. In addition, it was argued that Germany, which at the time had a remarkable commercial and industrial growth, had recognized the need to create a new type of company to accommodate its extraordinary economic development. Therefore, for that purpose and to attend to the needs of small and medium entrepreneurs, it enacted the *GmbHG* on 20 April 1892. The claims of the Portuguese business class, and these three cases, especially the German case and the nine years of experience with the *GmbH*, were considered to be sufficient justifications for the Portuguese legislators and the deputies in the Parliament to agree on the implementation of this law.\(^{123}\) Furthermore, it is worth highlighting the words of Arthur Alberto de Campos Henriques, Minister of Justice at the time: ‘It mattered for United States, certainly similarly to what happened in Germany to legitimize the adoption of the new type of limited liability companies, their convenience to colonial firms’. The law was published on 11 April 1901, and entered into force three months later, on 1 July 1901. It was altered by Decree - Law 48843, 5 August 1966.\(^{124}\)

PLLCS were perceived as an intermediate form between partnerships and joint stock companies. With this new type of company a new type of share was created – the *quota*.\(^{125}\) Unlike the shares of joint stock companies, which were and still are represented by certificates, quotas are intangible. Furthermore, PLLCs were characterized by a special system of limited liability. As pointed out in the presentation of the draft law and its respective discussion in the parliament, the novelty in the legal regime of PLLCs was that in principle, the company’s assets would pay for the debts of the company, but shareholders would be subsidiary liable.\(^{126}\) Flexibility and adaptability to small businesses were also features of this type of company. The Portuguese legislators considered that these characteristics would foster the participation of shareholders in the management and supervision of the company; they believed features as such would be favorable to the resolution of problems of liquidity of insolvent companies, and would help the heirs of a merchant to keep their business. It was believed that these companies would stimulate private

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\(^{123}\) In Germany, an important element to take into account was the fact that the *Aktiengesellschaft* was considered to be too restrictive for small businesses due to the high number of mandatory rules. Thus, the GmbH was created as a more flexible form. In Portugal, the profile of the joint stock limited liability company, at least between 1850-1914, is yet to be fully drawn. However, these were business organizations that were more complex than the PLLC or *sociedades por quotas* in terms of management and ownership structure.  

\(^{124}\) Later, Order 18946, 12 January 1962 required the application of PLLCs’ regime to provinces overseas.  

\(^{125}\) The same designation is used in Italian law. For ease of understanding I will refer to ‘share’ instead of ‘quota’.  

investment from those who were not willing to invest in joint stock companies. The liability of shareholders in joint stock companies was also limited. But these companies could not be incorporated with fewer than ten shareholders. Moreover, the anonymity and the way share capital was divided into shares tradeable in capital markets were not suitable for small and medium enterprises (SMEs). Additionally, legislators thought that PLLCs would suit shareholders unwilling to bear the unlimited liability for the company’s debts which characterizes partnerships. Hence, the Portuguese economic context, the claims of the business class, and the attractiveness of the new legal form constituted an advantageous setting for the implementation of PLLCs in Portugal at a very early stage.\(^\text{127}\)

What makes PLLCs special is the fact that their legal form suits the business plans of investors or entrepreneurs that need to think small first and want to keep their business between private parties, and therefore do not want to take the risk of investing in publicly held companies and in capital markets. Since its implementation in Portugal, the PLLC has been consistently used by SMEs.\(^\text{128}\) It is interesting to observe that from 1901 to 1939 the average amount of the share capital of PLLCs steadily decreased. One could think that the size of commercial enterprises was increasingly smaller and that the PLLC form managed to attract increasingly smaller enterprises. This is, however, a questionable inference to make. Firms could have a surplus or retained earnings. They could also take out more debt. Share capital alone does not reveal much about the company’s assets. Yet, the fact is that the use of the PLLC was skyrocketing.

\(^{127}\) In order to understand why the Portuguese business class lobbied with the Portuguese legislature to adopt the law, it is necessary to carry out a future comparative historical analysis examining the economic policies, the political situation, and the legal institutions already existing in countries such as Germany, the United Kingdom and the United States. It is important to note that the PLLC was created in the United Kingdom in 1907 and in the United States much later, in the second half of the twentieth century.

\(^{128}\) See _Estatísticas das Sociedades_, 1939, Instituto Nacional de Estatística, Porto, 1941 (providing data on the evolution of the Portuguese form of PLLC – _sociedade por quotas_ – between 1901 and 1939. These data refer to the number of PLLCs incorporated by sector of activity during the same period, and the amount of share capital of PLLCs. I have chosen to collect data referring to this period because of circumstances peculiar to the Portuguese economy. First, the adoption of the law creating PLLCs in 1901 coincided with a relative surge of industrial development in Portugal. Second, during the decades before the First World War, Portuguese and foreign economies were the set for a relative industrial development. The sample includes the years after the war so that statistics regarding the aftermath of the war can be compared to those regarding previous years. Additionally, see _Estrutura e Dinâmica das Sociedades não Financeiras em Portugal_, Estudos da Central de Balanços, Dezembro 2010, 2, Lisboa, Banco de Portugal, 2011, pp. 11-12 and 13 (showing the structure of the universe of non-financial corporations by legal form. According to the OECD’s Glossary of Statistical Terms, ‘non-financial corporations are corporations whose principal activity is the production of market goods or non-financial services’. As explained therein, this definition derives from statistical standards developed by international organizations such as the IMF, OECD, Eurostat and ILO. The study aforementioned aggregates data on these companies, including the Portuguese PLLC, as of 1991 to 2009. It reveals that in 2009, 91% of non-financial corporations were PLLCs. The study suggests, however, that public held companies represented 50% of the aggregate turnover and 32% of the people employed in the sector of non-financial corporations.
Raúl Ventura, the author of a draft reform of the law of PLLCs, presented figures contained in statistics produced by a Portuguese body on 31 December 1964. These figures showed that out of 28,359 companies with registered offices, in the Metropolis, 23,549 were PLLCs. The remaining 935 were publicly held companies, 3,366 were partnerships, 7 were limited partnerships, 492 were cooperatives and 10 of another kind. Regarding the total amount of the share capital of all types of companies, which was 29,758.536$00, PLLCs altogether had a share capital of 6,995.234$00. This shows that it was generally accepted, also in the specialized literature at the time, that once adopted in Portugal, the PLLC became the preferred legal form for SMEs. This was not exclusive to Portugal. It also happened in other countries.

II. Actors

i. The role of lawyers and other technocratic elites in drafting and disseminating the new legal form

A historical perspective of PLLCs is important, whether the inclusion of specific clauses in the companies’ articles of association was a reflection of certain aspects of the Portuguese economic history, politics or society. Article 6 of the Law of 11 April 1901 established the free transferability of shares. It stated that shares were transferable in accordance with the law. However, §3 of Article 6 stated that the deed of incorporation might subject the transfer of shares to the consent of the company or to other requirements. Notwithstanding the fact that, in principle, shares could be freely transferred, in reality, shareholders often introduced a clause in the company’s articles restricting the transfer of shares. Consequently, it is important to understand whether there were reasons that determined the introduction of such restrictions in a significant number of articles of association. Imitation may be at the heart of this phenomenon. Technocratic elites usually have a dominant position in society, allowing them to distribute their services without any major barriers. This is particularly true for lawyers, notaries, solicitors or attorneys who may provide their clients with standard contracts and

129 The author neither identifies the body nor gives additional sources.
130 The $ sign means the Portuguese currency at the time.
131 See Ventura, Raúl, Apontamentos para a reforma das sociedades por quotas de responsabilidade limitada e anteprojecto de reforma da lei das sociedades por quotas, 2nd ed., Lisboa, 1969, p. 33.
132 See Guinnane, Timothy et al. cit.
other template documents, especially when the legal market is small and not very competitive.\textsuperscript{133}

The analysis of a sample of 36 articles of association of Portuguese companies between 1905 and 2006 revealed that many of them were exactly the same; only the names of shareholders, the registered office of the company, the amount of the share capital and other elements were different. Therefore, reproduction or imitation of clauses in articles of association already available in the market, either through drafted minutes or rule books yielding standard terms, is a plausible explanation for the inclusion of this type of restriction in a great number of companies' articles of association.\textsuperscript{134} Other factors may have been the size of these companies, the number of shareholders and the kind of relationships among them. A family relationship between two shareholders might well make it more difficult for shareholders to accept the entry of a third party in the company. The list of possibilities is long.\textsuperscript{135}

The collection of the articles of association shows how shareholders, under a regime of free transferability, introduced with the help of their lawyers clauses restricting transfer of shares. These restrictions could be the requirement to obtain the consent of the company, of all shareholders, or of the management, the exercise of preemption rights by the company and its shareholders, a period during which shareholders could not leave the company, or formulas for determining the price of the sale. Furthermore, it was interesting to note that in this sample that there are companies that resemble in structure, amount of share capital, and number of shareholders joint stock companies. However, shareholders still chose to assign a personalistic character to the company by restricting the transfer of shares. Additionally, in some cases where there were restrictions on transfers, articles of association specified that only the majority shareholder could sell his or her shares, or at least sell them until a certain percentage of the value of the shares, to whom she deemed adequate. This captures the way...

\textsuperscript{135} In the Italian case treated below, the introduction of restrictions is closely linked with the family nature of the corporations, with kinship and gender. The family corporation was a men’s business in which the name of the family should be clearly printed. Women, although they have gained more power over time through the ownership of shares, were passive members (a sort of ‘silent partner’) and excluded from the management. Therefore, in case they wanted to leave, often articles granted other members (brothers and the father) pre-emption rights or rights of first refusal.
power and control in these companies were designed. This reality, in which articles of association attributed an *intuitu personae* nature to PLLCs, contradicted the capitalist and liberal vision the Portuguese legislature had in mind when it decided to import this legal form.

III. Market

i. Transfers of shares in the old and new regime and taxonomy of case law

One question poses itself: What is the historical purpose of transfer clauses included in the articles of association of Portuguese PLLCs? The Law of 11 April 1901 establishing the principle of free transferability was in force until 1986. On 1 November 1986, the Commercial Companies Code (CCC) came into force. This code repealed the Law of 11 April 1901. As was affirmed by the Legislature in the preamble of the Code, the reform of German limited liability companies that had recently taken place was borne in mind. Moreover, in the title of the CCC referring to PLLCs, the Legislature took advantage as much as possible of the case-law and opinions of legal commentators developed under the Law of 11 April 1901. The law on transfer of shares was additionally altered.

A sample of 7 cases held by Portuguese courts on Article 6 of Law of 11 April 1901, that is, under the regime of free transferability of shares, consistently yields bargaining failures between shareholders and between shareholders and managers representing and acting on behalf of the company. This qualitative sample comprises legal issues that can be assembled into a sort of ‘doctrinal clusters’.

1. Interpretation

(i) Interpretation of the transfer clause introduced in the articles of association, especially when the restriction on the transfer of shares is established by means of a formula to determine the price or the costs sellers and buyers will have to bear with the transfer;

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136 Part II, Chapter 1 discusses more extensively the economic reasons for restrictions on transfers.
137 This Latin expression refers to those relationships between specific people which cannot be transposed to other people.
138 The Portuguese case, in this particular aspect, is similar to the Italian case below.
140 One could ask if restrictions are typically linked to other features. Are they more common when there is a very concentrated ownership structure? Are they more common when members commit to providing specific work to the company (human capital)? Part II, Chapter 1 lists a number of reasons for restrictions. From the
(ii) Interpretation of article 6 and the meaning of restriction for the purpose of its §3.

2. Functionality of restrictions on transfers
   (i) The exercise of preemption rights by the company and its shareholders;

3. Un-consented transfer of shares
   (i) Transfer of shares or their donation without the company’s consent, when that consent was required by the articles of association;
   (ii) Transfer of the usufruct in the share without the company’s consent, when that was required by the articles of association for the transfer of shares.

4. Formalities
   (i) Participation of the buyers or grantees of the share in the meeting of the company’s general assembly, when the company’s consent to the transfer of shares was not obtained, which was required by the articles of association.

The cases collected show that courts, in a situation of conflict, tended to protect the interests of the seller and of the existing shareholders against the buyer. It seems that courts did not take the risk of letting the buyer enter the company through their judgments, especially when the articles of association foresaw some sort of restriction.

After the reform, Article 228 of the CCC replaced article 6 of the Law of 11 April 1901 and established a default rule\textsuperscript{141} on transfer of shares. This rule is still in force and is the absolute opposite of Article 6. Article 228(2) states that the transfer of shares between parties is binding but has no effect vis-a-vis the company, unless it consents to the transfer. In the words of some legal commentators, with the new rule the Legislature decided to mimic the market.\textsuperscript{142} Put differently, articles of association of most companies established restrictions on

\begin{footnotesize}
\textsuperscript{141} Along with the necessary and justified protection of creditors and minority shareholders, the regime of PLLCs was created to be flexible, a characteristic that the Portuguese Legislature considered to be the most important factor in the spread of this type of companies. This flexibility is mostly achieved through default rules.

\textsuperscript{142} In this context, see Bernstein, Lisa, ‘Merchant Law in a Merchant Court: Rethinking the Code’s Search for Immanent Business Norms’, \textit{University of Pennsylvania Law Review}, vol. 144, No.5, 1996, pp. 1765-1821
\end{footnotesize}
transfer of shares even at a time when the law did not require such restrictions. The case law outlined above under the old regime mirrors this assertion. Commentators say that the Legislature decided to change the law to reflect what in practical terms the actions of shareholders were whenever they incorporated a PLLC. However, so far, this assumption has never been empirically demonstrated. My discussion of the articles of association and case law is intended to help fill this gap. According to the information I collected, I would say that the historical purpose of transfer clauses included in the articles of association lies strongly on what has been the market performance. The legislators and courts administering the law seem to have taken this consideration closely into account.

In addition to the companies’ articles and contentious disputes decided under the previous legal framework, I present a taxonomy of 26 cases on Article 228(2) adjudicated by higher courts in Portugal. The treatment of these cases serves two basic purposes. First, I try to link them to the history of Article 228(2) briefly described above. In attempting to establish this link, I seek to understand whether cases are the same as the ones existing before Article 228(2) was introduced or whether with the adoption of the Commercial Companies Code and the introduction of Article 228, these cases changed and, as a result, there are new problems. These cases also yield bargaining failures between shareholders and between shareholders and managers representing and acting on behalf of the company. They are based on legal issues that I assemble according with the same clusters as above.

(challenging ‘the idea that courts should seek to discover and apply immanent business norms in deciding cases’).

143 See Neto, Abílio, Sociedades por quotas: Notas e comentários, Lisboa, Petrony, 1977, pp. 91 and ff; and Ventura, Raúl, cit., pp. 45-46. Also see Ayres, Ian and Gertner, Robert, ‘Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules’, 99 Yale L. J, No. 1, 1989, pp. 87-130 (115-116), and footnote 122 (making a reference to those situations in which courts fill gaps with the provisions that most parties bargain for in contracts. As it is stated by the authors, this way of filling gaps has been labelled ‘mimicking-the-market’. And on this matter it is interesting to quote both Ayres and Gertner: ‘The ‘mimic-the-market’ approach to default rules ignores the fact that the type of parties who contract around a given rule depends upon the rule itself. Parties who dislike a given default rule will contract around it; if we change the default rule to mimic the contracts these parties write, other types of parties may contract around the new default back to the original rule. This process could cycle forever. Setting defaults that mimic the market therefore will not assure efficiency’. So, Ayres and Gertner consider that the implementation of a complete theory of default rules demands attention to what the parties want, whether they will get it and to costs associated with getting it or not). Also Black, Bernard S, ‘Is Corporate Law Trivial?: A Political and Economic Analysis, Northwestern University Law Review, vol. 84, 2, 1990, pp. 542-597 (showing that rules may be trivial when they are market mimicking). 144 I use a qualitative method. Therefore, results only show one side of the Cathedral. They, however, shed light on shareholders and managers’ preferences and help predict and understand governance and regulatory choices in these companies.
1. *Interpretation*

   (i) The un-consented transfer of shares and the interpretation of the default nature of Article 228 (2), especially in situations where articles of association simply transpose Article 228(2) without further specifications;

2. *Functionality of restrictions on transfers*

   (i) Cases in which Article 228(2) is also applicable such as the division of shares, partial transfer of shares, and the creation of rights of usufruct in the share.

3. *Un-consented transfer of shares*

   (i) The un-consented transfer of shares between shareholders, family members and/or third parties. In these cases, the validity of the transfer and/or the terms and conditions for the exercise of pre-emption rights granted by articles of association to shareholders and the company whenever a share is transferred are discussed.

4. *Formalities*

   (i) Specific performance of the promissory share sale and purchase agreement when the consent of the company for the transfer of shares was not requested by the seller;

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145 See Perdices Huetos, Antonio B., *Clausulas Restrictivas de la Transmision de Acciones y Participaciones*, Madrid, Editorial Civitas, 1997 (referring to the Spanish law, at the time Article 20(5) LSRL 1953, argues that ‘Las normas del derecho de sociedade se contentan de este modo con afirmar que la sociedad puede ignorar esa transmisión, pero se desentienden de determinar la suerte del negocio y de la transmisión misma, ignorando de esa manera el interés del resto de afectados: las partes, los acreedores de éstas, etc.’) (The rules of corporate law are satisfied in this way with affirming that the company may ignore that transfer, but they are not concerned about determining the fate of the business and of the transfer itself, by ignoring in that fashion the interests of those affected: the parties, their creditors, etc.).

146 Regarding preemption clauses inserted in the company’s articles of association, they lose their original parasociality and relative effectiveness due its connection to the clause stating the requirement of the company’s consent. In other words, often articles of association, in addition to the requirement of the consent, state that shareholders and the company may exercise the respective preemption right in the share, which forms the object of the share sale and purchase agreement. This right can be exercised *erga omnes* because the preemption agreement included in the company’s articles of association does not only produce obligational effects among parties. Rights resulting from that agreement can be exercised against third parties as well. Therefore, it is relevant to understand how the preemption clause relates to the consent clause. Both clauses are forms of limiting the transfer of property rights in shares of PLLCs, and are often included together in the articles of association of the company. On this, see Cheves Aguilar, Nazira, ‘El Derecho de Adquisición Preferente como Cláusula Restrictiva a la Transmibilidad de las Acciones y de las Participaciones Sociales, Madrid, McGraw-Hill, 1999.
(ii) The un-consented transfer of shares and the legality of resolutions of the company’s general meetings in which the vendor or the usufructuary participated and voted.

(iii) Transfer of shares and compliance with legal requirements by the seller for obtaining the company’s consent (e.g., the convening of the relevant general meeting and the legality of resolutions taken by the remaining shareholders to decide on the transfer of shares).

The clause establishing the requirement of the company’s consent to transfer of shares aims at preventing the involvement of third parties within the company’s structure against the latter’s will or that of its shareholders. However, the selected case law shows that, notwithstanding the existence of a clause in most companies’ articles of association requiring the company’s consent for the transfer of shares, the clause did not prevent shareholders from selling their shares, nor did it prevent disputes pertaining to power and control or decision-making. There are some variations in the contents of the transfer clauses, namely regarding the transfer of shares between shareholders. In these cases, the transfer of shares is normally free of restrictions. This is not the case with shares transferred between spouses, ascendants or descendents which may be subject to restrictions. The consent of the company is always required whenever shares are transferred to third parties (often referred to by the Portuguese jurisprudence as ‘foreign’ to the company). Clauses establishing restrictions on transfer of shares have historically evolved together with the Portuguese PLLC, and have imbued in these companies a sense of closure that remains today, despite their failure to keep the company effectively closed.
1.2 FRANCE

I. State

i. The economic and social project of the société à responsabilité limitée and the creation of an experimental laboratory for the association of labor and capital

The société à responsabilité limitée was created in France in 1863 by the Law of 23 May 1863. These companies were, however, a variant of the joint stock company which was an exception to the rule in that it did not need a governmental authorization to be incorporated. Since they were in substance joint stock companies, the Law of 28 May 1863, under which they had been implemented, was repealed by the Law 24 July 1867, creating the société anonyme. At the beginning of the twentieth century there were six forms of business associations in France: The general partnership (société en noms collectives) the limited partnership (société en commandite par intérêt) the limited partnership with shares (société en commandite par actions), the joint stock company (société anonyme), the silent or undisclosed partnership (société en participation), and the société à capital variable.

In France the discussion about the adoption of a seventh form - the limited liability company similar to those created in Germany (1892) and in the United Kingdom (1907) - followed the reversion to France of Alsace-Lorraine, after the First World War. This region had been under German power until then and the Gesellschaft mit beschränkter Haftung

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147 It was in the latter half of the eighteenth century that many events related to the uprising of the commercial society and transformations of commercial institutions of the Old Regime occurred. This was the case for business associations. New types and more complex forms of business associations were created. On this topic, see Kessler, Amalia, A Revolution in Commerce: The Parisian Merchant Court and the Rise of Commercial Society in Eighteenth-Century France, New Haven and London, Yale University Press, 2007.

148 See Journal de Sociétés, No. 5, May 1925, pp. 257 – 296 (260) (explaining that the new société à responsabilité limitée later created in 1925 was very different from the ones which existed in France with the same name between 1863 and 1867).

149 The société en participation was regulated by Law 24 June 1921 but existed long before. Jurists would define it as a joint stock company following L’Ordonnance of 1673. See Bédarride, J., Commentaire du Code de Commerce, Livre Premier, Titre Troisième, Des Sociétés, 12th ed., Paris, Larose; Aix, Achille Makaire, 1876, pp. 269-332 (saying that ‘Il faudra donc, dans le doute, recourir à ce que l’usage avait sanctionné. Le Code de commerce n’a rien inventé sur ce point; il s’est contenté de consacrer l’association en participation admise et consacrée sinon par la legislation, du moins par la pratique commerciale’) (It is necessary, therefore, in case of doubt to resort to what custom has sanctioned. The Code of Commerce has not reinvented anything at this point; it is satisfied to consecrate the société à participation, which was admitted and consecrated if not by the legislation, at least in commercial practice). The SaP does not have any legal personality. See Hudson, Maitland Alexis, France Practical Commercial Law, London, Longman, 1991, p. 48 (listing other forms of business such as the société cooperative, société d’économie sociale, société immobilière pour le commerce et l’industrie).

150 See Part I, Chapter 3.

151 The authorization of ‘trade of limited risk with associations of capital and labor with limited liability’ (commerce à risque limité avec association du capital et du travail) was also on the legislative agenda at the time. See Documents Parlamentaires – Chambre, Annexe No. 3349, Session extr. – Séance du 16 Novembre 1921.
adopted in Germany in 1892 governed limited liability companies incorporated in that territory.\textsuperscript{152} Since 1919 several attempts had been made to change the French commercial legislation. The first bill was presented by MM. Mane Réville and Leredu in 1919. Nevertheless, it was considered to be an ‘abridged translation’ (\textit{traduction abrégée}) of the German law of 1892.\textsuperscript{153} It was not adopted for it was thought it could not be adapted to French business associations. In January 1920, MM. Maillard and Georges Bureau offered a new bill. In March 1920 this bill was deposited at the Commission of Commerce and Industry. The bill was elaborated by the Committee of Commercial Legislation, which was presided by the honorable M. Lyon-Caen, and by the services of the Ministry of Commerce. The bill was debated and it was subject to the scrutiny and opinion of the French Parliamentary Trade Commission, and of several Chambers of Commerce, namely those of Strasbourg, Paris, D’Angers, Saumur, Mans, Cholet and Marseille.\textsuperscript{154} It also was evaluated by the Federation of Industrialists and Merchants and, in particular, by the Society of Legislative Studies. After this period of public debate, the proposed law for the creation of \textit{société à responsabilité limitée} was presented by MM. Maillard and Georges Bureau to the Chamber of Deputies in 1921.\textsuperscript{155}

French legislators made sure to point out that the French proposed law on the limited liability company was profoundly different from the German law (the new law was defined as \textit{une oeuvre bien française}).\textsuperscript{156} Specifically, not only were the organizational rules different,
but also the rules pertaining to the functioning of the companies were diverse. However, nothing strikingly new was created since the new law was based on the French Law of 1867 regulating the joint stock company (*société anonyme*). There was a broad understanding that a company with limited liability should be more of an enlarged partnership than a narrow corporation. So, French legislators did not immediately view the SARL as a company with manifest capitalist features. It recognized, however, that members should be given wide freedom to negotiate the legal regime for their businesses. In terms of policy, the adoption of the SARL was based on the principle of freedom (*liberté*) which was viewed as the hallmark of commerce (and everything else) in France. Also, legislators were not oblivious to the fact that it was important to take measures against the speculative practices put in place through the use of family companies. A further consideration was to provide guarantees of security by means of which interests of third parties such as creditors and of shareholders themselves would be protected.

This bill addressed two different questions. The first was related to the legislative consecration of limited liability companies in France. The second question was connected to the obligation of these companies to allow their workers to share in the companies’ profits. The introduction of these business associations in the French legal system was viewed as a matter of utmost importance. On one hand, it was thought that they would close a loophole in French law, which did not anticipate companies in which members enjoyed limited liability. As a matter of fact, the opportunity given to members of these companies to limit their risks and their responsibility to their capital contributions was these companies’ distinctive feature. On the other hand, as a result of the reversion of Alsace-Lorraine to France it was reported that more than four hundred limited liability companies, which had previously been adopted under the German law of 29 April 1892, were integrated into the French legal system. Later, Alsace-Lorraine was divided into three departments - Bas-Rhin, Haut-Rhin, and Moselle: the local company law and the French company law. See the Law Regarding the Introduction of French Commercial laws in the Departments of Bas-Rhin and the Moselle in Journal Officiel de la République Française, Lois et Décrets, N.º 151, 3 Juin 1924, pp. 5043. Article 5 of this law states that ‘La législation locale en matière commercial est abrogée, sauf les dispositions suivantes qui continuent à être appliqué dans leur teneur au moment de la mise en vagnar de la present loi: Les articles 48 à 53 du Code de Commerce Allemand sur la procuration générale (*procura*), mais seulement en ce qui concern les commerçants ainsi que les sociétés commerciales qui restent soumises à la loi locale et dans les conditions prévues par cette loi’ (‘The local commercial legislation is repealed except the following provisions that remain applicable in their content in the moment the present law enters into force: Articles 48 to 53 of the German Commercial Code

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157 This differs, for example, from the Spanish case below.
159 Until the new law was fully adopted, two types of laws developed cotermoinously in the three departments of Bas-Rhin, Haut-Rhin and Moselle: the local company law and the French company law. See the Law Regarding the Introduction of French Commercial laws in the Departments of Bas-Rhin and the Moselle in Journal Officiel de la République Française, Lois et Décrets, N.º 151, 3 Juin 1924, pp. 5043. Article 5 of this law states that ‘La législation locale en matière commercial est abrogée, sauf les dispositions suivantes qui continuent à être appliqué dans leur teneur au moment de la mise en vagnar de la present loi: Les articles 48 à 53 du Code de Commerce Allemand sur la procuration générale (*procura*), mais seulement en ce qui concern les commerçants ainsi que les sociétés commerciales qui restent soumises à la loi locale et dans les conditions prévues par cette loi’ (‘The local commercial legislation is repealed except the following provisions that remain applicable in their content in the moment the present law enters into force: Articles 48 to 53 of the German Commercial Code

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and Moselle – where the company with limited liability had already been adopted. The new bill was not only to be applied in these regions, but also in all French territory, including Algeria and other French colonies.

The société à responsabilité limitée was designed in the new bill as a hybrid form that bridged the general partnership and the joint stock company limited by shares. In the partnership the responsibility of its members was unlimited. Their personal assets were inevitably linked to the company’s destiny. Third parties and creditors, in general, had the right to be paid with the company’s assets as well as with the assets of the members without any limitations. All members had joint and several liability. Besides the burden of being in a company where the members were personally liable for the debts of the company, often these companies would dissolve upon the death of one of its members. Frequently, the heirs were incompetent or unknowledgeable enough to take the place of the deceased member, but still wanted to take advantage of the good reputation of the business. In other situations they were just prohibited from being tradespeople, according to the laws in force at the time, because they were lawyers, notaries, or officers. On the other hand, the société anonyme, although limiting the responsibility of its members, was meant to operate in larger markets where shares were more easily tradeable. It was mandatory that this company be formed by seven members, at least. Additionally, the provisions of the Law 1867 regulating the société anonyme were severe not only for national but also for foreign investors. Foreign investors intending to invest in French joint stock companies encountered several constraints. They would have to comply with complex and burdensome provisions for the incorporation, publicity, and overall functioning of the company.

The fact was that none of the business forms already provided by the law addressed situations such as those where a father, feeling the burden of his contributions to the family venture, wished his children or closest relatives to bear part of that burden. Neither were the existing business forms appropriate for those situations where investors linked by kinship and family ties wanted to stay together in business in a longstanding fashion. The société à responsabilité limitée was meant to bridge this gap. It was drawn up to be a company which on general powers of attorney (procura), but only with regard to the merchants and commercial companies that remain subject to local law and under the conditions foreseen by those laws”). Additionally, it is worth seeing Annexe N° 86 (Session ord. – Séance du 20 Février 1925), Documents Parlementaires – Senat (discussing the report elaborated by M. Chapsal on behalf of the Commission of Trade, Industry, Labor and Post in charge to examine the Bill elaborated by M. Eccard regarding the regime of the SARL in the departments of Bas-Rhin, Haut-Rhin and Moselle). See Documents Parlementaires – Chambre, Annexe No. 3349, Session extr. – Séance du 16 Novembre 1921, p. 146; and Journal Officiel de la République Française, 1925, No. (illegible), Débats Parlementaires, Séance du Mardi 17 Février 1925, pp. 119-120.
allowed its members to take the management of their interests in their own hands and to find solutions in order to keep third parties from entering the company. The role of jurisprudence in developing this form was crucial in the sense that courts adapted the Law 1867 regulating the joint stock company to the increasingly different and new needs of the business community.\textsuperscript{161} Case law pertaining to small joint stock companies would be used as a sort of ‘precedent’ to solve new cases. For instance, jurisprudence admitted restrictions on transfer of shares of joint stock companies such as clauses of consent and pre-emption rights. The taming process of the joint stock company carried on by courts transformed it into a recycled business association closer to the partnership (but still not quite) than to the corporation. Consequently, one of the joint stock company’s main disadvantages in its recycled form was to transform a family business into a business with an underlying capitalist purpose. Furthermore, family affairs were too complex to be solved with an ill-fitting legal form. Due to its open nature, the joint stock company could not prevent members of the same family, who did not have the same life opportunities and money, from behaving differently. Additionally, it could not prevent, after a couple of years had passed, the ‘prodigal son’ from selling his shares to foreigners against both the company's interests and the will of the family patriarch.\textsuperscript{162} Courts adapted the joint stock company to smaller businesses, but did not create anything new out of it. Once again, this is a situation in which particular features of business association’s law are assembled in unexpected ways to serve the interests of market agents (both individuals and firms) who lobbied for these changes to happen.

As in Portugal, and as it shall be clarified later, in Spain,\textsuperscript{163} the SARL in France came up has a middle-term solution. It was a hybrid with characteristics both from the partnership and the corporation (or societé de capital as the French termed it). The SARL shared mostly the same given features of PLLCs in the other selected jurisdictions: they prevented the unlimited liability of members’ personal assets for the company’s debts, they allowed a small number of people to get together to form a permanent business association, and they were useful in when there were too many members to jointly and directly manage the company. These companies were considered useful for those situations in which a commercial establishment was transmitted to the heirs who, though unable to manage it, nevertheless needed to keep it in the family. They allowed for restrictions on transfer of shares.

\textsuperscript{161} Here, a comparison can be made with the United States and UK’s courts regarding their role in shaping law and interpretation of contractual choices of parties to the contract.

\textsuperscript{162} Journal Officiel de la République Française, 1925, No. (illegible), Débats Parlementaires, Séance du Mardi 17 Février 1925, pp. 119-120.

\textsuperscript{163} See sections 1.1. and 1.4.
It also was understood that these companies would be highly suitable for firms developing an agricultural line of business. This had been the case in Germany, and the French legislators followed in the steps of their German counterparts.\(^{164}\) For example, retailers would have the possibility of incorporating a SARL to jointly buy the products they sold in order to fight the influence of wholesale houses or multinational branches. Manufacturers, wishing to reorganize their equipment and buy equipment to improve their production, would organize themselves into a SARL. However, the SARL was not limited to agriculture. It could be adapted to any other line of business from transport and navigation to printing firms. Moreover, the scope of this new form of business association was not limited to family firms. It would be applicable to all business associations whose members had common interests and wished to implement or improve new forms of doing commerce or business in general.

The proponents of the new bill declared they had been inspired by the experiences of the United States and the United Kingdom. These countries were perceived as some of the most industrialized nations, which happened to be using similar business forms and formulas.\(^{165}\) Even though it had to deal with German law applicable to the companies in the Alsace region, the French legislators as well as French doctrine attributed the creation of the limited liability company to England, where the form of private companies were said to have been introduced by a law of 1862.\(^{166}\) The German influence was recognized, nevertheless. The

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164 An interesting issue was the use of this business form by insurance companies and banks. Whilst insurance companies could not adopt this form, there was some discussion as to their use by banks. The Chamber of Commerce of Strasbourg and Marseille suggested that the same interdiction for insurance companies was applied to banks. This was so because they considered that this legal form would not provide the necessary guarantees of security to individuals who did not know much about these affairs. However, the Parliamentary Trade Commission thought that the system of limited liability was especially convenient to banks with a secondary importance such as some regional banks which rendered services to small merchants pledged only their integrity, moral values, and to whom institutions of higher importance certainly would refuse giving any loans for the start-up of a small business. The final version of the law ended up excluding insurance, banking and saving companies from the object of the SARL.

165 It is important to note that the PLLC would only be created in the United States in the second half of the twentieth century. Despite this, the fact that Portugal and now France refer to similar structures in the United States suggests that business associations with a similar profile may have been created in the United States earlier. Regarding the French case, the doctrine has openly assumed that the reason for the creation of the SARL was solely due to the influence of foreign law. See Journal de Sociétés, No. 5, May 1925, pp. 257 – 296 (260) (providing that ‘La vérité est qu’il ne faut pas chercher dans la legislation française un precedent historique des nouvelles sociétés à responsabilité limitée. Ce precedent se trouve en réalité dans des legislations étrangeres…’) (The truth is that it is not necessary to look towards the French legislation for a historical precedent of new limited liability companies). Also see Journal Officiel de la République Française, Débats Parlementaires, 1925, No. (illegible), Séance du Mardi 17 Février 1925, p. 122 (where it is said by M. Chapsal that ‘Nous imiterons … les Anglais qui, avant d’arriver aux status de leurs companies, ont du établir toute une série d’acts. Nous devrons faire de meme en France’) (We will imitate … the English who, before reaching the status of their companies, had to establish a series of acts. We must do the same in France).

166 I believe that the law the French legislator referred to was the Companies Act 1862. The fact is that in the United Kingdom the private company would only be formally implemented in 1907. However, this suggests that there were private companies long before that. Moreover, as it is further discussed in Chapter III, in the United Kingdom public and private companies traditionally were not differently treated by the legislation. It may be that
role the GmbH played in the economic development of Germany was acknowledged. All in all, however, the French legislators considered English law more flexible.\textsuperscript{167} That the proponents of the bill made particular reference to the private company in the United Kingdom signaled their intention to follow a model of business association which could likely contribute to the economic development of France in the same terms.

The promise of the SARL in France was big; the scope of its application was wide. It was recognized that the SARL was meant to be private and should be kept this way. The inclusion of restrictions on transfer of shares and alteration of ownership was an important step to achieve this goal. Despite the close nature of these business associations, MM. Maillard and Georges Bureau, the proponents of the project, thought of them as a laboratory for an experiment with social contours where labor and capital should be brought together. This experiment would be put into motion by guaranteeing that their members shared their profits with the company’s workers. This was perceived as a desirable social development and a measure of justice in as much as it would facilitate the access of all citizens to property ownership. It was thought that this, in and of itself, would promote higher levels of economic development.\textsuperscript{168} This is reminiscent of the prevailing notion in the Old Regime wherein the self-interests of the individual were toned down with the purpose of enhancing the general welfare. The partnership was depicted as epitomizing this (re)distributive goal and functioning as a sort of ‘merchant sociability’.\textsuperscript{169} Still, this idea was not straightforward for some stakeholders who were concerned that asking a company with limited liability to serve as an experimental platform for such a social enterprise could compromise the development of these business associations and delay the implementation of legal solutions for the association of all those who cooperate in any capacity as a business.\textsuperscript{170}

The project was voted in by the Chamber of Deputies in July 1923 after alterations were introduced to adapt it to different economic needs of stakeholders. The SARL was finally

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\textsuperscript{167} See Journal de Sociétés, No. 5, May 1925, pp. 257 – 296 (261-264).
\textsuperscript{168} See Documents Parlementaires – Chambre, Annexe No. 3349, Session extr. – Séance du 16 Novembre 1921, p. 147.
\textsuperscript{170} See Documents Parlementaires – Chambre, Annexe No. 3349, Session extr. – Séance du 16 Novembre 1921, p. 147.
voted in and adopted in France by the Law of 7 March 1925. I did not have access to
documents that explained the gaps between 1921, 1923 and 1925. There was a manifest delay
in French legislation in formally accepting the new business form compared to countries such
as Austria, Germany, Portugal, and the United Kingdom. It took over five years (at least as of
1919 until 1925) for French legislators to overcome deadlocks in the legislative process, and
finally adopt the new legislation. For reasons that are not clear, French legislators were
apparently hesitant to implement the law. We do know that authors such as Pierre-Henri
Conac did not consider company law, and in particular the adoption of a German form
thereof, the most pressing item on the agenda of the French legislator, especially after the
First World War.

The SARL, however, was not adopted without criticism. How was it possible, it was
asked, to allow an individual or a group of associated individuals to develop a commercial
activity that could limit their responsibility? How could it be that an individual or a group of
individuals could create a legal entity independent of themselves and with its own assets? The
bottom line, however, was that these companies were perceived as contributing to the greater
good of France. They increased considerably in number since their implementation, and it
seemed that private credit was not put at stake as a result of market agents investing in these
companies. The SARL became an important legal form in France, widely adopted by
French firms. It has played an outstanding role in the French economy from the early
twentieth century to date. The SARL has several other advantages. It allows family firms to
opt to be levied as partnerships. Their incorporation is relatively easy and their management is
flexible. Consequently, the SARL was, and remains, an alluring form for small and medium
enterprises and investors who face economic difficulties (including the payment of taxes) and
want to ensure that the size of their business is adequate to surmount these problems.

171 See Journal Officiel de la République Française, 1925, No (illegible), Debats Parlementaires, Senat, Séance
du Mardi 17 Février 1925, pp. 118 (where the rapporteur stresses that ‘En France nous devons mettre fins à nos
hesitations et accepter cette réforme’).
172 I thank Pierre-Henri Conac for having taken his time to explain his point of view to me.
173 See Girardier, R., ‘Le Développement de la Notion de L’Affectation de Patrimonie Doit Conduire à La Création
de L’Entreprise Individuelle à Responsabilité Limitée’, La Société a Responsabilité Limitée, 3ème Année, N.º 1,
1er Trimestre 1951, p. 13. (The author is a notary and suggests in this article a new idea of patrimony which
would lead to the evolution of a new form of business).
ii. The legal framework of the société à responsabilité limitée: new rules out of old business forms and the transfer of shares (parts sociales)

The Law of 7 March 1925 stated that sociétés à responsabilité limitée could be incorporated out of sociétés anonymes created under and subordinated to the Law 27 July 1867. Although legislators stressed that this was a new form of business association, many of the legal solutions drew upon the existing provisions for the société anonyme. This was not quite the case, however, for the transfer of shares which in these companies, unlike in the société anonyme, was subject to restrictions. Article 23 of the bill provided that transfers could only take place with the consent of the majority of shareholders representing at least three-quarters of the share capital. The company would have a pre-emption right. It would be exercised by the administrators according with a decision taken by them. The Commission of Commerce and Industry did not see fit to retain this right of pre-emption for the company. On one hand, it was not considered acceptable that a company would buy its own shares. On the other hand, the right of pre-emption could be given to the shareholders if that would not cause great practical difficulties. Furthermore, the requirement of three-quarters was considered to be a sufficient guarantee against the ‘intrusion’ of third parties. Thus, the rule that shares could only be transferred with the consent of a majority of shareholders representing three-quarters of the share capital was retained in the Law of 7 March 1925.

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174 See Documents Parlementaires – Chambre, Annexe No. 3349, Session extr. – Séance du 16 Novembre 1921 (where the report made on behalf of the Commission of Commerce and Industry examining the bill on limited liability companies was published. Article 23, of the bill provided that ‘Les cessions ne peuvent avoir lieu qu’avec le consentement de la majorité des associés, représentant au moins le trois quarts du capital social. La société a un droit de préemption. Il est exercé par les administrateurs en vertu d’une décision prise par eux’).

175 Most articles of association ended up providing pre-emption rights to shareholders.

176 See Journal Officiel de la République Française, 1925, No. (illegible), Séance du Mardi 17 Février 1925, p. 120 (presenting Article 22.º of the Bill on limited liability companies where it was provided that “Les parts sociales ne peuvent être cedes à tiers étrangers à la société qu’avec le consentement de la majorité des associés représentant au moins les trois quarts du capital social”). (Shares can only be transferred to third parties foreign to the company with the consent of the majority of shareholders representing at least three-quarters of the share capital). In the discussion that led to the approval of the project it was stressed in respect to this article that in certain cases it would be necessary to go further and give the opportunity to the children who wish to maintain the family business to buy the shares of those who want to sell them. The respective provisions in the bill were not changed accordingly because the government did not want to delay the approval of the bill. In the literature see Pellerin, Pierre, and Pellerin, Jean, cit., pp. 27-28 (translating chapter VIII of the Law 7 March 1925, including Articles 21, 22 and 23 regarding shares, form and assignment. Article 21 of the Law 7 March 1925 provided that: ‘Les parts sociales ne peuvent être représentées par des certificats négociables que sous forme de billets de compte ou de lettre de change; ils peuvent être assignés en pursuance des dispositions des articles suivants’. Article 22 established that ‘Les parts sociales’ of the company cannot be assigned to third parties outside the company except with the consent of the majority of the partners representing between themselves at least three-quarters of the capital of the company’. Finally, Article 23 stated that ‘Les assignations des parts sociales de la société doivent être établies par acte notarié ou par acte de mandataire privé signé’. They are valid as regards the company and third parties only when they have notified to the company or accepted by the company in a notarial deed pursuant to article 1690 of the Civil Code”).
This rule was mandatory. This is different from what happened in other jurisdictions where identical provisions were default rules. Besides the requirement of a majority of shareholders representing three-quarters of the share capital, other formalities were laid down. Transfers must be undertaken either through a notarial or a document under private signature. They, however, would only have effects on the company after the company had acknowledged them and accepted them through a notarial act. The bottom line was that the three-quarters rule was a mandatory rule. This was so because it involved the transfer of shares to a third party outside the company.

Other important rules were those related to the management and its managers (gérants). I stress Article 24 of the Law where it was established that the SARL was managed by one or several managers who could also be shareholders. Managers were perceived by the legislator as mandataires or agents. They might or might not receive a salary. They were appointed by the shareholders either in the deed of incorporation or subsequently for a determined or undetermined period of time. Unless articles of association provided otherwise, managers were granted wide powers to act on behalf of the company in any circumstances whatsoever. It was also foreseen that any limitation of the powers of the managers had no effect on third parties. Most interestingly, according to this provision the mandate of the managers appointed, either by the deed of incorporation or subsequently, could only be terminated on justifiable grounds. This differed from the protections attributed by law to directors of the joint stock company. The latter could be dismissed ad nutum.

iii. The legal framework of the société à responsabilité limitée: (cont.)

Currently, Article L. 223-14 is now a default rule, but in respect to the majority requirement. It provides that ‘The shares may only be transferred to third parties outside the company with the consent of the majority of the shareholders holding at least half of the shares, unless a higher majority has been stated in the articles of association’. Ordinance No. 2004-274 of 25 March 2004 reformed the law and substituted the previous mandatory rule regarding transfers of shares. The new rule gave other non-transferring members the


178 The legal regime of the SARL was subsequently changed by Law No. 2005-882 of 2 August 2005. This law targeted small and medium enterprises and altered the rules of quorum and majority, and the statute of the EURL (enterprise unipersonnelle à responsabilité limitée). In particular, the threshold of three-quarters of the shares held by the members present or represented in the general meeting was lowered to two-thirds. The underlying idea was to facilitate the modification of articles of association of the SARL and to align them with the evolution
right to opt out and agree otherwise in respect to the majority needed to consent to the transfer. This is viewed by some authors as a move of the SARL away from the partnership.  

Additionally, it imparts a contractual flavor to the SARL which, unlike the Portuguese system already studied, is not based upon a purely contractarian approach due to the historical imposition of mandatory rules.

Other aspects of the current legal regime of the transfer of shares to third parties are relevant. For a start, I should stress that the French regime for the transfer of shares and alterations to the ownership structure of the company is comparatively rigid. Procedurally, if the company has more than one shareholder, the member who wishes to sell her shares to a third party must notify the company and each non-transferring member about the proposed transfer. The purpose of this notification is to obtain the company and other members’ consent to the transfer. The company’s decision is taken by means of a collective resolution of the members at the general meeting. The manager of the company convenes the general meeting to resolve on the transfer. The manager can also consult with each member in writing, if this is foreseen by the articles of association. Subsequently, the transferor is informed about the company’s decision. Unless the articles of association provide otherwise, the consent of the company is given through the majority vote of shareholders representing at least half of the shares. The company’s lethargy is sanctioned if it does not inform the transferor about its decision within a three-month period as of the moment the transferor notified the company.


179 See Saintourens, Bernard, ‘L’attractivité renforcée de la SARL après l’ordonnance n° 2004-274 du 25 mars 2004’, Revue des sociétés, 2004, p. 207- (…) (claiming that ‘L’abaissement des trois quarts à la moitié du seuil de représentativité constitue un assouplissement sensible des conditions d'autorisation de la cession des parts de la SARL à un tiers étranger à la société et pourrait être jugé comme traduisant un éloignement des SARL de la catégorie des sociétés de personnes. Pour autant, les statuts peuvent prévoir une majorité plus forte, ce qui doit permettre aux associés de renforcer, si tel est leur souhait, l'intuitus personae au sein de leur société. La conception que l’on peut avoir de la place de la SARL au sein des sociétés commerciales ne dépend donc plus de la position de la loi mais de l’usage que feront, au cas par cas, les entrepreneurs utilisant la SARL pour structurer juridiquement leur entreprise’) (‘Lowering the threshold of representativeness from three-quaters to half is a significant easing of the conditions for authorization of the sale of shares of the SARL to a third party outside the company and could be considered a shift away from the partnership. However, the statutes may provide for a greater majority which will allow the partners to strengthen, if they so wish, the intuitus personae within their company. The conception that one can have of the SARL within business associations no longer depends on the position of the law, but of the use that is made by members in each case to legally structure their business.’).

180 For instance, by analyzing the articles of association of SARLs I want to understand whether members changed their articles and decreased or increased the threshold of the majority so that consent is given to transfers. It is also a way to test how much use shareholders make of the contractual flexibility provided by the law on this matter.
about her project. If, at the end of this period, the company has not conveyed this information, the transfer is considered approved and the transferor may freely transfer her shares.

If consent is not given by the company, shareholders must buy the shares or cause them to be bought, within a three-month period as of the refusal. The price is determined according to Article 1843-3 of the Civil Code, unless the transferor withdraws her proposal and quits selling her shares. The valuation costs should be borne by the company. The period of three months can be extended once by a court order, as per the manager director’s request, for no more than six months. The company may also decide to reduce its share capital, within the same period, with the consent of the transferor, by the amount of the registered par value of that partner’s shares and to buy back the shares at the price determined pursuant to the terms and condition set out above. When duly justified, a court order may extend the payment period up to no more than two years. The amounts due earn interest at the legal commercial interest rate. If the company has not acquired the shares of the transferor or cause them to be acquired, or depending on the circumstances, the company has not bought the shares back, at the end of the given period, the transferor may freely sell her shares as she had originally proposed.

In principle, shares are freely transferable to other shareholders and family members of the transferor because it is thought that this would put at stake neither the closed nature of the company, nor the influence of other shareholders. Article L. 223-16 provides that shares are freely transferable between shareholders. If the articles of association contain a clause limiting the transferability, the provisions of the article L. 223-14 apply. Nevertheless, the articles of association may, in this case, reduce the majority or shorten the time set in that article. Moreover, pursuant to L. 223-17, the transfer of shares is subject to the provisions of L. 221-14, which is applicable to partnerships. This article establishes that the transfer of shares in the partnership must be in writing. A transfer is not binding on a third party until these formalities have been completed and, in addition, after public notice of it is made through the commercial and companies register. Like restrictions on transfers to third parties, articles of association may determine restrictions on transfers to spouses, heirs, ascendants and descendants such as the consent of the company or shareholders to the transfer. These

181 The right of the transferor to withdraw from her proposal (droit de repéntir) was overly discussed by the jurisprudence and doctrine. It was acknowledged by Order of 24 June 2004. See Mortier, Renaud, ‘Contre le droit de repentir en droit des sociétés’, Revue des sociétés, 2009, p. 547- (…) (criticizing Article L. 228-24, al. 2 of the Commercial Code which, after the reform introduced by Order of 24 June 2004, established the right of the transferor to withdraw her proposal (droit de repéntir).

restrictions notwithstanding, the majority to vote resolutions on this regard must not be more demanding than to vote the consent to transfer to third parties outside the company.

II. Actors

i. Applying the SARL’s law by drafting the company’s articles of association: ownership and corporate control

I collected a sample of 50 articles of association of French SARLs. In order to identify the companies I wanted to analyze, I used the Bureau van Dijk’s database Astree which is available to the public at the Centre Georges Pompidou in Paris. In order to streamline the research I selected eight different variables. The choice of these variables was made in the context of the variables provided by the database and pursuant to the elements of the knowledge that I considered necessary to answer my main research question and the sub-research questions listed in the comparative matrix (Table 1). The first variable was the statut juridique: actif. The search yielded 1.136.400 events. The second variable was forme juridique: société à responsabilité (SARL). It yielded 296.297 results. The third variable was date de creation de l’entreprise: du 01/01/2000 au 31/12/2012. I obtained 165.410 events. The fourth variable was Ville: Paris. The research yielded 1.445 results. The fifth variable was Description textuelle d’activité (objet et code NAF Rêv. 2): UnDeCesMots (“prod*”, “habillement*”, “boisson*”, “pharmacie*”. The number of results decreased to 441. The sixth variable was Dirigeants. At this stage, I first chose the option to have dirigeants or managers who were also shareholders. This yielded 28 events. I then decided to select the option of having companies in which the reported managers were currently in office (this did not necessarily mean that managers were also shareholders). This yielded 401 companies. To decrease this number, I further narrowed down the research by including a seventh variable: Années de comptes disponibles: 2012. It did not provide any results. I introduced an eight variable: Effective salarié de l’entreprise: Toutes les entreprises avec une valeur Dernière année disponible. The research, then, yielded 28 results. Thus, by introducing the latter variables into the database, I delineated a sample with 28 companies in which managers were also shareholders and 28 companies in which managers were currently in office, without

183 This is a database of Bureau van Dijk (BvD) that provides specific information about French companies. It includes data regarding the business activity, accounts, management, and ownership structure.
184 See Part I, Chapter 1.
185 In choosing the time frame, I was limited by the availability of resources of the Center. It was not possible, therefore, to collect articles of association dated as of 1925 to date.
specifying whether or not they were shareholders. I collected the relevant companies’ articles of association from the database *infogreffe.fr*. I mostly selected the original articles of association (*statuts constitutifs*) that were deposited with the *Greffe du Tribunal de Paris* at the date of incorporation of the company. Where this was not possible, I selected the updated version of the articles (*derniers statuts a jour*). All articles of association included restrictions on transfer. Half of them, which were of companies incorporated after 2004, opted out from the one-half majority rule of Article L. 223-14, and established a higher majority of shareholders representing three-quarters of the shares to consent the transfer. One company established a majority of two-thirds. The other half, comprised of companies incorporated before 2004 and after 2004 did not opt out from Article 223-14 either in its old or updated version. In the situations where companies opted out from the rule, it was difficult to learn whether they did so because they really wanted to opt out or because the articles of association were just a copy of previous ones. This hypothesis becomes more plausible when considering that the wording of the articles is alike, despite of the absence of any visible connection between the companies. On one hand, this was the case because the applicable rules were copied in the articles of association. On the other hand, it appears there is a dissemination of legal knowledge, the channels of which are difficult to identify by just the mere analysis of companies’ constitutional documents.

A few words should be said about the management of the company. Database *Astree*, from which the sample of companies was collected, provided for each company a BvD Independence Indicator. This indicator characterizes the degree of independence of a company with regard to its shareholders. Putting it differently, this source labels categories of shareholders in so far as they are able to exert a controlling power in a company. The analysis of the BvD indicators for each company in the sample suggests that, in general, French companies present a high level of dependence on their shareholders. Unlike the United Kingdom case, as we shall see below, shareholders are often managers. Normally, the majority shareholder is elected manager of the company. Thus, in principle, shareholders are in a position to control or exert power over the ownership and governance structures of the company. It would appear that, in these circumstances, the separation between ownership and control is more trivial. Additionally, it would appear that conflicts of interests in the company

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186 This database makes available to the public documents of French companies that are deposited with the offices of French Commercial Courts for purposes of register (*Greffes des Tribunaux de Commerce*). See https://www.infogreffe.fr/societes/ (last accessed 30 January 2014).

187 See Part I, Chapter 3.
are more likely rooted in the relationships between minority and majority shareholders provoked by abusive behavior, and not so much between shareholders and managers.

The current legal regime makes a distinction between what I call the internal and external relations of the managing directors. The internal relations refer to the relationships managing directors have with shareholders. The external relationships refer to the relationships established between managing directors with third parties. In this respect, Article L. 223-18 is relevant. I point out the fact that the powers managers enjoy in their internal relations are determined by the articles of association. If the articles of association make no mention of it, then Article L. 221-4 regulating the powers of managers in the general partnership is applied. In their external relations with third parties, managing directors have broad powers to act on behalf of the company, notwithstanding the powers that the law grants exclusively to shareholders. Managing directors even have the power to bind the company in acts not related to the business object of the company unless the company proves that the third party knew, or should have known considering the circumstances, that the act was beyond the business object of the company. The publication alone of the articles is insufficient to constitute that proof.\textsuperscript{188} The articles of association limiting the powers of the managing directors, pursuant to this Article, are not enforceable against third parties. Managers may decide, subject to ratification of their decision by shareholders under Article L. 223-30, to bring the articles of association into compliance with mandatory legal and regulatory provisions.

The severity of the regime of transfer of shares in the SARL is suggested by the lack of negotiability of the shares, by the fact that transfers must be registered with the commercial registry, and by the tax costs associated with it. Moreover, the management of the company is undertaken by one or several managers who must necessarily be individuals and not legal entities. But unlike the United Kingdom where control of the company seems to belong, in fact, to directors, managing directors of the SARL are highly scrutinized by shareholders. Perhaps this is so because there is no collective body such as the board of directors that is required to periodically report its activity to the president of the board or to the general meeting of shareholders.\textsuperscript{189} Despite all this, the major flexibility of the SARL and its ability to

\textsuperscript{188} See Bermann, George A., and Kirch, Pierre, cit., p. IV-41.
\textsuperscript{189} See Article L. 223-18, first paragraph.
be a company ‘bonne a tout faire’, that is to say, a company which can be adapted to a wide gamut of firms, is recognized by the literature and jurisprudence.  

III. Market

i. Litigation over the requirement of consent (*agrément*): personal relationships of trust and conflicts cheek by jowl in the SARL

Despite the SARL’s flexibility, the fact is that in practice its legal framework does not emerge for their members as clear-cut. The analysis of a sample of 14 cases that were adjudicated by French courts and saw appeal shows precisely this: personal relationships of trust go hand in hand with conflicts over power and distribution of shares in the company. I collected these cases from the database *legifrance.gouv.fr*. I selected the period between 1 January 1930 and 30 September 2012 for my research. First, I introduced in the research engine the words ‘cession parts sociales’. This yielded 1555 results, including decisions of the *Cour de Cassation* (1235), *Cour D’Appel* (319), and *Tribunal de Grande Instance* (1). Second, in an attempt to refine my research, I have followed the same scheme, this time introducing as key words ‘agrément’ and again ‘cessions parts sociales’. This research yielded approximately 130 results. I have chosen those cases where the word consent (*agrément*), SARL, and transfer of shares (*cession de parts sociales*) were automatically highlighted in the summary provided by the database to match the terms of the research I initially provided. Again, my choices of cases were made within the number of variables provided by the database and included the knowledge I considered essential to accurately grasp the market, the bargaining complexity, and these companies' dynamics. The cases are based upon contentious disputes where consent to the transfer of shares was refused or an un-consented transfer of shares was executed. I gather the multiple legal problems deriving from there according to the following clusters:

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190 See Bissara, Philippe, ‘L’inadaptation du droit français des sociétés aux besoins des entreprises et les aléas des solutions’, *Revue des sociétés*, 1991, p. 553 - (…) (referring to the SARL as an instrument more liable to be adapted to the needs of the firms than the société anonyme. As a matter of fact, the SARL has been, to the eyes of the author, ‘injustement négligée’ perhaps because some of its peculiar features could also be applied or adapted to the société anonyme, but they have not to the moment. For an account of the French legal regime of transfer of shares and ownership rights in the SARL, see Cozian, Maurice et al. *Droit de Sociétés*, 15th ed., Paris, LexisNexis, Litec, 2002.
1. **Interpretation**
   
   (i) Difficulties in interpreting legal provisions and contract clauses. 
   
   (ii) Difficulty in understanding when resolutions taken at the general meetings are valid and enforceable. 
   
   (iii) Obscurity regarding the moment when shares are effectively transferred, and the actual position of the transferee in the company’s dynamics when it comes to a vote in the general meetings, or take a stand on an ongoing conflict involving shareholders, managers and / or managers and shareholders, particularly if the transfer was un-consented. 
   
   (iv) Learning whether the mere proposal of transfer binds the transferor once it is accepted by other non-transferring shareholders. 
   
   (v) Doubts as to the effect of the consent given by shareholders to the transfer of shares. 
   
   (vi) Lack of clarity as to whether the consent is or it is not part of the sales contract.\(^{191}\)

2. **Functionality of restrictions on transfers**
   
   (i) Conflicts of interests, disputes between shareholders as a result of changes in the balance of distribution of the shares and the power shareholders keep inside the company. 

3. **Un-consented transfer of shares**
   
   (i) Non-compliance with the law or legal provisions shareholders themselves have not opted out from, either because they ignore them, or because they do not mind circumventing them. 
   
   (ii) Concomitant transfer of shares and the need to understand whether there is a fraud in the sense that the transfers are undertaken to circumvent the requirement of consent of the shareholders. 

4. **Formalities**
   
   (i) Dilatory practices developed by managers and non-transferring shareholders to

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\(^{191}\) See, for instance, the ruling of the Cour de Cassation, 1 October 1996, Appeal N.º 94-20219, where the Cour D’Appel submitted that the resolution of the respective general meeting was a mere authorization of the transfer and not a recognition of that transfer. This suggests that the consent given by shareholders to the transfer is not part of the share sale and purchase agreement.
avoid the transfer being executed.

(ii) Managers and non-transferring shareholders’ opportunism and bad faith, which translates into silent and apathetic behavior of both managers and non-transferring shareholders toward reports provided by experts on the value of the shares to be transferred. The cases selected also demonstrate that on the management and non-transferring shareholders’ side there is often no real intention to rely on the opinion provided by such expert.

(iii) Abusive behavior of managers and non-transferring shareholders to harm the transferor’s interests such as acquiring the shares at their fair value.

(iv) Un-consented transfer of shares, especially because the managers or non-transferring shareholders were late in complying with their legal obligation to repurchase the transferors’ share.

(v) Copy of legal rules by the members into the articles of association whilst there is no real intention of deviating from entrenched corporate practices such as those related to the functioning of general meetings, and their documentation in the minutes’ book.

(vi) Irregularities in the form of the notification and as to the proceedings regarding the general meetings in which the consent to the transfer of shares is voted.

This set of cases suggests that property rights held by shareholders in their shares seem not to be strong enough to prevent dilatory maneuvers by managers and other shareholders. This is especially so because, similar to the other jurisdictions, there is no competitive market liable to break path-dependent behaviors of the members who strive to keep the control over the company, surpass the lack of liquidity of their shares, and push managers to run the extra mile when it comes to guarantee that the best investors will, actually, invest in the company. Curiously enough, members want to keep control over the company even when they do not hold highly liquid dividend shares based upon strong sources of profitability. Shareholders seem to be willing to be kings in a land without a kingdom. Many of the actions reported in the case law can, in extremis, lead to the ‘silent’ expropriation of the transferor’s own share by her cohorts. This does not necessarily make the company better off, nor does it spell its development in the long run.
1.3 ITALY

I. State

i. The history of the Italian private company (società a responsabilità limitata): legislative projects, parliamentary debates and the allure of foreign investment

Italian legislation appears to have remained indifferent for over thirty years to the adoption in other countries of a legal framework for private business associations. In 1942, apropos the discussion regarding the reform of the Italian Civil Code, the longstanding need for a new type of company alongside the joint stock company was stressed. This new type of business association would be a limited liability company whose shares would not be freely transferable. However, that this need had already been noted and discussed way back in 1882 – before the adoption of the Gesellschaft mit beschränkter Haftung (GmbH) in Germany, on 20 April 1892 - in the framework of the reform of the Code of Commerce. This code had already established the joint stock company (società anonima per azioni) and the joint stock company limited by shares (società anonima per quote). However, the complacency of Italian businessmen regarding the inclusion of these new forms of joint stock companies in the system of the Code of Commerce rendered these solutions sterile.

Italians already knew of the implementation of an autonomous type of business association with limited liability. In the provinces of Venezia Giulia and Tridentina, which were formerly part of the Empire of Austria (Austro-Hungarian Empire) and annexed to the Kingdom of Italy after the First World War, the limited liability company had been adopted according to the Austrian law of 6 March 1906. This company was transitorily maintained until after the legislative unification with the Royal Decree of 4 November 1928. It was also reported that from 1931 to 1940, 382 companies limited by guarantee had been created in the District Appeal Court of Venezia Giulia. In addition, 253 of these business associations had been created in the circumscription of the Appeal Court of Trento, and 23 in Fiume. Certain

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193 See Relazione alla Maestà del Re Imperatore del Ministro Guardasigilli (Grandi), Presentata nell’udienza del 16 Marzo 1942 – XX per l’approvazione del testo del ‘Codice Civile’.
194 These business associations existed also in other regions such as Trentino-Alto Adige (South Tyrol) and Istria (which belonged to Austria before the World War I and to Italy until World War II).
companies in the Kingdom of Italy, in order to take the form of limited liability companies, had already learned to incorporate in Trieste, while having the seat of their business in the most distant regions of Italy. With the new Italian Civil Code of 1942, adopting the new form of corporation – the limited liability company (società a responsabilità limitata), all these previous corporate forms created in Italian provinces were subjected to the same legal system.

Notwithstanding the late adoption of a legal framework for the private company, the introduction of a new form of business association – the società a garanzia limitata (company limited by guarantee) – was discussed in all projects of reform of the Code of Commerce, respectively in 1921, 1925, and 1940. They all promised a wide movement of research and debate, assembling practitioners and scholars for the creation of a new legal framework. For example, in the Project of the Code of Commerce of 1925 several reasons were given for the adoption of these companies.

First, it was intended to extend the projected law to the Italian provinces and colonies. Additionally, it was thought appropriate to make adequate the system of law to the realities of life and to the Italian code for the African colony of Eritrea. The application of the law to provinces and colonies was made under the principle of national unity (l’unità nazionale) which was part of the backbone of fascist Italy.

Second, it was perceived as important that Italian legislation bridge the gaps and close the loopholes in the commercial law, especially by taking into account the legal innovations in countries such as Germany, Austria, the United Kingdom and, more recently, France. It is

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195 This company was named at the time società a garanzia limitata. This is a previous form of the società a responsabilità limitata adopted in 1942.
196 This is a fascinating case of regulatory arbitrage. Two questions may be asked: First, was it possible to form an Austrian GmBH in these Italian provinces after 1918? And second, could the GmBH be retained after 1928? This issue is beyond the scope of this chapter, but it sets the grounds to investigate the promise of jurisdictional competition in Europe from a historical and empirical perspective. On this, see Part III, Chapter 2.
197 It is fair to ask whether Eritreia was used as a sort of experimental laboratory for the implementation of the law.
198 See Commissione Reale per la Riforma dei Codici, Sottocommissione B, Codice di Commercio, vol. II, Relazione sul Progetto a cura del Presidente D’Amello, dei Commissari: Arcangeli, Asquini, Bolaffio, Bonelli, Jannitti A. e del Secretario Frè, Roma, Proveditorio Generale dello Stato, 1925, p. 63 (‘il legislatore italiano non può rimanere indifferente di fronte alla crescente tendenza verso il principio della limitazione della responsabilità, che caratterizza il movimento associativo dell’economia moderna e che da noi non è meno viva che altrove. Esaminando la situazione delle società per azione, nelle cui forme questa tendenza ha finora dovuto trovare il suo sbocco, ognuno può avere la precisa sensazione, che un notevole numero di tali società corrispondono a imprese di proporzioni moderate e di stretto caratere famigliare, se non addirittura personale, le quali hanno dovuto assumere le forme della società per azioni, perchè la nostra legislazione non offre via per assicurare ai soci la limitazione di responsabilità’) (‘the Italian legislation cannot remain indifferent to the increasing tendency to apply the principle of limited liability which characterizes the corporate movement of the modern economy, and which between us is not less vivid than elsewhere. By examining the situation of the joint stock company, in which this trend has at the moment found its end, one gets the distinct feeling that a
said with respect to the improvement of Italian commercial law that ‘…parve giusto non mantenersi fuori da quella corrente di studi di legislazione comparata e di unificazione legislative internazionale, che caratterizza, nel campo del diritto pubblico e privato, la ripresa attività scientific del dopo guerra’. It was understood that Italy could not set itself apart from the legislative movements taking place in other European countries.

Third, Italian legislators seemed to be committed to search for a harmonization of Italian commercial law. An analysis of historical sources shows numerous legislative references to ‘a minimum of uniform international law’, to a community of legal rules designed to fulfill the noble aspiration of Latin legal thinking. This seemed to be the mission attributed to commercial law. This discipline was considered, more than any other, likely to promote a common type of legal rules. Unlike the institutes of civil law, which were taken as the outcome of a common feeling of human coexistence and perceived as specifically conserving the ‘intimacy’ of the historical tradition and ethic characteristics of the ‘race’, rules governing commercial activities were seen as capable of naturally equating themselves with other rules of the same kind beyond the borders of the Motherland.

Fourth, it was aimed at providing Italian producers with better access to the biggest world markets and promoting commercial relationships between Italian and foreign industries. Indeed, the largest industrial and financial associations, unions and professional colleges, banks, and organizations of merchants were heard in the context of this project of reform. It was accepted that the rigidity of legal formulations sacred to lawyers, commentators and jurisprudence had to give in once they faced the challenges of the practice and of ‘law-in-action’. However, and despite all this, the reform was not undertaken.

In 1935 an interesting debate was held at the Italian parliament (Camera dei Deputati). Among other topics, the compelling need to reform the Code of Commerce was stressed. This urgency in reform was justified with the legitimacy of the legislative process in accommodating new legal phenomena and establishing the line between norms and institutes of public and private law. Moreover, it was acknowledged that the legislation at the time did
not prevent the evasion of that law. Therefore, not only the implementation of criminal provisions regarding commercial companies was discussed, but also the role of business associations. As put by one of the parliamentarians

…l’attività delle società commerciali nella economia moderna non riguarda soltanto quell numero più o meno limitato di individui che vi hanno un interesse diretto ed immediate, ma tocca l’economia di tutta la Nazione, alla quale in definitive appartengono I capitali che vengono sperperati e distolti dalla loro naturale ed essenziale funzione produttiva.^[201]

Having particularly in mind the joint stock company, and the fact that this company seemed no longer able to fulfill the needs of business and businessmen in general, it was contended that fascism had the role of moralizing all national activities and also those with an economic nature. Often, private companies (not yet recognized by the law at this moment^[202]) were used to elegantly elude legal provisions on joint stock companies. This is not different from the case of the United Kingdom as it is described in Chapter 3 below. As a consequence, it was thought that the reform should not be limited in substance. It should be undertaken by formalizing the creation of a new type of corporation by means of which the doctrine and fundamental principles of fascist practices (e.g., the conciliation of the interests and subordination of private interests to the overall general interest - the ‘fascist corporate principle’) could be safeguarded. The parliament openly assumed an educational role on this matter^[203]. Hence, the claims favorable to a reform of the legislation in force were based on three premises of political, social and moral nature.

The società a responsabilità limitata would only be definitely adopted in Italy in 1942.^[204] In the report to the Majesty of the King Emperor by the Minister Guardasigilli

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^[201] See Atti Parlamentari, cit., p. 1015 (‘...the activity of commercial companies in the modern economy is not only that which concerns a more or less limited number of individuals who have a direct and immediate interest, but also affects the economy of the whole nation, to which definitely belong the capitals being squandered and diverted from their natural and essential function of production’).

^[202] For example, I am referring to those that had been incorporated in former Austrian territory.

^[203] See Atti Parlamentari, cit., p. 1017 (‘Le nuove norme dunque sono indispensabili per creare il nuovo costume, il quale del resto è già nelle coscienze dei più e dovrà penetrare in quelle di tutti attraverso l’opera educative del Partito e dei Sindacati Forensi’) (‘The new rules are, therefore, essential to create the new custom, which is already in the minds of many and will penetrate all others through the educational work of the Party and Bar Associations’).

^[204] It is worth stressing that before the società a responsabilità limitata, there were other corporate forms which had been designed to fulfill more or less the same objectives. This was the case of the joint stock company by shares (società anonima per quote), which was totally ignored and useless. Consequently, it was abolished in 1942 by the reform of the Italian Civil Code. The new Code also introduced two other new forms of corporation: the unlimited liability cooperative (cooperative a responsabilità ilimitata) and the limited liability cooperative (cooperative a responsabilità limitata). It is noteworthy that, although these new corporation forms were created, the fact that the joint stock company in its different forms was not given in Italy the same importance as in other
(GRANDI), presented in 1942-XX for the approval of the text of the Civil Code, it was submitted that the adoption of a new type of business association was meant to legally frame business associations likely to substitute the small joint stock company. The new type of company was not, however, created solely for this purpose. It could be used by bigger firms – as no maximum threshold for the share capital was established - whenever its members wanted to limit their responsibility and to assure that member’s activities were more closely linked to the business object of the company. It was also expected with this new form that relationships between members and between them and third parties would be driven by trust (fiducia) and not only determined by the amount of shares they held in the company’s share capital and their level of responsibility in the company. The private company in Italy was designed to be an ‘elastic’ concern, which could be formed by a large or small number of members, with a big or small amount of share capital, with manager-shareholders or, in case this was provided by the articles, a ‘union membership’ (collegio sindicale). Its main features were the limited liability and the division of the share capital into quote. (Nevertheless, these features are not distinctive of the Italian case).

ii. The default principle of free transferability of quote and the openness of the legislation to private autonomy in Fascist Italy

The two Italian projects of the Code of Commerce of 1921 and 1925 respectively provided default rules establishing pre-emption rights to non-transferring shareholders in the Western capitalist countries such as the United Kingdom shows how Italian capitalism was less mature at this time. On this point, see Yanagisako, Sylvia Junko, Producing Culture and Capital: Family Firms in Italy, Princeton and Oxford, Princeton University Press, 2002, p. 27.

205 Relazione alla Maestà del re Imperatore del Ministro Guardasigilli (GRANDI) presentata nell’udienza del 16 Marzo 1942-XX per l’approvazione del testo del ‘Codice Civile’.

206 In the Italian società a responsabilità limitata this governing body was mandatory when their share capital reached or was over L. 1,000,000 (one million lire). Its function was to supervise the board of directors. The collegio sindicale would be formed by three or five effective members, who could also be appointed among shareholders. See, in this context, Toso, Agostino, La Società a Responsabilità Limitata: Disciplina Legale, parte prima, 2.ª ed., Superstampa, Roma, 1943 (providing an overall account of the legal framework of the newly created corporation).

207 The Italian limited liability company (società a responsabilità limitata) has been defined as ‘…quella in cui… per le obbligazioni sociali risponde soltanto la società con il suo patrimonio, ed in cui, a differenza della precedente, le quote di partecipazione dei soci non possono essere rappresentate da titoli azionari, la loro proprietà risultando unicamente dall’atto costitutivo e dal libro dei soci.’ (‘… one in which … only the company’s assets are responsible for corporate debts, and in which, unlike in the previous [type of company], the shares of the members cannot be represented by certificates, their property resulting solely from the company’s articles of association and shareholders’ register’).
transfer. This was considered an intermediary measure between the German and Austrian laws - which established the principle of free transferability of shares, unless the articles of association provided otherwise – and French law requiring the consent of a majority of members for transfer of shares to third parties.

The project of the Civil Code of 1942 set as a goal the assignment of as much ‘elasticity’ as possible to the new business form. As a result, the legislation considered inadequate the requirement of consent or an intermediary measure. The governance strategy of the company - including the terms by which shares could be transferred and the company’s ownership altered - should be provided by the articles of association (atto costitutivo). Only if nothing was established by the articles, rules provided by legislation on this subject would be applied. Accordingly, the legislation gave members an opportunity to opt-out from the legal system by providing a default rule (currently, Article 2469 of the Italian Civil Code) establishing the free transferability of quote. However, the Civil Code also sanctioned (currently, in Article 2470) that the transfer of quote only would have an effect vis-a-vis the company from the moment of its register into the register of members. It appeared to be a form to offset the free transferability of shares. It also generated problems of interpretation regarding the effectiveness of the transfer if it was not registered in the register of members despite being valid between the parties. It was submitted, though, that directors or managers of the company could not unreasonably refuse the register of the transfer without incurring serious liability towards the damaged party as a result of the omission. Article 2470 was altered by Decree Law 29 November 2008, n. 185 and converted with amendments into Law 28 January 2009, n. 2. At this point, it provides that the transfer only has effects toward the company if the respective share sale and purchase agreement, with authenticated signature, were to be filed by the authenticating notary at the office of the Companies.

See Commissione Reale per la Riforma dei Codici, Sottocommissione B, Codice di Commercio, vol. I, Progetto, Roma, Proveditorato Generale dello Stato, Libreria, 1925, p. 62 (Article 149 foresaw that ‘Salvo disposizioni contrarie dell’atto costitutivo, le quote sono trasferibili mediante atto pubblico, com diritto di preferenza, a parità di condizioni, a favore degli altri socii’. (Unless established otherwise in the articles of association, shares are transferable according to a public deed, pre-emption rights and conditions established in favor of the other members) This article also provided that ‘Il trasferimento delle quote ha effetto di fronte alla società dal momento dell’iscrizione nel libro dei soci ed è soggetto all’iscrizione nel registro del commercio…’) (The transfer of shares has effects on the company from the moment it is registered in the shareholders’ register and it is registered in the commercial registry).

209 French legislation, as it is treated above, created the societé a responsabilité limitée or SARL in 1925. Currently, German and Austrian laws require that the transfer be formalized by a notary public. In Italy the transfer had to be formalized through notary public until 2008, when the respective law was altered. As of that date transfers must be entered into by a private document to which a digital signature must be introduced. It has, then, to be deposited with the Commercial Registry. Additionally, the transfer must be registered in the members register.

210 Such problems still happen today. See, for example, Cassazione Civile Sez. I, 23-1-97, n.º 697.

211 See Toso, Agostino, cit., pp. 38-39 (referring to the transfer of shares).
Registry in which jurisdiction the registered office of the company is established. The reference to the register of the transfer into the register of members as a condition of effectiveness towards the company has been excluded.

Unlike the partnership, the legislature did not put obstacles to quote of Italian PLLCs being subject to enforcement by creditors.212 This situation would be relatively easy if members adopted in their articles the principle of free transferability. This, however, would not be so easy if restrictions were established. In these circumstances, if creditors, the transferor/debtor and the corporation reached an agreement, all difficulties would be surpassed. If no agreement was reached, however, interests would have to be weighted – the interests of the creditor in the sale, and the interests of the company, which had demonstrated at the outset by including in the articles restrictions on the transferability that it would not want to let a third party in the company. Despite this fact, it is rather interesting that Italian legislators opted for enhancing members’ private autonomy, which is reflected in their wide freedom to contract the clauses of the company’s articles, when law at the point of its enactment was explicitly attributed a moralist and educational instrumental role in pursuing the fundamental values of the fascist state.213

II. Actors

i. The Italian SrL: how the ownership and governance structures fit a mold primarily based on private ordering

A close analysis of transfer clauses of the articles of association and related documents of 35 Italian PLLCs incorporated as of 1946 to 2009 shows that, similar to the Portuguese case, members of these corporations preferred to introduce restrictions on transfer of shares despite that, in principle, shares could be freely sold. This is both understandable and surprising. On one hand, these corporations are smaller in size, and their members are bound by personal ties. So, it is understandable that they would wish to keep the company as it is: closed. On the other hand, this clearly contradicts the Italian legislature’s venture, markedly

212 I am not referring to the cases of bankruptcy of the company since the principle of limited liability prevailed in these companies.
213 See Yanagisako, Sylvia Junko, cit., pp. 49-50 (noting that one of the legacies of Mussolini’s fascist government was the transformation of the Chamber of Commerce – Camara di Commercio – from a civic association to a state agency in order to promote and regulate commerce. The commitment of the state to steer the physical and mental health of the Italian population is on the same footing as its efforts to promote commerce and industry by increasing regulation and surveillance).
capitalist and liberal. One of its goals was to attract foreign investment to Italy. To that end, it altered the commercial legislation and created a new form of corporation.  

The 35-item events sample was collected from the Bollettino Ufficiale delle Società per Azioni e delle Società a Responsabilità Limitata published between 1956 and 1996. This sample was complemented by another sample of companies collected from Bureau van Dijk’s database Aida provided by the Università Commerciale Luigi Bocconi. To define my research strategy on this database, I selected 9 variables. Similar to my selection of companies in France, I chose variables within the number of variables provided by the database and in accordance with the elements I deemed necessary to answer my main research question and Table 1 sub-research questions. First, I chose the variable stato giuridico: attiva. The outcome was 919,033 results. Then, I selected the variable forma giuridica: SrL. I obtained 665,891 events. The third variable I selected was data di costituzione: nel e dopo l’anno 1970 fino a ed incluso l’anno 2012. The sample of events was reduced to 651,624 events. As a fourth variable, I chose Regione, provincial, commune: Firenze. The research produced 13,136 results. The fifth variable was Descrizione dell’attività ... (“prod*”, “abbigliamento*”, “bevande*”, “farmacia*”). The outcome was 4,134 events. The sixth

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215 This official gazette is available at the National Central Library in Florence. However, only volumes from 1958 to 1996 are available for consultation. This publication stopped being published in 1997. Therefore, I have selected companies whose articles were published in the Official Gazette during the decade of 1958-1968 in order to make a historical account based on information dated as close as possible to the date of these companies’ implementation in Italy - 1942. Some of the articles published are dated before 1958. They were, however, subsequently published. It is worth pointing out that the Bollettino Ufficiale delle Società per Azioni e a Responsabilità Limitata (BUSARL) is also held by the Camera di Commercio di Firenze. The BUSARL was adopted in the end of the nineteenth century. It contained the transcripts of incorporation, amendments and liquidation of companies of capital and cooperative companies throughout Italy. It was drawn up in files with an annual index, but the copies held by the Chamber of Commerce of Florence date as late as 1930s. In the mid-sixties, due to the exponential growth of joint-stock companies in Italy, it was decided by the competent ministry to separate the BUSARL into regional files, and entrust the preparation and publication to the Chamber of Commerce of the regional capital. Since that time, the chamber of Commerce of Florence has retained only the files within its regional jurisdiction. That is, it has keep files only regarding companies in Tuscany. As far as it was possible to learn, two libraries alone in Italy have kept until a few years ago the series of unique national BUSARL. These libraries were the Biblioteca del Senato della Reppublica (Library of the Senate of the Republic) in Rome and the library of the Camera di Commercio di Firenze. Yet, it is possible that the Commerce Chambers of the Regional Capitals have maintained the respective BUSARL. I was informed that it appears that the Library of the Senate dismissed its own publication three years ago. Thus, the Chamber of Commerce of Florence remains, at this moment, the only Chamber in the whole country to have BUSARL almost complete (including companies with registered office in Tuscany and other Italian regions). In the mid-nineties the Chamber of Commerce of Florence ceased the print publication of the the series of bulletins because data started to be available online. At the time that this research was being undertaken, in August 2013, the headquarters of the Chamber of Commerce of Florence where the library is located was being restructured. As a consequence of the project, the library of the chamber was closed and the materials were sent to a special deposit in Valdarno. Hence, those materials could only be analyzed after the restructuration work was completed.

216 See Part I, Chapter 1.
variable I singled out was *Indice di Indipendenza BvD*: A+, A, A-, B +, B, B-, C+, C, D, U. This variable took into account all shareholder with a stake greater than 25% who were individuals. The seventh variable was *Esponenti: Carica* which included the board of directors, the CEO or managing director, situations in which there was a proxy of some kind, advisory board and committee. The results drop to 1,678. The seventh variable I chose was *Ricavi delle vendite: tutte le società con un valore conosciuto ultimo anno disponibile.* There was no alteration in numbers and it still yielded 1,678 results. Then, to streamline the strategy a bit more, I selected the eighth variable *Dipendenti: tutte le società con un valore conosciuto ultimo anno disponibile.* The research gave forth a total number of 1,667 events. Out of this number, I targeted 10 companies which I added to the remaining companies collected from *Bollettino Ufficiale delle Società per Azioni e delle Società a Responsabilità Limitata.* The articles of association of the companies tracked in Aida were made available by the Camera di Commercio di Firenze.

The sample of Italian companies is indicative rather than representative. It does not spell out specific information regarding the dynamics of the company because, in most cases, it was not available. Nonetheless, by screening some of the certificates of incorporation of these companies it was curious to discover that specific relevant acts for the life of the company such as its dissolution would only be registered three decades thereafter. I scrutinized the articles of association (*atti costitutivi*) in the sample to understand if transfer clauses varied according to each company’s ownership and governance structures. I did not find a consistent variation. Most companies’ articles foresaw restrictions on transfers regardless of the nominal value of the shares held by the shareholders or the profile of the management. However, the companies whose articles of association established free transferability of shares had in common a high number of directors or managers and considerable share capital. In one of the companies the board of directors might be composed of up to 7 members. Furthermore, the board could appoint a technical committee which might have up to 14 elements. This hints at the notion that private companies, in practical terms,

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217 See Yanagisako, Sylvia Junko, cit., p. 50 and pp. 51-53 (recalling the stories of Italian firms, she collected bit by bit ‘Stories the State can Tell’. She also reports that there were systematic omissions in the information provided. These exclusions were mainly related to the involvement of relatives and non-relatives as partners and investors in the firm. She treats these omissions as systematic exclusions, the reason for which she ignores).

218 This was the case of the company Astuccifio Cadorino Di A. Fanton & C. – SrL, with registered office in Calalzo di Cadore. This company was incorporated in 1947. It was dissolved in 1957. This fact only was communicated to the Commercial Registry of Belluno in 1993.

219 I am referring in the text to the company Svemar – Società di Studi e Iniziative per lo Sviluppo Economico delle Marche – Società a r.l. This company was incorporated in 1960 and dissolved in 1970. Its registered office was in Rome.
were similar to public companies in that they would not impose such restrictions. Still, other companies’ articles foresaw the free transferability of shares when the number of board members was not high. Other circumstances in which shares could be freely transferred implied reference by the articles of association to the default rule.

Database Aida also provided a BVD independence indicator, which I analyzed with respect to the 10 companies I selected on this database. All but two of these companies revealed a high level of dependence on their shareholders, which reportedly have a recorded direct ownership of over 50%. The articles of association do not deviate from this line. Despite attributing wide powers of direction and representation to managers or directors, they ensure that the supervision of the management is in the hands of the shareholders through their resolutions at general meetings and a supervisory board - the *collegio sindicale*. This picture is manifestly different in the United Kingdom, as we shall see below. Additionally, some of these companies, but not all of them, were indicated in Aida to be very large companies. This suggests that in a country where the motto ‘small is beautiful’ is taken seriously, Italian PLLCs are not necessarily small in terms of earnings, number of employees, and the respective corporate group.

It is worth mentioning that the period between 1950 and 1970, in which part of the companies in my sample were incorporated, was one of great economic development in Italy. These two decades have been considered the ‘golden age’ or ‘miracle years’. This period is comparable to the *Wirtschaftswunder* in Germany and to the *Trente Glorieuses* in France. Moreover, during this period, most small competitive firms, operating in the textile, clothing and consumer goods industries, in general were incorporated in North and Central Italy. This justifies the collection of articles within this timeframe and the selection of companies whose registered offices were geographically located in these regions.

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220 Italy is known for its luxury goods and family owned firms such as Gucci, Salvatore Ferragamo, Benetton, and Fiat to name a few. All of them started as small businesses which grew bigger due to the art of designing and craftsmanship conveyed by older to younger generations of entrepreneurs.

221 See Castagnoli, Adriana, ‘Piccoli e Grandi Imprenditori’, in Cardini, Antonio (ed.), *Il Miracolo Italiano (1958-1963)*, Bologna, Il Mulino, 2006, pp. 69-85 (84) claiming that ‘…fu la miriade di imprenditori a capo di piccole e medie imprese che contribuì diffusamente alla crescita del paese. E l’attuale capitalismo italiano, di cui sono emblema le medie aziende, a proprietà e controllo familiare, divenute talora leader mondiali in alcuni prodotti altamente specializzati e in particolari, importanti segmenti produttivi, ha tratto per molti aspetti origine e linfa dall’universo impreditoriale del miracolo’) (’it has been the number of entrepreneurs at the head of small and business enterprises that has widely contributed to the growth of the country. And the current Italian capitalism, whose midsized businesses of property and family control are emblematic and which have become world leaders in some highly specialized products and in particular production segments, has been created and nourished in the universe of entrepreneurship of the miracle’). Also see Cohen, Jon, and Federico, Giovanni, *The Growth of the Italian Economy 1820-1960*, Cambridge, Cambridge University Press, 2001; and Battilani, Patrizia, and Fauri, Francesca, *Mezzo Secolo di Economia Italiana 1945-2008*, Bologna, Il Mulino, 2008.
Most articles of association of the companies selected provided restrictions on transfer of shares. Those restrictions consisted of clauses requiring the consent of other shareholders to the transfer (clausole di gradimento), clauses granting shareholders pre-emption rights or rights of first refusal in the transfer (clausole di prelazione), clauses prohibiting the pledge of shares and their usufruct (clausole impeditive e limitative del pegno e che limitano il godimento), and in limine clauses absolutely prohibiting any kind of transfer (clausole di intrasferibilità assoluta). In some cases and similar to the articles of association of Spanish companies as it will be apparent below, the requirement of consent incorporated the exercise of pre-emption rights. In other words, obtaining consent to a transfer would depend on a choice of other non-transferring shareholders to exercise their pre-emption rights or not.

Additionally, I created a sample of 16 contentious disputes regarding transfer of shares of PLLCs adjudicated by Italian courts between 1988 and 2011. These cases were collected from the Italian database De Jure. They suggest that the introduction of restrictions on transfers in the companies’ articles of association continues today.

III. Market

i. Bargaining failures in the middle of a back-and-forth movement towards regeneration and preservation of the status quo in the company

The case law selected can essentially be divided into (i) an interpretation cluster and (ii) an un-consented transfer of shares cluster. Court decisions show that shareholders seem not to understand or want to abide by the rules they have introduced in the articles of the company. At a certain moment in time, these rules seem not to operate according to their expectations. As in the Portuguese and French cases, this too leaves in doubt the effects of un-consented transfers and shareholders’ property rights. This state of affairs begs two questions. First,

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223 See Yanagisako, Sylvia Junko, cit., p. 141 (reporting the frequent process of sloughing off of relatives as a form of betrayal and consolidation of the ownership and control of the company in the hands of lineal descendants of the owner. She describes this phenomenon in the context of the conflicts and struggles among subcontractors. However, she equates these conflicts with negotiations and struggles over ownership and control, concentration and dispersion of capital involving members of family companies in the upper echelon of Como’s bourgeoisie. The focus of the struggles, however, is different. Whilst as to subcontractors - the lower portions of the bourgeoisie - conflicts refer to the control of technical knowledge and labour, in the upper-echelon firms of Como’s bourgeoisie focus is put on the accumulation and dispersion of financial capital. I reckon that often these situations are neither public, nor do they turn into contentious disputes adjudicated by the courts. They are settled
why is it that shareholders feel the need to introduce restrictions on transfers at the outset? Second, how much autonomy do shareholders really need?

Yanagisako in her anthropological study about family firms in Italy submits that in the early years of a firm’s development, sentiments of trust and solidarity made possible the pooling of labor, greater flexibility in its organization and the deferral of compensation which, therefore, enhanced a firm’s competitiveness. Conversely, as the firm and its legal structure matured and members from the second generation were recruited, limits to firm growth came to be viewed with distrust and suspicion. These sentiments provoked antithetical movements such as the division of the firm, the diffusion of technology, and the destruction of families. Yanagisako, interestingly, presents trust and betrayal as inherent aspects of the struggle over production and of the power to exclude others from a company. Moreover, this seemed to fuel the creation of new companies by members who had left. Trust and betrayal are seen by her as forms of regenerating family capitalism. Although based on an anthropological view of the family firm, this argument may provide a clue as to how much autonomy shareholders need. This regenerating effect could indicate that the existence of no restrictions on transfers represents a better alternative. The argument, however, that betrayal and trust drove production and reproduction in Italian family capitalism, although intriguing and possibly true, does not explain why restrictions on transfer of shares were and still are introduced in the Italian società a responsabilità limitata.

First, although many companies in my sample were family companies, not all of them were family companies. Second, capital contributions could be in kind or consist of the supply of specialized work by the shareholder. For someone who has lived in Italy and is acquainted with the saying piccolo è bello, this is easy to understand. Also, the management was frequently attributed to shareholders. Hence, imposing restrictions would work as a form to preserve human capital. Third, self-financing may be one of the answers explaining the need members have to impose restrictions on transfers at an early stage of the company. This may not be the case once they have steadily established their business in the market, and their ownership rights are well defined. Then, it is understandable that shareholders might want to

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225 This idea of a regenerating system is explored throughout the dissertation, in particular in Part III.
plan other forms of outsourcing their financial needs and the company’s development.\footnote{226} The point in question is how the credit system and schemes of corporate finance within the context of a country adopting liberal economic measures, but with a civil society tending to promote the ‘insiders’ rather than the ‘outsiders’, influence the way members of the società a responsabilità limitata transferred their shares and altered the ownership structure of their company. While analyzing the articles of these business associations (atto costitutivo) and the companies’ by laws (statuti) presented to the notary public for the incorporation of the company, and subsequently published in the Official Gazette (Bollettino Ufficiale) or deposited at the Court of Florence (Cancelleria del Tribunale di Firenze), I often found receipts or proofs of payment of the initial share capital.\footnote{228} These were additionally published together with a Decree (Decreto) showing the order of the court (normally with jurisdiction over the city where the company had been incorporated) determining the articles be published.\footnote{229} From the analysis of these documents it was not possible to learn the source of finance of the start-up company. I assume that most of them were self-financed. However, this assumption and its relationship with the introduction of restrictions in the articles have yet to be tested.\footnote{230} Fourth, the reason for restrictions on transfers may be found in the diffusion of technical knowledge of lawyers. Often, as in the Portuguese and French cases, transfer clauses introduced in the articles of association were structured in the same way and featured a similar wording.

\footnote{226} See the United Kingdom case below and the practices surrounding the issue of preference shares and debentures by private companies. Additionally, see Jefferys, James B., \textit{Business Organisation in Great Britain 1856-1914}, New York, Arno Press, 1977, pp. 213-292 (referring to the issue of preference shares, the use of debentures by public and, in particular, private companies, to raise capital, and founder shares. Many of these practices were not regulated, at least not until 1907). Also see \textit{The Economist}, Italian Business, ‘Brave the World: Backs to the Wall, Italian Companies are Turning to the Markets’, 4 January 2014 available at URL: \url{http://www.economist.com/news/business/21592657-backs-wall-italian-companies-are-turning-markets-brave-old-world} (accessed on 24 April 2014) (recently reporting that ‘Old-style family businesses dealt with local banks and thought in terms of doing business within their region. Now entrepreneurs think more globally from the start. Their age and vision leads to their interest in accessing capital markets and their ability to do so’).

\footnote{227} I am referring to the period of the ‘golden age’ or the ‘miracle years’ with reference to which the sample of articles of association was created. On this see Castagnoli, Adriana, cit., p. 83 (noting that the Italian credit system was historically extremely politicized and rested on an extensive and closed network of local, social, and political relationships. Those closer to the political party of the government and well connected in the Catholic world were more likely to move upwards in Italian society. In her opinion, this helps to explain that the spread of small and medium-size enterprises has remained a long-standing pattern of the development of Italy).

\footnote{228} Most likely, the company would only be registered if the promoters showed that the share capital had been paid up.

\footnote{229} Other times, only information as to the deposit of the articles with the court and their register with the Companies Registry was provided.

\footnote{230} A possible assumption is that founders could have borrowed the money. An interesting point to explore is whether creditors would prefer to lend money to the individuals or directly to the company.
1.4 SPAIN

I. State

i. The creation of the sociedad de responsabilidad limitada: from outlaw enterprise to legal business association boosted by jurisprudence, notarial practice, and the political values of franquismo

Spanish legislation took even longer than its Italian counterpart to create a legal framework for the PLLC – the sociedad de responsabilidad limitada. A Bill on the Legal Regime of Private Limited Liability Companies (Proyecto de Ley sobre el Régimen Jurídico de las Sociedades de Responsabilidad Limitada) (the ‘Bill’) was published in 1952.\(^\text{231}\) As it is mentioned therein, the PLLC had been to that point entirely subject to private autonomy. The adoption of the Law 17 July 1951 regulating publicly held companies was an incentive for the creation of the legal regime of the PLLC which had been demanded by the business community and scholars for some time.

The abandonment of the PLLC by the Spanish legislature devoted this business association to the uncertainty of its nature and character and, therefore, to the uncertainty of the legal regime applicable. The adjudication of the Supreme Court (Tribunal Supremo) and the work of notaries based on the dictates of the Directorate General of Registries (Dirección General de los Registros) developed the PLLC from the bottom to variant degrees.\(^\text{232}\) I analyzed documents issued by notary publics and articles of association of private companies incorporated in Madrid between 1871 and 1887, long before the PLLC would be formally adopted in Spain almost one century later. These documents were provided by the Archivo Historico de Protocolos de Madrid. Clearly, notaries played an important role in defining the legal nature of these companies. Their legal form was different then, but their nature was that of private companies with limitation of responsibility of their members. Nevertheless, because there existed at that time no legal form to fit private firms in Spain, the jurisprudence and notaries were often compelled to apply the rules of public limited companies and partnerships. This echoes the French case. Even upon their incorporation, PLLCs were often designed as

\(^{231}\) See Boletín Oficial de las Cortes Españolas, 29 de Diciembre de 1952, n.º 415, p. 7796.

\(^{232}\) I tabulated information contained in five deeds of incorporations of private companies in the ‘community of Madrid’ as of 1871 to 1887, that is, before the LSRL was adopted in 1953. Notaries played an important role in defining the legal nature of these companies. They were different, but their nature was that of private companies with limitation of responsibility of their members to variant degrees.
public limited companies, partnerships with limitation of responsibility, or as a combination of different legal forms. All of them were ill-fitting. Despite their dexterity, lawyers, jurisprudence and notaries were regulating in the dark. The adoption of the legal regime of the PLLC was meant to plug up a hole. The legislative process was triggered by the implementation of a legal framework for publicly held companies with the Law of 17 July 1951.\textsuperscript{233}

According to the Bill, the conception of the PLLC should be based on principles of great elasticity to allow their members to bargain as much as they wanted or needed to, provided that that would not violate the basic principles of the new corporate form. Spanish legislators were not so interested in getting drawn into the discussion frequently dividing legal scholarship regarding whether the PLLC was a personalistic or capital company. While defining the PLLC’s legal form, these legislators were driven by principles of greater flexibility than those in which the publicly held company was laying down. It was intended to introduce into Spanish law a new corporate form that, on one hand, limited the responsibility of its members and, on the other hand, was an efficient tool which small and medium enterprises could easily use without having necessarily to choose an ill-fitting form.

The PLLC was created in 1953 with the Law of 17 Julio 1953.\textsuperscript{234} However, the riddle is: What took Spain so long? Susana Martínez-Rodríguez explains that the Srl had been used successfully since 1919, due to the passage of the Regulation of the Commercial Registry determining the registration of these companies. This success might have been related to the post-World War I economic boom. She also submits that the lack of regulation of the Srl in Spain, a country with a strong civil law tradition, was exceptional. She finds the explanation for this in the Spanish Commercial Code of 1885 which despite providing for three types of business associations – the partnership, the limited partnership and the corporation – allowed members to create forms that suited them best. She argues that this ‘odd’ behavior created a platform for legal innovation through practice and experience similar to what happens in countries with common law.\textsuperscript{235} In other words, she bases the development of the Srl upon a principle of \textit{numerus apertus} which led lawyers and other stakeholders to create the Srl. My research shows, however, that this phenomenon is not exclusive to Spain. Even in France,

\begin{footnotesize}
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  \item \textsuperscript{233} For an excursion into the historical development of the Srl in Spain see Martínez-Rodríguez, Susana, ‘¿Sin Ley y Dentro de la Legalidad?’, DT-AEHE N.º 1304, Asociación Española de História Económica, March 2013. Before Susana published this article, which she sent to me directly, I had the opportunity to discuss with her my views on my topic, including the Spanish case.
  \item \textsuperscript{234} As it will become apparent below, this law was altered by two major pieces of legislation: Law 2/1995, 23 March, and the Royal Legislative Decree 1/2010, 2 July, which approves the consolidated legal regime of Spanish companies of capital (\textit{Ley de Sociedades de Capital}).
  \item \textsuperscript{235} See Martínez-Rodríguez, Susana, ‘¿Sin Ley y Dentro de la Legalidad?’.
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where Martínez-Rodríguez says the Commercial Code adopted a principle of *numerus clausus* of business associations, lawyers, jurisprudence and notaries bypassed legal loopholes and helped create the PLLC from below. The fact that Martínez-Rodríguez does not evaluate the Srl from a contractual perspective and that she makes no reference to manifestations of political and economic path-dependence may explain why she does not go as far as explaining why the law by itself was not enough to consolidate the new business form for almost an entire century.

In my view, for the Spanish legislator, creating a law for the PLLC was a question of timing. After the Law of 17 Julio 1951, a reform of the legal regime of public companies was implemented, and adopting a legal framework for the PLLC appeared the right thing to do. In terms of context, the analysis of several documents, namely regulations (*circulares*), issued by the Ministry of Industry (*Ministerio de Indústria*) and the General Directorate of Industry (*Direcção Geral de Indústria*) between 1942 and 1958 showed that the number of requests for the creation of new industries (*nuevas empresas*) increased dramatically. Matters discussed in these letters, regulations and documents, in general, were especially administrative in nature. Despite having not been possible to relate this with the adoption or increase of limited liability companies in Spain, it was still possible to learn that often requests for the authorization to create new industries were denied by the General Directorate of Industry. Several arguments were presented to justify the denials. One was that there were too many family firms in the country. Considering that in these companies regulations, especially those pertaining to labor, administration and taxes were easily breached, the government decided that an overload of family companies would create a true economic disequilibrium. It was submitted that the reduction of the industry to small firms would render them invisible to the public eye and thus to surveillance of their legal compliance as well as of their syndical and social obligations. 236 I discovered that not infrequently, a request for the creation of a new industry would encounter massive opposition from private interests, such as those of other entrepreneurs running similar businesses. This opposition was also evident when stakeholders were members or wanted to become members of national or provincial syndicates. 237 Members of these syndicates were also entrepreneurs operating in the same industries, and they erected all manner of obstacles to competition. This was, therefore, a scenario wherein creating a scheme favoring the

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236 This information was collected from the *Archivo General de la Administración*, by analysing records of the High Council of Industry (*Consejo Superior de Industria*), box 71/6324.

237 Syndicates were essential organisms in the economic organization of the state which should have objective information to help the state to decide. It seems that neither the Industrial Delegations nor the Dirección Geral were fully fledged independent organisms.
incorporation of more firms was generally out of the picture. The analysis of documents collected at the Archivo General de la Administración suggests that there was an expansion of national industries, at least in the decade of the 1950s. This augment of new firms would likely put at stake the position of older firms, which, without competition, benefited from a situation of monopoly on the supply side.

The PLLC was mentioned for the first time in Article 108 of the Commercial Registry Regulation (Reglamento del Registro Mercantil) adopted on 20 September 1919. It was then referred to in the Profit Contribution Act (Ley sobre Contribución de Utilidades) of 19 April 1920. At this point, the admissibility of this kind of company as well as its legality was being debated. Those advocating its lawfulness based their arguments on the predicaments of Article 122 of the Code of Commerce of 1885, which established a principle of freedom of types and forms of companies. Those against it, including the Academy of Legislation and Jurisprudence of Barcelona (Academia de Legislación y Jurisprudencia de Barcelona) which dedicated a closed session to the topic in 1905, maintained that the absence of a legal framework rendered dangerous the constitution of the PLLC. Back in 1909 the Chambers of Commerce (Cámaras de Comercio) asked the government in a meeting taking place in Valencia to cover the legislative gap and provide for a regime for the PLLC. In 1914 the Academy of Legislation and Jurisprudence of Barcelona drafted the basis for a bill. In 1918 the Minister of Justice, Roig y Bergadá, developed a bill on the PLLC which was disregarded due to a political crisis in the government. In 1926 the Bill on the Code of Commerce provided rules regulating the PLLC, but they were withdrawn.

In sum, the Bill was created to fill in an obvious legal hole to which the state was indifferent for more than fifty years. There is in the speech of the Ministry of justice delivered to the Justice Commission in which he presented the Bill a manifest intention to associate the program of economic development of the Francoist Movement to the law. It is reminiscent of the Italian case. In fact, corporate legal forms were adapted to the social and economic realities at the time. Looking back at the evolution of business associations in Spain, the Minister conveyed the following information. Partnerships were being created in increasingly fewer numbers. The tendency was to create forms that limited the responsibility of members. Between 1947 and 1951, 1,237 partnerships had been created with a total share capital of 691.2 million pesetas, against 3,521 PLLCs with a total share capital of 1,200 pesetas, and

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238 This information was collected from the Archivo General de la Administración, box 71/6324.
239 See Boletín Oficial de las Cortes Españolas, Sesión del día 13 de Julio de 1953, No. 434 p. 8156.
240 See Boletín Oficial de las Cortes Españolas, Sesión del día 13 de Julio de 1953, No. 434 p. 8162.
3,880 public companies with a total share capital of 12,049 million pesetas. Small and medium enterprises tended to adopt the form of the PLLC. In the words of the Minister, approving this Bill would promote the principle of legal certainty, as it was proclaimed in the *Fuero de los Españoles* (art. 17)\(^{241}\), and the principle of justice as an informing principle of the Spanish system of law. Like the Italian context, which has been historically the stage for corporativism and fascism, it is interesting to see that in Spain legislators opted for a legal regime based on private autonomy and great flexibility of legal solutions for the PLLC, even if in a political context of dictatorship.\(^{242}\)

The Spanish PLLC was built by jurisprudence, but mostly by notaries. Again, law came afterward, as a byproduct. I am, thus, interested in the eclectic nature of the PLLC, which can be grasped by the clauses of their articles of association. These were the concrete sources of inspiration for the legal solutions, despite the political values informing the reform. I have collected a sample of fifty-five articles of association which have been selected from a number of articles that were sent to me by the Commercial Registry of Madrid.\(^{243}\) Articles were also collected from the *Archivo Regional de Madrid*. In both cases, I have requested articles of association which had been adopted not only under the Law of 17 July 1953, but also under the subsequent Law 2/1995, 23 March, and the Royal Legislative Decree 1/2010, 2 July. A scrutiny of the articles in this sample suggests that most articles of association display restrictions on transfer of shares. Moreover, they are drafted in a very similar way. As we shall see in more detail below, this fact has distinct similarities with the Portuguese, French and Italian cases.

\(^{241}\) See Boletin Oficial del Estado, No. 199, 18 July, 1945, pp. 358-360. This law guaranteed fundamental freedoms to the Spanish people. Nevertheless, it was seen by many as a political cloak with which to hide the true intentions of the regime.

\(^{242}\) In this sense it is relevant to read article 16 of the *Fuero de los Españoles*. It establishes that ‘Los españoles podrán reunirse y asociarse libremente para fines lícitos y de acuerdo con lo establecido por las Leyes. El Estado podrá crear y mantener las organizaciones que estime necesarias para el cumplimiento de sus fines. Las normas fundacionales, que revestirán forma de Ley, coordinarán el ejercicio de este derecho con el reconocido en el párrafo anterior’.

(‘The Spanish people may freely assemble and associate for lawful purposes and in accordance with the provisions of the law. The State may establish and maintain organizations that it considers necessary for the fulfillment of its purposes. The ground rules, which will take the form of law, coordinate the exercise of this right recognized in the previous paragraph’).

\(^{243}\) I thank Don Manuel Casero and his assistant Alicia Martin for having met with me at the Commercial Registry of Madrid in May 2012, and for having sent to me articles of association of *sociedades de responsabilidad limitada*, which otherwise would have been very difficult, if not impossible, to obtain.
ii. The PLLC out of the dark: Flashbacks from the legal regime of transfer of shares and its reforms

Article 20 of the Bill established a preemption right in favor of the non-transferring members and the company. The transfer of shares was viewed as dualistic in nature – individual and collective. That is to say, it affected not only the individual sphere of the transferor, but also affected the company and non-transferring members. There was the overall understanding, which was disclosed by the Ministry of Justice in his communication, that there were two extreme positions incompatible with the legal nature of the PLLC. One was absolute prohibition. The other was free transmissibility without any restrictions. The first position coincided with the model of the partnership. The second position was that of the publicly held company. Spanish legislators adopted an in-between position. This becomes apparent in a review of the relevant legal provisions on this matter.

Article 20 of the Law of 17 Julio 1953, pretty similar to its version in the bill, foresaw pre-emption rights for shareholders and for the company if shareholders did not wish to exercise them. In particular, the first paragraph of the article provided that shareholders wishing to transfer their shares to a person foreign to the company should inform in writing the members of the Board of Directors so that, within the deadline determined by the law, they could inform other shareholders about the transfer. The purpose of this communication was to give the chance to non-transferring shareholders to exercise their rights to pre-empt. If, once the deadline was passed, neither the company, nor shareholders had exercised their pre-emption rights, the transferor would be free to sell her shares in the form and matter she deemed appropriate. Notwithstanding this possibility, the fact is that this was a default rule. Article 20 also established that the deed of incorporation of the company could determine other agreements and conditions for the transfer of shares. However, the law said that in no circumstances the pact absolutely prohibiting transfers of shares would be valid. Moreover, transfers to people foreign to the company which did not adjust to the provisions of the public deed of transfer, or to the provisions of the law would be void.

This Article was altered by Article 29 of the Law 2/1995, 23 March. This Article established that unless otherwise provided in the articles of association, the voluntary transfer of shares inter vivos would be free between shareholders as well as transfers to spouses, ascendants or descendants of the shareholder or to the companies belonging to the same group as the transferor. In other cases, the transfer would be subject to the rules and limitations established by the articles of association and, by default, the legal provisions. Besides free
transferability, this rule combined a default regime with a statutory one. The clause of consent teams up with the provision of pre-emption rights of shareholders. In other words, the company, if it denied its consent, would need to propose a buyer for the share, and shareholders would have the right to pre-empt. The transferor would be allowed to transfer her shares on the same conditions reported to the company when three months had elapsed since she had made known her intentions to sell the shares without the company having released the identity of the purchaser or purchasers. As to the effects of transfers in breach of the law and the provisions of the articles of association, Article 34 of Law 2/1995 established that transfers of shares which were not adjusted to the law or to the provisions of the articles of association had no effect vis-a-vis the company. This is different from Article 20 of the Law of 17 Julio 1953 that determined voidness in these circumstances.

The Royal Legislative Decree 1/2010 2 July revoked Law 2/1995 and is the most recent historical event of Spanish corporate law. Finally, for the first time in history, legal provisions regarding publicly held companies (sociedades anónimas) and PLLCs (sociedades de responsabilidad limitada) were consolidated into a single law. Moreover, this was an exercise of coordination by which legislators tried to fill in lacunae, and to perfect rules which had been the object of doctrinal debate and jurisprudential dissent to that point. These were some of the reasons underlying the request of the Spanish Parliament (Cortes Generales) made to the government to consolidate the Law of Companies of Capital into one piece of legislation. In addition, Section 4 of Title I of Book II of the Code of Commerce of 1985 on limited partnerships and the Securities Market law were added to the new law.

At this moment, despite the longstanding debate about the nature of the PLLC (i.e., was it capitalistic or personalistic?), Spanish legislation took a position in that debate by determining the PLLC to be a business association with a capitalistic nature. Interestingly, there is a stark normative generalization of legal solutions which had been originally conceived for the PLLC. A case in point is the competence of the general meeting and, in

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244 The Spanish literature does not define the clause of consent established by default by the law as a pure clause of consent. Like the French law, the refusal of consent by the company depends on the company finding buyers – shareholders or third parties – for the shares. See Albert Albert, Pablo et al., Comentarios a la Ley 2/1995 de Sociedades de Responsabilidad Limitada, Madrid, Ed. de Derecho Reunidas, 1995, p. 130 (dwelling on this matter).

245 In July 2010 I was a Visiting Researcher at the Department of Commercial Law of the Faculty of Law of the Universidad Autónoma de Madrid, and had the opportunity to discuss the implementation of the new law with António B. Perdices Huetos. He had had an active participation as an academic in the process conducing to the adoption of the new law.

246 Limited partnerships, publicly held companies and private limited liability companies are defined in Spanish law as companies of capital as opposed to partnerships which are indisputably considered companies delectus personae.
particular, those rules referring to the dissolution and liquidation of companies of capital. These rules were much more developed for the PLLC than for publicly held companies. The fact that Spanish legislators made this choice is based on the understanding that the PLLC, which is also in Spain the business association chosen by most market agents, has assumed for itself a profile that is closer to a capitalistic company than a partnership. This is the opposite view assumed by the French legislature which, as we have seen above, perceived the company with limited liability to be more akin to an enlarged partnership than a narrow corporation.

The fact, however, is that even if from the outside the PLLC in Spain looks like a capitalistic company (despite the lack of requirements for investment in these companies), on the inside it still works as a partnership. Moreover, their regime is fleshed out by a thick secrecy which is difficult to penetrate. This is in line with the alterations introduced by Law 19/1989, 25 July that suppressed the need for registration of transfer of shares with the Commercial Registry. Transfers are executed through a public document and then registered in the register of members. Only if this register is executed can the transferee expect to exercise any shareholder’s rights in the company. Other than this private control, there is no sort of public inside look at the changes of ownership in Spanish PLLCs. Furthermore, Article 28 of Law 1/2010, which is very straightforwardly titled ‘Private Autonomy’, specifies that founding shareholders may include in the public deed of incorporation of the company as well as in its articles of association all agreements and conditions they deem appropriate to establish. Most of these agreements and conditions are only known to shareholders themselves. The allure of this narrative rests on the idea that the flexibility and pro-market nature of legal provisions enabled the Spanish PLLC to develop capitalist features closer to the publicly held company. However, from the inside it developed personalistic features similar to the partnership. (As we will see below, the way clauses of transfer of shares mirror this evolutionary phenomenon is surprising and interesting). Additionally, this becomes apparent with the new wording and legislative options taken by Law 1/2010, wherein were blended general and specific parts of the law, and only the particularities of each business organization were left exposed to the eye of the interpreter.

Article 107 of the Law 1/2010 provides the regimen of voluntary transmission of shares inter vivos in PLLCs. This provision is basically the same as Article 34 of Law 2/1995. Article

247 Currently, the minimum amount of PLLCs’ share capital is 3,005.06 € which corresponds roughly to 3,842.65 US dollars, and to 2,406.12 British pounds.
248 Law 19/1989, 25 July partially reformed and adapted the Spanish commercial legislation in accordance with the European Directives of the European Economic Community (EEC) in respect to corporations.
112 establishes the effects of un-consented transfers of shares and, like Article 34 of Law 2/1995, also determines that transfers which are not adjusted to the legal provisions or to the provisions of the articles of association have no effects toward the company.

II. Actors

i. Transfer clauses in the articles of association and the multiple designs of restrictions on transfers

Like the Portuguese case, rules on transfer of shares of Spanish PLLCs were based on the current practice of members of these business organizations, lawyers and notaries. In practice, restrictions on transfers were frequently introduced because of the mutual trust members had in each other and because of the family nature of the companies. This is a trend that continues today. I collected a sample of 55 articles of association of Spanish SRLs with registered offices in Madrid. These articles were part of documents issued by notary publics and filed with the Commercial Registry of Madrid. Some of them also were filed with the Industrial Registry, and I was able to find them in the portfolio of documents of the Regional Archive of the Community of Madrid. The dates of the articles range from 1951 to 2012. This sample covers not only articles of association adopted under the Law of 17 Julio 1953, but also those adopted under the subsequent legal alterations introduced to the regime of the SRL by Law 2/1995, 23 March; Law 19/1989, 25 July, Law 7/2003, 1 April, Royal Legislative Decree 1564/1989, 22 December, and Royal Legislative Decree 1/2010, 2 July.

All articles of association establish restrictions on transfer of shares. Most of them are verbatim duplications of the legal provisions. The type of restrictions included in the articles range from the consent of the company given by a resolution of the company’s shareholders, pre-emption rights or rights of first refusal, post-sale purchase rights

249 Companies which have a line of business in the industrial sector must register with the Industrial Registry the incorporation of new businesses as well as their alteration, extension, ownership changes, modifications in the registry data, and revisions.

250 See Albert Albert, Pablo et al., Comentarios a la Ley 2/1995 de Sociedades de Responsabilidad Limitada, cit., p. 120 (stating that: “Hasta hoy, son raros los estatutos, de S.A. o S.L. donde faltan cláusulas estatutarias limitativas de la transmisión. En general, há podido decirse que los socios apenas han hecho uso en los estatutos sociales de las posibilidades que el legislador les concede para configurar cada sociedad, com un amplio margen de la autonomia de la voluntad, de modo que los estatutos pactados vienen a ser simples transcripciones de preceptos legales”) (To this day, articles of association lacking clauses restricting transfer of shares are rare. In general, it may be said that shareholders have only in a limited manner made use of the possibilities that legislation has given to them in the articles of association to configure each company, with broad private autonomy, so that the articles of association agreed upon are mere transcriptions of legal provisions).
(implemented through a scheme of notifications), option rights or resgate\textsuperscript{251} in favor of shareholders, the company and third parties, a combination of clauses (e.g., the articles may require that the buyer has certain objective characteristics or qualities; they may submit the transfer of some shares to the rules of the articles of association and leave others under the default regulation of the law; they may establish a system of deferred payment for the transferee).\textsuperscript{252}

The PLLC in Spain was legally conceived from an early stage as a closed business association. In Spain the SRL is clearly a byproduct of a longstanding practice of market agents using this form to accommodate their business interests. Being a closed business association is in the PLLC’s ‘DNA’.\textsuperscript{253} The clauses of the articles of association on transfer of shares illustrate this in their multiple designs. Nevertheless, the fact that the SRL is at the same time perceived by legislation as a capitalist company creates an interesting dynamic regarding the private autonomy shareholders enjoy to design their own company, which is often adverse to unnecessary protectionist measures. This dynamic is suggested by a number of case laws. They are treated in the next section.

III. Market

i. Zooming-in on the effects of the un-consented transfer of shares: disputes over transfers and changes in the ownership and governance structure of PLLCs

Having a corporate law structure and trying to deviate from it leads to litigation. This is precisely what happens with the un-consented transfer of shares. This can be illustrated by a sample of seventeen cases adjudicated by the highest Spanish courts as of 1983 to 2012 and four administrative cases decided by the Dirección General de Registros y del Notariado as of 1995 to 2012. I collected case law from the database Westlaw Spain.\textsuperscript{254} I selected the cases by introducing into the search engine the keywords transmission de participaciones sociales (transfer of shares). Using this set of keywords yielded 3,746 results of which not all were related to the breach of restrictions on transfer of shares in PLLCs. Considering that only a

\textsuperscript{251} Where there is a resgate the beneficiary may buy, under certain circumstances, the shares of the transferee.

\textsuperscript{252} In this sample there are no mandatory buy-sell agreements, which are also a form of restricting transfers. Mandatory buy-sell agreements are included in the American LLC agreements, as we shall see below.

\textsuperscript{253} For instance, Article 30 of the Law 2/1995, 23 March stated that “Serán nulas las cláusulas estatutarias que hagan prácticamente libre la transmission voluntaria de las participaciones sociales por actos inter vivos. (Clauses of articles of association which make practically free the voluntary transfer of shares inter vivos will be void).

\textsuperscript{254} This is an electronic database containing Spanish legal information provided by Aranzadi. This database provides the full text of Spanish legislation and case law of the highest courts. It also provides case law of the European Court of Justice and European Court of Human Rights.
small part of disputes are actually dealt with at court.\textsuperscript{255} I have not randomly chosen these cases. Cases were selected depending on whether their description referred to transfer of shares \textit{inter-vivos} and whether it referred to restrictions on transfers in general, or to the consent of the company to the transfer or to pre-emption rights as a pre-requisite for the execution of the transfer, in particular. The contentious disputes were based on legal issues that I categorized into clusters.

1. \textit{Interpretation}

(i) Problems of interpretation of the law and the provisions of the articles of association, in particular during a transitional period of the law. These problems also occur in the situations where the articles of association are incomplete and refer to a default rule in the law. Frequently, shareholders do not understand the rules and, in particular, they are not aware of the implications of the imposition of restrictions such as pre-emption rights.

(ii) Problems in understanding how legal default rules work (i.e., how pre-emption rights should be exercised and consent of the company be given). Shareholders do not understand the relationship between clauses of consent and pre-emption rights. They also have difficulty following the rules and comprehending how they should be integrated in the articles of association for which they have bargained.\textsuperscript{256}

(iii) The validity of the transfer, the effects of the sales contract as well as the moment when one becomes a shareholder or loses this quality as a result of the transfer of ownership rights in their share.\textsuperscript{257}

(iv) The definition of default and mandatory rules and how this analytic task conditions the negative effects associated with an un-consented transfer.\textsuperscript{258}


\textsuperscript{257} Jurisprudence associates this debate with the nature of consent and the shares in these companies. Furthermore, this debate must be understood within the context conveyed by the \textit{Dirección General de Registros y del Notariado} that articles of association have an \textit{erga omnes} effect. The contractual and organizational aspects of the company are clearly related to the property rights shareholders have in their shares.
Interpretation of contractual clauses. For example, the question as to the deadline to exercise pre-emption rights due to the chain of notifications foreseen by the company’s articles was recurrent. This question, if not properly answered, spurs not only litigation but also many other implications, especially in respect to the company and the liquidity of other shareholders’ shares.

To know when the share sale and purchase contract was concluded, namely if the articles of association impose a chain of notifications to comply with restrictions on transfers.

2. Functionality of restrictions on transfers

(i) Problems in combining the freedom of contracting their own articles of association with the particular closed nature of the PLLC and mandatory rules which determine that the regime adopted by shareholders for the transfers cannot make them practically free.\(^{259}\)

(ii) Problems of shareholders ignoring the law or the clauses of their own company’s articles of association providing restrictions on transfers.

(iii) The imposition of restrictions on transfers which boil down to clauses obliging shareholders to remain in the company for a long period.

3. Un-consented transfers

(i) The un-consented transfer of shares, that is, the transfer of shares executed without the consent of the company, or without the knowledge of other shareholders, and its effects (is it void; is it likely to be avoided by the parties to the sales contract; is it unenforceable toward the company whilst still binding the parties?). In general, courts hold that the un-consented transfer is valid between the parties and is likely to be avoided.\(^{260}\) Arguments span from a legal

\(^{258}\) See, for example, paragraph 4 of Article 20 of LSRL 1953 that established that the un-consented transfer of shares should be void. This was changed afterwards by Law 2/1995, 23 March where it was established that transfers in breach of the articles of association and legal provisions did not have any effects vis-a-vis the company. This is still the rule today, as established in Article 112 of the Royal Legislative Decree 1/2010, 2 July.

\(^{259}\) Article 108 of the Royal Legislative Decree foresees that clauses of the articles of association which make practically free the voluntary transmission of shares \textit{inter vivos} are void.

\(^{260}\) This has also been the understanding in the literature. See Uria, Rodrigo et al (eds.), \textit{Comentario al Régimen Legal de las Sociedades Mercantiles: Régimen de las Participaciones Sociales en la Sociedad de Responsabilidad Limitada (Artículos 26 a 34 de la Ley de Sociedades de Responsabilidad Limitada)(Artículos 35 a 42 de la Ley de Sociedades de Responsabilidad Limitada), Tomo XIV, vol. 1.” B, Madrid, Civitas, 1999, pp. 192-193 (claiming that ‘La ausencia de efectos transmisores de las participaciones sociales y su fundamentación no tiene por qué afectar a la validez del negocio realizado entre las partes. La ausencia de poder
to a social perspective. For example, the court of appeal in case AP Madrid (Sección 9), sentencia núm. 375/2011, 6 Julio (AC 2011\1500) determined that a shareholder who had not obtained the consent of the company was not entitled to use the fact that the transfer did not have any effects toward the company to breach the contractual obligations he had assumed with the buyer. There are other cases where courts discuss the effects of the un-consented transfer of shares in the external and internal relationships of the parties to the sales contract of shares. One case in point is the discussion courts undertake as to whether the lack of consent determines the inexistence of the essential element for undertaking the transmission of property rights in shares. This essential element would be the transferor’s own capacity to dispose of his shares. Some courts in the sample have submitted that if the consent of the company was not obtained, the transferor had an innate incapacity to sell her property rights. However, the causal contract, or in other words, the contract from which contractual obligations derive, is considered valid and enforceable. As a consequence, the transferor would be contractually liable.

It must be underscored that jurisprudence has not always provided a clear answer and unanimous understanding about this matter. In general, there is the tendency for courts to say that the un-consented transfer is not absolutely void. They often consider that the sales contract has effects on the parties to it and, therefore,

261 See Uria, Rodrigo et al (eds.), Comentario al Régimen Legal de las Sociedades Mercantiles: Régimen de las Participaciones Sociales en la Sociedad de Responsabilidad Limitada (Artículos 26 a 34 de la Ley de Sociedades de Responsabilidad Limitada)(Artículos 35 a 42 de la Ley de Sociedades de Responsabilidad Limitada), Tomo XIV, vol. 1.° B, Madrid, Civitas, 1999, p. 188 (saying that legal doctrine and jurisprudence have put aside the effects of an absolute voidness when it comes to the un-consented transfer because that would endorse abusive behavior of the parties who take advantage of the absolute voidness and do not comply with the contractual obligations they themselves have assumed).

262 This understanding is inspired in the principles of abstraction and separation that are prevalent in German contract law. See Horn, Norbert et. al., German Private and Commercial Law: An Introduction (translated by Tony Weir), Oxford, Clarendon Press, 1982, pp. 69-70 at p. 69 (explaining that ‘The principle of abstraction, which has been known to cause problems even to German students, lays down that, while contract and transfer are connected in the sense that the latter is a performance of the former and that the former constitutes a justification or causa for the latter, they are nevertheless to be treated as separate or abstract, even though they often constitute a single unit in legal reality’). This principle contrasts with the principle of consensualism found in Portugal, Italy and France where ownership is transferred by mere effect of the contract. The United Kingdom with the Sale of Goods Act and the United States with the Uniform Commercial Code have adopted similar principles. In both jurisdictions it is understood that ownership is transferred in accordance with the agreement entered into by the seller and the buyer. Both laws, however, accept by default that ownership is transferred when the seller delivers to the buyer the object of the sales contract.
could only be avoided by them through a legal action, and not by an officious declaration of the court.\textsuperscript{263} There are cases referring to the validity of resolutions taken at the companies’ general meetings. For example, courts adjudicated cases in which a director, who was simultaneously a shareholder, purposefully changed the articles of association providing pre-emption rights to other non-transferring shareholders, so that the transfer could be executed without any limitations.

(ii) Problems in combining the exercise of political rights, on one hand, and economic rights on the other, as a result of an un-consented transfer of shares and uncertainty as to who should exercise shareholders’ rights.

4. \textit{Formalities}

(i) Coalitions made within the voting process of the general meetings so that a resolution proposed by a director or the majority shareholder is passed. In one of the cases scrutinized, a shareholder became a majority shareholder after having bought shares in the company without the consent of the company or the knowledge of other shareholders, and tried to dictate his interests in the company’s business.

(ii) Cases of fraud in which the parties to the sale contract determine a shammed price to prevent other shareholders from exercising their pre-emption rights.\textsuperscript{264}

(iii) The transfer of shares executed in disregard of third parties interests. For instance, registration requirements with the Commercial Registry were often not complied with.\textsuperscript{265}

In addition to the case law brought up to the highest Spanish courts, I have also collected disputes which were dealt with by the \textit{Dirección General de Registros y del Notariado}. Some of the cases tackle the following legal problems, which I also frame into the same clusters.

\textsuperscript{263} The court decision AP Alicante (Sección 8.ª), sentencia núm. 303/2011, 14 Julio (JUR 2011\330807) is an excellent example.


\textsuperscript{265} This, however, did not jeopardize the validity of the transfer between the parties to the sales contract.
1. **Interpretation**

[...]

2. **Functionality of restrictions on transfers**

   (i) The conflict between the protection of individual rights of shareholders against the majority, and private autonomy. In these circumstances the opinions of the Dirección General de Registros y del Notariado were given in the sense that the provisions of the articles of association should prevail. Put another way, when it comes to evaluate provisions in the articles of association the important thing is not the protection of individual rights, but the private autonomy and freedom of contract members enjoy.\(^\text{266}\)

3. **Un-consented transfers**

   [...]

4. **Formalities**

   (i) The inclusion of clauses in the articles of association in which the payment of the price of the shares to the transferor is postponed.

   (ii) The alteration of articles of association as to the system of evaluation of shares. This is particularly relevant when the evaluation of the shares is purposefully made below their real value to prevent the transferor from receiving the reasonable value for her shares. This has been viewed by the Dirección General de Registros y del Notariado as a form to jeopardize the rights of shareholders to transfer their shares and objectively obtain a real value for them. This is the case when the price agreed upon is notoriously below the market price.\(^\text{267}\)

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\(^{266}\) Here, a comparison can be made with the United States and the United Kingdom regarding the importance courts give to contracts. They tend to make the parties to the contract accountable for their choices much more than in the other jurisdictions.

\(^{267}\) The value of the shares should not be taken by the accounting value which results from the balance sheet. The Dirección General de Registros y del Notariado, however, recognizes that an extreme application of this principle may create problems of liquidity of the holders of pre-emption rights, which is precisely what the imposition of restrictions on transfers tries to avoid.
These clusters of legal issues within the competence of the Dirección General de Registros y del Notariado are grained with administrative and registry-related questions which did not go to court. Perhaps, this is the reason that the interpretation and un-consented transfer of share clusters are not completed: they are more related to the substantive aspects involving the share sale and purchase agreement and the clauses of the articles of association of the company. However, these administrative cases also illustrate the contentious framework wherein corporate constituencies, especially shareholders, bargained. Both sets of cases reveal the sort of environment in which the relationships between corporate constituencies in the PLLC may evolve.

2. Conclusions

The historical excursion to the Portuguese, French, Italian and Spanish cases was meant to tell three stories: (i) a story of interest groups interfering with the outcomes of legislative policies; (ii) a story of how law is a byproduct of private ordering manifestations; and (iii) a story of the legal evolution of business organizations. Each story is informed by a parameter which is constant in the historical narrative. The first story is informed by the parameter ‘state’ which is linked to the role of legislatures and courts in downloading and designing the new corporate form. The second story is shaped by the parameter ‘actors’. This parameter can, to a certain extent, be equated with the external influence of society in shaping patterns of normative conduct. I focus on the interesting phenomenon that consists of drafting the articles of association based on crossover of legal solutions likely to affect the ownership and management structures of these companies. The third story comes into being through the parameter ‘market’. It can be coupled with economy in a broad sense because it entails an array of choices made by market agents in face of the limited nature of resources in the PLLC. Many of these choices spur bargaining failures that deter development and investment in these companies.

These three stories about the PLLC are told at three levels. There is the level where legislatures and courts operate. There is the level where there seems to be a sort of social commitment led by lawyers and notaries regarding the proliferation of rules for these business organizations, namely through the respective articles of association. There is the level where market agents exchange. These narratives are told differently, yet identically in the four selected jurisdictions.
At the first level, legislatures in Portugal construed the PLLC as an intermediate form between partnerships and the so-called joint stock companies. In France, it was perceived as an enlarged partnership. In Italy, the PLLC was also historically conceived as an intermediate form between the partnership and the joint stock company. It was, moreover, designed to be sufficiently flexible so as to serve the interests of investors wanting to incorporate either small or big companies. In Spain, the PLLC was also drafted as an intermediary between the partnership and the joint stock company. However, unlike French legislation, Spanish legislation framed the PLLC as a narrow joint stock company or corporation. Still at the first level, rules on transfer of shares are legally designed as defaults in Portugal, Italy and Spain. Here, transfer of shares requires the consent of the company, unless it is otherwise established in the articles of association. The French case is different. Transfer of shares requires the consent of the company and/or compliance with other restrictions in the articles of association. This was historically designed as a mandatory rule. However, the majority of shareholders required to consent to the transfer may be opted out and the articles of association may, therefore, provide for a less strict majority.

At the second level, it was interesting to track a phenomenon in which legal solutions crossed over in the relevant jurisdiction, as well as a situation of interstate crossover of legal provisions. This process was advanced by the adoption and drafting of articles of association. The development of interstate crossover was especially evident between Portugal and France, where contracts with a temporal lapse of almost a full century were similarly drafted. Crossover occurred in all selected jurisdictions. It happened in Portugal where legislators decided to mimic the market and substitute the law determining a principle of free transferability for a law providing a default rule establishing restrictions on transfer of shares. The French case shows that legal solutions were adopted as a matter of opportunity. Importantly, legal solutions, once adopted, were an adaptation, that is to say, a byproduct of previous practices and customary actions which were, at a certain point, unavoidably recognized by legislation. The SARL was based upon an existent mold of business association – the société anonyme, which for a long time served (even if inadequately) the goals of all types of firms in France. The adjustment was undertaken by jurisprudence, lawyers and notaries on the sidelines. In other words, they acted as gatekeepers where the initiative of legislators fell short. Nevertheless, there is something unique about the French case. The SARL was subject to mandatory rules which prevented it from enjoying much of the flexibility of the partnership, and of PLLCs in the other selected jurisdictions. The Italian case is an interesting example of how contractual choices of market agents, that is, the introduction
of restrictions on transfers, are framed by the institutional environment. In Italy, the motto ‘piccolo è bello’ has been taken seriously to the point the PLLC became a fundamental unit of economic growth in this country. This is a country where manifestations of social and institutional embeddedness are pervasive, and they should be taken into account in the study of small businesses in Italy. Besides, regarding the microstructure of companies, other factors like labor practices undertaken by the governing bodies of the company, and how the payment of corporate taxes was perceived by the company’s members need to be investigated. This will enable a full understanding of the dynamics of the SrL and the reasons restrictions on transfers were established and changes in the governance and ownership structures are difficult to operate. Also in Spain the PLLC was ‘downloaded’ by legislators. Rules regarding these companies were created and developed by experimentation at the lower level, well before legislators decided to adopt them. When the law was finally enacted, research shows that members of these companies did not take full advantage of the flexibility provided to them by legislation to draft the articles of association their own way. On the contrary, members preferred to transcribe or refer directly to default rules which filled their incomplete articles of association in. Law appears here, once again, as a byproduct and the fact that members chose to use these defaults helped them to maintain a certain status quo, despite the shadow of litigation.

At the third level, it was striking to find that the default rules that parties to the articles of association did not contract around did not prevent their defection by the members. This also happened in France where legislatures have taken a statutory approach to transfer of shares. Even more striking was the Italian case in which a principle of free transferability prevails and, in spite of that, shareholders still introduce restrictions on transfers, only to breach them at a later stage. In many situations, but not all of them, bargaining failures derive from an attempt to maintain a prevailing status quo. In the Portuguese case, opposite conclusions can be drawn regarding the role and importance of the respective default rule: either this norm is very efficient and, as a consequence, shareholders while drafting the company’s articles of association simply comply with the default rule; or this norm is very

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268 The text is pointing in the direction of what is called ‘lavoro nero’ (unreported labor), which is part of the economia sommersa (underground economy) in Italy. Additionally, see Curami, G., ‘Contribuente e Fisco Oggi in Italia’ in Assorel [Associazione Nazionale tra Società a Responsabilità Limitata e Accomandita Semplice], Bolletino Mensile D’Informazione, Anno I, Novembre 1966, N.° 2, pp. 19-21 (In this article Curami stresses the overall distrust of Italian taxpayers of the state and makes reference to small businesses or private companies as forms used to circumvent tax law).
inefficient because it raises transaction costs considerably and has created a lock-in effect.\textsuperscript{269}

The sample of case law suggests that costs resulting from compliance with this rule are not so much associated with measures taken to prevent the respective transaction as with the transaction costs and the costs of disputes such that the rule is enforced.

In sum, these three stories, each of which is informed by its specific parameter, tells a larger story of how the existence of default rules has influenced the historical development of business organization law in the selected jurisdictions.

\textsuperscript{269} As we shall see in Part III, Chapter 1, a lock-in effect can be efficient ex-ante by raising incentives for members to work hard(er) for the success of the firm.
CHAPTER III

DISCLOSING THE PLLC’S LEGAL REGIME THROUGH A HISTORICAL OVERVIEW AND EMPIRICAL EVIDENCE: THE CASES OF THE UNITED KINGDOM AND THE UNITED STATES

Our primary thesis is that the English approach to law is more formal and the American more substantive. As will have been apparent from our insistence that all legal systems rely heavily on both formal and substantive reasons, we are anxious to avoid exaggeration or caricature.


Introduction

This chapter analyses two systems on the two sides of the Pond – the United Kingdom and the United States. It continues to scrutinize PLLCs – the UK’s private company and the US’s limited liability company (LLC) – to understand their principles and their ownership and governance structures. This chapter presents a historical narrative of these business organizations in two common-law countries. The investigation is based on parliamentary debates, articles of newspapers, and literature that reflect the reality of business in the second half of the nineteenth and the twentieth century. In respect to the empirical data, I have analyzed the articles, memoranda of association and other documents of the corporations deposited with the Companies House, United Kingdom dated as of 1888 to 2008. I have studied operating agreements of US LLCs dated as of 2001 and 2012.270 The analysis of these documents was complemented, where data were available, by information collected from the

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270 Due to the fact that LLC agreements are not archived in any organized way and to resource constraints, I limited the spread of the sample to the decade of the 2000s.
Bureau van Dijk’s databases Amadeus\(^{271}\) and Fame.\(^{272}\) Furthermore, in the United Kingdom, I have analyzed manuscripts and assorted documents such as board of directors’ minute books, general meetings’ minute books and shareholders’ registers, reports, private letters, court records not available in databases and stored in historical archives, share certificates, letters sent by companies to the Board of Trade (UK)\(^ {273}\), and communications from solicitors and accountants. The case studies I present regarding the Hay’s Wharf Cartage Company Limited, the use of the private company and the one-man company for tax avoidance, the irregular transfer of shares in the British Stone Marble Company, and the Directors’ Private Minute Book of the Forest Hill Brewery Company, Limited shed light on the profile of the private company in the United Kingdom and the social, economic and political aspects of this type of company. Again, the veil hiding the private sphere of the PLLC is lifted at several stages in this chapter. More interestingly, it hints there was a flux of law not only from the United States to Europe as the Portuguese and French cases suggest,\(^{274}\) but also from Europe to the United States.

This chapter continues the three stories I introduced in the previous chapter. It tells of interests groups influencing the legislative process and of how law is a byproduct of private ordering manifestations. In this context, it highlights the dynamics between private ordering and legislative outcomes. Further, it tells of the legal evolution of business organizations. This chapter continues to address each story from three parameters: (i) state, (ii) actors, and (iii) market. It is structured as follows. Section 1 treats the case of the United Kingdom. It analyses parliamentary debates, the constitutional documents of the company and explains the importance of private ordering to the unleashing of the British private company. In addition, it treats the case study of Hay’s Warf Cartage Company, Limited. It explores the use for tax avoidance of the private company form and the one-man company form. It explores the case of the super-tax and the Finance Act 1927, c. 10. It treats the case of irregular transfer of shares in the British Stone Marble Company, Limited. It scrutinizes the private minutes’ book of directors of the company Forest Hill Brewery Company, Limited. In addition, this section dwells on the types of restrictions established in the articles of association of UK’s private

\(^{271}\) This is a pan-European database which provides financial and business data on the biggest 520,000 companies, by assets, in 38 European countries. Amadeus includes information about standardised annual accounts (consolidated and unconsolidated), financial ratios, sectoral activities and ownership.

\(^{272}\) Fame is a United Kingdom and Irish database wherein seven million companies are listed. This database provides access to information about business associations such as accounts, shareholders, and directors. Searches can be designed according to the industry, location or financial information.

\(^{273}\) The Board of Trade was later known as ‘Department of Trade’ and afterward it received the designation of ‘Department of Trade and Industry’ (DTI).

\(^{274}\) See Part I, Chapter 2 above.
companies and the bargaining failures regarding transfer of shares that are the root of contentious disputes adjudicated by UK courts. Section 2 treats the case of the United States. It examines the reasons that led to the breakthrough of the LLC in the United States. It screens the statutory provisions of the Delaware Limited Liability Company Act and the New York Limited Liability Company Law. It looks at the fashion in which members' interests are regulated in LLC agreements. Additionally, this section reviews some case law regarding the transfer of membership interests in LLCs. Section three concludes.

1. THE UNITED KINGDOM

I. State

i. Parliamentary debates, the constitutional documents of the company, private governance and the unleashing of the private limited company

In 1907, the PLLC (or simply ‘private limited company’ as it is termed in UK legislation) was created, or, more precisely, legally accepted, in the United Kingdom.\(^{275}\) I refer to 'acceptance' because seven years before, in 1900, while the discussion of the Companies Bill was held in the parliament, frequent references to ‘small trading companies’ or ‘private companies’ were made, even though their respective legal form had not yet been created. In the period between 1862 and 1907,\(^{276}\) the political debate about private limited companies was a second-rate one. It was mostly driven by considerations about publicity and transparency made apropos public limited companies, the advantages of promoting combined actions of shareholders through general meetings (particularly in situations where their interests had been defrauded), and the benefits of codification of the numerous ‘Companies Acts’ that had been thus far separated. In the late nineteenth century, the political debate about the private limited company was triggered by the discussion about the abuses of limited liability involving the public company.\(^{277}\) There were several scandals relating to public limited companies, and what some considered their destructive effects on trade, commerce,

\(^{275}\) One can discuss if whatever the United Kingdom had at the time could be qualified as a distinctive form of company. In fact the United Kingdom's private and public companies were hardly distinctive from each other until the implementation of EU Directives in the 1980s. See Edwards, Vanessa, *EC Company Law*, New York, Clarendon Press, Oxford, 1999.

\(^{276}\) I chose this timeframe because 1862 was the year in which the Companies Act, 1862 c. 89 was enacted, and 1907 is the year in which the Companies Act 1907, c. 50 was enacted.

\(^{277}\) This is reminiscent of the Spanish case where the law on private limited liability companies was anticipated by the public debate and enactment of the law regulating public companies.
and commercial morality. These scandals were related with secret payments made by companies to vendors and promoters, the constant practice of underwriting shares, the mortgage of the company’s assets which investors and creditors could only be acquainted with after the winding up of the company, and the plundering of investors by means of company arrangements made on the side. These were some of the ‘evils’, as the parliamentarians called them, deeply associated with limited liability companies and which impregnated the business environment at the time with uncertainty and notorious distrust.\textsuperscript{278}

Law was approached, perhaps unintentionally, with an evolutionary standard. There was this perception, at least, conveyed by some members of the parliament that facilities given by the law for investment had constituted until that moment a means of attracting investment to the United Kingdom. Some thought that if it had not been for the law, hundreds of millions of dollars in capital would have been invested elsewhere.\textsuperscript{279} Hence, in order to preserve those facilities provided by the law, the debate on the importance of setting rules regulating the issue of prospectuses, ‘statutory meetings’ or general meetings, the qualifications of directors and the information to be given as to their position and their fees and commissions, the minimum amount of share capital to incorporate a business, as well as the registration of any mortgages, debentures or other charges was, at times, passionately held.\textsuperscript{280} The vivacity of the arguments was even more notorious when it came to decide whether requirements upholding publicity and transparency in order to prevent the abuses of limited liability aforementioned also should be applicable to private limited companies. It was submitted by some parliamentarians that many of the problems with the public company were due to reckless management and remissness of directors that inevitably caused the winding up of the companies.\textsuperscript{281} However, when considering the case of private limited companies, the views of parliament members diverged. Some took a step back and submitted that private companies should be exempted from tight scrutiny.\textsuperscript{282} Others disagreed because they considered that

\textsuperscript{278} See, for example, HC Deb 24 July 1900 vol. 86 cc1065-160, available at URL: http://hansard.millbanksystems.com/commons/1900/jul/24/companies-bill (accessed on 16 January 2012).

\textsuperscript{279} This idea is interesting as it creates a bridge with Part III and the role of law in triggering patterns of competition between states.


\textsuperscript{281} See, for example, the intervention of the parliamentarian, Mr. Charles McArthur (Liverpool, Exchange) at HC Deb 26 June 1900 vol. 84 cc1139-86 at URL: http://hansard.millbanksystems.com/commons/1900/jun/26/companies-bill (accessed on 16 January 2012) (exhorting the members of the parliament to take measures to prevent managers from evading their responsibilities).

\textsuperscript{282} See the several interventions of the members of the parliament at HC Deb 26 June 1900 vol. 84 cc1139-86 at URL: http://hansard.millbanksystems.com/commons/1900/jun/26/companies-bill (accessed on 16 January 2012). In addition, see Denoon, D.J.N., ‘Capitalist Influence’ and the Transvaal Government during the Crown Colony
some of the worst scandals surrounding not only British companies, but also South African companies, foreign companies and colonial companies in general were related to companies that did not issue prospectuses and did not make an appeal to the public. It was said that companies, including private companies, strategically collected money from the public and then went into speedy liquidation.\textsuperscript{283} As a consequence, for these parliamentarians not only public companies, but also private companies should make the substantive elements of the firm public.\textsuperscript{284}

The fact is that private and public companies were frequently treated as if they were part of a single genre, with no need for further distinctions. Private companies were understood as companies that did not issue prospectuses and did not make an appeal to the public. They were characterized as ‘limited liability companies which divided the capital amongst the partners of the concerns’. They were pictured as companies which had prohibitions upon the sale of their shares outside the particular family interested in the business and in regard to which no cash payment took place. They were viewed as companies which did not have a market for their shares and, therefore, there was no need to turn their ‘family affairs’ public. In this sense, it could be that the political debate was revolving around business organizations with an equivalent form to the closely held corporation in the United States and not always around the PLLC, of which the American equivalent is the limited liability company. United Kingdom law did not establish at this point any definition of private company that could help

\textsuperscript{283} See the speech of the parliamentarian Mr. Butcher (York) at HC Deb 26 June 1900 vol. 84 cc1139-86 at URL: http://hansard.millbanksystems.com/commons/1900/jun/26/companies-bill (accessed on 16 January 2012). It is not clear who was benefiting from these fraudulent practices, but promoters and other persons who intended to profit from them were the most likely candidates. For other opinions pro and con the introduction of restrictions to incorporation and functioning of private companies, namely the issuance of a prospectus by these companies as demanded to public companies for the purpose of transparency, and as to the need to bring up a distinction between public and private companies, see the member of the parliament, Sir Thomas Lea (Londonderry, S.) at HC Deb 24 July 1900 vol. 86 cc1065-160 at URL: http://hansard.millbanksystems.com/commons/1900/jul/24/companies-bill (accessed on 16 January 2012) (claiming that ‘A very large proportion of the manufacturing trade of this country was done by private limited companies who did not appeal to the public at all. The hon. Member who had just spoken asked why private companies should not come under a section of this sort. Where were they to draw the line? The result would be that private limited companies would come under the whole of the provisions of the Bill and it would be against the trade of the country and detriment to the manufacturing and industrial interests’).

\textsuperscript{284} See the opinion of the parliamentarian Mr. Marks (Tower Hamlets, St. George's) at HC Deb 26 June 1900 vol. 84 cc1139-86 at URL: http://hansard.millbanksystems.com/commons/1900/jun/26/companies-bill (accessed on 16 January 2012).
in the categorization of business organizations and private companies, in particular.\textsuperscript{285} Such a definition was only provided by the Companies Act, 1907. Even after 1907, the private-public divide was not clear in United Kingdom’s corporate law.\textsuperscript{286} Consequently, the debate about the private company was rooted in this ambiguity. Another point is that members of these companies did not have to go to the companies’ registry to register the opening of their business. This means there was no sort of public control of the contractual forms taken by these companies or of any other agreements entered into between their members. All things were kept private. This only would not be the case when their members, creditors and third parties ended up together in court to solve disputes among them. In sum, at this moment in history (1862-1907), I would venture to say it was fairly difficult to look directly in the face of private companies. Information about them, their shareholders and any other agreements between them, and between them and third parties were scattered and held private. There was a shared conviction that those agreements did not have to be disclosed. Forms of legal evasion were, consequently, difficult to detect due to the thin line drawn between companies’ forms.\textsuperscript{287}

\textsuperscript{285} See Harris, Ron, ‘The Private Origins of the Private Company: Britain 1862-1907’, Oxford Journal of Legal Studies, vol. 33, No. 2 (2013), pp. 339-378. Harris presents research similar to mine. I became acquainted with this author’s work when I met Naomi Lamoureux at the Department of History of Yale University, in February 2013. Ron Harris argues that the private company was formally introduced in 1907, but, in fact, it evolved informally from below after 1862 and was privately ordered by shrewd lawyers. First, this was not exclusive to the United Kingdom. The research for this dissertation shows that the same phenomenon happened in Portugal, Spain, Italy, and France. Furthermore, it may be that the private company evolved even before 1862. Given that United Kingdom legislation did not distinguish between private and public companies, at least until 1907, Harris fails to clarify whether he is addressing the evolution of small corporations, similar to closely held corporations in the United States, or whether he is addressing the evolution of PLLCs equivalent to the American LLC. In this sense, the reference to the ‘uncorporation’ referring to LLCs, partnerships, and limited partnerships, and which was popularized by Larry Ribstein in the United States, is useful because it excludes corporations (closely held or publicly held) from the outset. One of the ways to sort this out is by learning if articles of association establish restrictions on transfers and, if so, what kinds of restrictions. This work should be coupled with an assessment of the ownership and governance structures and the structure of the market wherein companies develop their business object. Other important elements that help to distinguish between public and private companies and between private companies themselves are the total of the balance sheet, turnover, and the number of employees. See Edwards, Vanessa, cit., pp. 125-127.

Harris uses the Salomon case (Salomon v. Salomon and C. Ltd. [1897] AC 22) for it represents a range of new responses to the emergence of the private company. He refers to the existence of a wide social-economic phenomenon underpinning the adoption of the private company caused by the introduction of general limited liability, following the adoption of the 1855-56 Companies Acts, and caused by freedom of incorporation, pursuant to the General Incorporation Act 1844. This phenomenon illustrates practices regarding the transformation of one-man firms into partnership-like firms. This change of organizational forms was motivated by kinship, family ties, the need to renovate the decision-making process in the company and with the will of the patriarchs of first generation to leave the company to the second generation of owners. I aver that the private company may have evolved in the United Kingdom even before this time frame.

\textsuperscript{286} See one of the interventions of the parliamentarian, Mr. Bousfield (Hackney, N.) at HC Deb 24 July 1900 vol. 86 cc1065-160 at URL: http://hansard.millbanksystems.com/commons/1900/jul/24/companies-bill (accessed on 16 January 2012) (saying that ‘There was no distinction. Every company was in the eye of the law a public company, even though it was what was commonly called a private company’).

\textsuperscript{287} I tried to get the sense of what I discuss in the text by analysing private documents related to private limited companies which somehow were given to the archives of British libraries by their members.
The political debate, additionally, focused on the enforcement of rules. For example, it was argued that it would be desirable that legislation tracked acts of misconduct connected to the formation and functioning of companies. There was an assumed thrust of putting more power into the hands of courts, especially the Courts of Equity, to patch loopholes in the law. The task of strengthening the law in its general principles so that they could be convincingly used by courts was left to legislators. ‘It is better to lay down principles and to trust to the Courts to carry them out’, in the words of one parliamentarian. The common perception was that the legislator would steer the ship of law, and it was widely accepted that the legislative process had a word to say as to the evolution of these institutions. When the private limited company was finally legally accepted, the Companies Act, 1907 defined it as ‘a company which limits the number of its members to thirty and restricts the right to transfer its shares and is prohibited by its regulations from issuing any invitation to the public to subscribe for its shares or debentures’. This definition was altered by the Companies (Consolidation) Act, 1908. It still provided restrictions on the transfer of shares, the limit to the number of shareholders (now to fifty), and the general prohibition of any invitation to the

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288 See the intervention of Mr Bryce (Aberdeen, S.), at HC Deb 26 June 1900 vol. 84 cc1139-86 at URL: http://hansard.millbanksystems.com/commons/1900/jun/26/companies-bill (accessed on 16 January 2012).


290 See Report from the Joint Select Committee of the House of Lords and the House of Commons on the Companies Consolidation Bill [H.L.] together with the Proceedings of the Committee, and the Minutes of Evidence, London, 1908. It is interesting to see in this report how the deliberative process took place, as well as the nature of the considerations made by the members of the committees. Those considerations show that what the members considered the ‘present law’ was based upon several non-legal elements. Additionally, arguments in some instances were far away from being purely legal arguments. For example, besides the consolidation and uniformity purpose all members shared (e.g., the execution of legislation by reference to other Acts, transplantation within legal systems is dealt with, and model articles of association are proposed), importance was given to the ‘likes and dislikes’ of the Colonial Office. Reference was also made to the stakeholders, and who had already commented on the law (the name of Lord Justice Buckley is mentioned several times). It was openly said that the language of this Bill was ‘different’ when colonial matters were discussed. Parliamentarians decided to assign to the courts the task of solving doubts or questions arising under the law, which they decided not to solve by themselves, even though they had the opportunity to do so. Parliamentarians did not solve the questions the law posed, and they deliberately decided to maintain a certain status quo. There were confusing clauses, as parliamentarians themselves recognized, but they preferred to leave them as they stood. Also, the existence of different jurisdictions inside the United Kingdom was considered and kept in mind during the task of consolidation. There was a notorious preoccupation that members of the committees did not preclude their self-imposed rules, especially when evaluating whether any actions would result in an alteration of the law or merely in an addition of explanatory clauses. The political process and the respective deliberations were made while taking into account the decisions of courts. No alterations were introduced if a particular matter had already been settled in court. Law was altered to give the effect of court decisions. Likewise, if a previous decision taken by the political power was put in jeopardy by the task of consolidation, they preferred to keep it. The introduction of amendments to the law was more consistent with the need to keep up with existing laws, and not so much with social practices that would suggest different legal solutions. In sum, the general power to make rules was designed by factors and/or elements outside the legislative process. This renders law a matter of perspective.
public to subscribe for any shares or debentures of the company as the main features of the private company.\footnote{1}

I understand the ‘story’ of the private company in the United Kingdom as an interesting example, among many others, of how parties to a contract do not need the law to come up with their own system of rules. For instance, the existence of unincorporated business organizations is even acknowledged by some companies’ memoranda and articles of association which include them in their definition of ‘company’ along with any partnerships or other bodies of persons, whether incorporated or not and whether formed, incorporated, domiciled or resident in the United Kingdom or elsewhere.\footnote{2} The private company is a good example of a spontaneous system of rules embedded in social practices of businessmen, which filled in the lack of legislation.\footnote{3} Law came afterward as a byproduct of this spontaneous system of rules.

II. Actors

i. The private limited company as a third way: some historical empirical evidence

The private limited company exemplifies how it is possible to overcome the dichotomy between pure considerations of legal autonomy and the functionalism of legal systems. In this

\footnote{1} The Companies (Consolidation) Act 1908 defined private limited company as it follows: ‘Meaning of “Private Company.”’

\footnote{2} See, for example, the memorandum of association of Henry Bath & Son, Limited, drafted pursuant to the Companies Acts 1908 and 1913, 1948 to 1980 and 1985 and 1989. Also see the memorandum and articles of association of Coca-Cola & Schweppes Beverages Limited, incorporated in accordance with the Companies Acts 1862 to 1886 and the Companies Act 1985.

\footnote{3} See Maitland, F.W., ‘The Unincorporate Body’ in Runciman, David and Ryan, Magnus (eds.), Maitland: State, Trust and Corporation, Cambridge, Cambridge University Press, 2003, pp. 9-31, and 52- 61 (p. 59)(stating the following: ‘...we came by our English Anstalt or Stiftung without troubling the State to concede or deny the mysterious boon of personality. That was not an inconsiderable feat of jurisprudence. But a greater than that was performed. In truth and in deed we made corporations without troubling king or parliament though perhaps we said that we were doing nothing of the kind’).
sense, the private company represents an alternative path for institutional evolution. This alternative yields a dynamic approach to law and overcomes claims of static functionalism of law in which rules are designed to stand in immutable relation to the events of life they are supposed to regulate. This cries out for an explanation.

The private company was not foreseen by the law before 1907, but yet it managed to flourish in Great Britain’s business environment, in particular during the second half of the nineteenth and the early twentieth century.\footnote{294} Moreover, this business organization, at least in its origin, seems to prove wrong those framing the development of legal institutions exclusively through the lens of functional arguments. This is so because its growth in numbers until it became the most-used form of business association in the United Kingdom was not consistently accompanied by reforms in company law. Furthermore, the incorporation of these companies before their legal regime was adopted was not registered, at least not in any consistent manner. The Registration, Incorporation, and Regulation of Joint Stock Companies Act 1844 only applied to joint stock companies. The Act provides a definition of joint stock company which does not include the private company. At most, it would be applied to partnerships consisting of more than 25 members. Given that public and private companies were not differentiated by the law, it is difficult to establish any reliable general link between their existence and patterns of economic development. Time and again, private companies were looked at with suspicion by judges and legislators. They were viewed as promoting ways of hiding information and deceiving the investor. Hence, their existence was hindered whenever disputes and fraudulent cases involving members, creditors and investors were taken to court.\footnote{295}

\footnote{294} It is possible to find in the literature reference to ‘private businesses converted into companies’. See, for instance, Jefferys, James B., \textit{Business Organisation in Great Britain 1856-1914}, New York, Arno Press, 1977 (referring to trends of financial structure and investment mechanisms in business organizations – including private and public companies – in Great Britain between 1856 and 1914). In this context, the analysis of a license issued by the Board of Trade pursuant to Section 23 of the Companies Act 1867 following a request of the St. John’s Hospital for Diseases of the Skin, incorporated under the Companies Act 1862 to 1900, suggests that business entities and non-profit associations often struggled to find other legal forms to fit their businesses than those provided by the law. In this particular case, St. John’s Hospital, similar to many other institutions, wished to be registered as a limited liability company. This having been done, the Hospital proposed that an application be made to the Board of Trade under the provisions of Section 23 of the Act of 1867 for a License to dispense with the use of the word ‘Limited’ in the company’s name. The hospital was concerned that the word ‘Limited’ would misrepresent its philanthropic nature, although it wanted to benefit from the limited liability attributable to companies. In other words, St. John’s Hospital was not an association created to make profit. No portion thereof should be paid or transferred, directly or indirectly, by way of dividend or bonus to its members. Adjusting, however, its profile to the legal forms of business associations at the time and subjecting this to the discretionary power of the Board of Trade shows that there were legal loopholes in the law regarding principles of association. These loopholes were institutionally addressed on a case-by-case basis, whether private or public associations were involved.

\footnote{295} See Jefferys, James B., cit., pp. 241-292 (considering the use of the debenture and the problems resulting from it, especially in private limited companies).
The importance, however, of the legal acceptance of private companies for the creation of consistent company law and for economic development by providing suitable investment infrastructures is undeniable. This can be better illustrated by some historical empirical evidence based on the analysis of business records of these business organizations in the United Kingdom at the beginning of the twentieth century. Additionally, an analysis of these records yields the sense that these companies have a peculiar internal dynamic mostly fuelled by close ties binding their members. The power and control creditors have over the company’s management, especially when the company enters into negotiations likely to lead to the alteration of its ownership structure, as well as the political character with which the internal affairs of these companies are dealt with are worth mentioning. These aspects can affect the governance choices made by members of the company such as the inclusion of restrictions on transfer of shares to safeguard certain corporate constituencies’ positions. I illustrate this with the following case studies.

a. Hay’s Wharf Cartage Company Limited

(i) Assessment of the company’s constitutional documents

The example of Hay’s Wharf Cartage Company Limited - a private limited company incorporated on 11 January 1913 – helps to point up my arguments. I have reviewed this company's minute book and register of members. The minute book contained minutes of the general meetings of its members and meetings of the board of directors, as of 29 December 1916 to May 1935. Furthermore, I have examined share certificates as of 1948. The company had a recorded number of 21 preference shareholders and 5 ordinary shareholders. It had 12 directors. Its share capital was £ 2,221,008, divided into 138,292 preference shares of one pound each and 2,082,716 ordinary shares of one pound each. The nominal share capital was initially £25,000, divided into 25,000 shares. This is a private company of considerable size, and records demonstrate that it became bigger over time.

(ii) Distribution of dividends

In a private letter sent by the accountants of the firm - Gray, Stainforth, Newton & Co, Chartered Accountants – on 8 February 1913, it was explained that, according to the register, two ordinary shareholders - Mr. John Edward Humphrey and Mr. John A. Humphrey – both
held 20 shares each. The cheque for the dividend on 40 shares, however, was made payable only to Mr. John Edward Humphrey and Mr. John A. Humphrey’s name was omitted. Judging by the names, both shareholders had a family tie.

(iii) Restrictions on transfer of shares and creditor protection

At an extraordinary general meeting, held at Hay’s Wharf registered office, on Monday 14 June 1920 it was proposed that the articles of association be altered so that restrictions on the transfer of shares could be included. Specifically, it was proposed that articles be altered so that the board could decline to register any transfer of shares not made to another member of the company. It was, however, proposed that sanctions to any transfer of preference shares should not be unreasonably withheld. It was also proposed at this general meeting that another company, which was Hay’s creditor, – Carter Paterson & Co Limited – so long as it should hold at least 20,000 preference shares of the company, should have the right to nominate and appoint one director of the company from time to time, and to remove any director so nominated and appointed. Carter Paterson also had the right to nominate and appoint the successor of a director who ceased to hold office irrespective of the cause. The resolution was also passed in the company’s general meeting that any nomination or removal of a director made under the articles of association should be effected by a notice in writing under the seal of Carter, Paterson & Co. Limited. If at any time Carter Paterson & Co Limited should cease to hold at least 20,000 preference shares of the company the director nominated by it should at once cease to be a director of Hay’s Wharf.

(iv) Membership and corporate governance

Through the analysis of the register of members and the share ledger, it was possible to learn that shareholders stayed in this company for long periods of time. In fact, this was also the case for other companies in respect to which a period of almost 30 years of membership was recorded. The analysis of the register of members suggested that transfers were mostly made to family members or to transferees with whom the transferor had close ties. By reading the minutes of the general meetings, it was also possible to see that one shareholder, always seconded by another, proposed that the companies’ accounts be approved. Furthermore, the same proceedings were used to propose and agree on the payment of dividends. I did not have access to information as to how the company was bound vis-à-vis third parties, nor regarding
the voting procedure in the company’s general meetings and board of directors. For instance, in one of the minutes there was an assignment of debt, sealed and signed by one of the shareholders. It was difficult to say whether this shareholder was also a director of the company. These comments regarding the authority to bind the company in general, are equally valid when at stake were banking arrangements, mortgages and debentures, insurance arrangements, review of the organization of the company, or simply the need to endorse cheques on behalf of the company. It is clear that there were at least one or a few shareholders whose presence in the general meetings and decision-making power in the company was obvious.

(v) Other corporate constituencies: customers and employees

I took simultaneously into consideration the role of corporate constituencies other than shareholders and directors such as customers. For example, in one of the minutes of Whay’s board of directors it is reported that the general manager was asked to prepare, after consultation of the ‘proprietors’ of Whay’s Wharf Ltd., a report showing the effect which recent changes in the arrangements of that company with its customers had had on the volume and remuneration of services supplies by Hay’s Wharf Ltd. There were also reports of the company dealing with trade unions, and decisions being taken as to the attribution of temporary pensions and gratuities to directors, and the increase of salaries of members of the staff.296

(vi) Taxation and new legislation

Minutes of meetings of the company’s board of directors show how costs resulting from increased taxation and recent legislation were a matter of concern for the management of the company.297 In one of those meetings, held on 11 December 1934, the general manager was asked to prepare an estimate of the effects increased taxation and recently approved legislation regulating driver’s hours of work and the maximum loads to be carried had had on

296 The workers are a central concern of the managers. It is recognised by the latter that in particular and important moments for the companies’ business development the labour force is restless. In some cases, it is possible to register an open-ended commitment of directors towards their workers in alleviating any hardship they go through by granting them ‘dearness allowances’ or trying to control the prices of the company’s products in the market. In other cases inducements are offered to employees working in the firm to improve their output. Notwithstanding these measures, labour is admittedly considered a constant source of anxiety within the firm.

297 Costs of business included costs of acquiring new equipment, expenses of transferring household effects from vendors’ depository to company’s premises, taxes, etc.
each department of the company. Claims of efficiency and economy were frequently made in
the context of operation of a company’s specific department.298

b. The use of the private limited company and the one-man company for tax avoidance:
the case of super-tax and the Finance Act 1927, c. 10

I learned by analyzing private letters of businessmen and other communications of the
Inland Revenue as of 1920s that there was a problem with tax evasion and the operation of
legislation dealing with the avoidance of taxes such as the super-tax. The private company
and the one-man company were used as tools to that end. It was understood that legislation
could only come into operation where it was shown that there was an avoidance of super-tax
by the unreasonable withholding of profits from distribution after debts had been paid and
necessary or advisable payments for the maintenance and development of the business had
been made. The need for legislation arose from the fact that the super-tax was chargeable on
the total income of individuals and it was not chargeable upon companies as such. This state
of affairs led to a practice under which individuals turned over their businesses to companies
in which they held all shares and then proceeded to distribute little or nothing in the way of
dividends (in some cases they took their profits from the companies in the form of loans,
which were capital receipts, and did not fall to be included in a statement of total income for
taxation purposes). The ordinary Income Tax was, of course, paid on the full profits of the
business, but the proprietor was only charged with super-tax on such portion of those profits
as he might choose to take by way of salary and dividends. By this means, an increasing
number of rich people sought to evade the full measure of taxation which they should have
borne in respect to their real financial position.299

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298 The concerns members and directors shared about the effect of taxation and legislation on the development of
their business and lock-in of capital are not isolated ones. For example, at the ordinary general meeting of The
Mysore Gold Mining Co., Ltd., held on 1 August 1945 the chairman in his speech referring to the long-term
policy of the company stated the following: ‘Our expectation was that, even though we mined a lower grade of
ore, the higher price we should get for our gold would enable us [the company] not only to pay a modest
dividend, but also to provide funds for capital expenditure. But these plans, unfortunately, went awry. There are
two main causes for this; firstly, the immensely increased burden of taxation both in Mysore and in this country,
and secondly, the increasing difficulty of obtaining essential supplies and replacements both in India and from
this country (…)’. He reiterates that ‘Increased taxation, of course, is the inevitable result of a world war, but the
imposition of the Mysore gold duty in March, 1940, came as an unexpected blow’.

299 Heavy taxation has long been a problem for companies. Interestingly, in a meeting held on 28 February 1910,
the chairman of The Forest Hill Brewery Company, Ltd, as it was written in the company’s Minutes Book of the
General Meetings, stated that ‘in the present conditions of taxation the state was practically a partner in the
Brewing Trade, without liability, as for years the state had taken in duties over 60% of the company’s total
earnings’. See box LMA/ 4453/ M/ 01/ 002 at the London Metropolitan Archives.
With regard to the so-called one-man company, the documents I have scrutinized reveal that members would take care of their matters personally. They had private talks with the members of the Board of Inland Revenue, in the course of which they complained about the application to their companies of the ‘One-Man Company Legislation. Their point was that the profits not being distributed were essential for the proper development of the business, and for keeping up-to-date the equipment of the works. Moreover, members of private companies argued that the procedure which was being followed in the application of the terms of the Finance Act 1927, c. 10 to the assessment for income tax of the profits of PLCs would prejudice the maintenance of adequate financial resources within the company for future business development. Members of private companies contested that the Finance Act 1927 was being used to bring pressure to bear upon such firms as was to distribute a larger proportion of their profits than was desirable.

It was a fact that companies, private companies included, were exposed to fierce competition not only from inside the United Kingdom but also from the United States and from Germany, as there were no taxes of any kind against the importation of competing goods. Furthermore, the level of internalization of some of these companies is noteworthy. They held businesses in Russia, the United States and in Africa. Many competing concerns were carried on either with loss or very inadequate profits. In many cases these unsatisfactorily results had been due to failure to conserve the liquid assets of the respective companies with the result that they had found themselves with insufficient funds. Despite of the avoidance of super-tax, there were still private companies whose directors stated openly that their financial policy was kept uninfluenced by considerations regarding the super-tax. As a matter of fact, their directors recognized that it was not hard to trace the beginnings of the trouble in the insufficient restraint exercised by companies in the distribution of profits with a consequent inability to finance themselves in times of exceptional stress such as the years after the First World War. Nevertheless, private companies, when faced with a proposal to become public companies, which might have resulted in an improvement of their directors’ personal financial position, for some reason would refuse and go on as private.

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300 As described in the preamble of the Finance Act 1927, c. 10 this was an act to grant certain duties of customs and Inland Revenue (including Excise) to alter other duties and to amend the law relating to customs and Inland Revenue (including Excise) and the National Debt, and to make further provision in connection with finance. Article 31 (Provisions relating to super-tax) is germane to this narrative.

c. Irregular transfer of shares in the British Stone Marble Company, Limited

I have also analyzed a complaint as to irregularities regarding a transfer of shares committed by the director of the company British Stone Marble Company, Limited. This complaint was filed with the Board of Trade in November 1908. This was a peculiar case where the question upon which the Board was called to decide was narrower than the case itself: Should the Board of Trade prosecute or not?

I analyzed a letter from the Inland Revenue, dated as of 10 November 1908, letters as of 1909 exchanged between the solicitors’ department of the Inland Revenue, a letter sent by the Secretary of the Inland Revenue, dated as of 17 March 1909 to the company, a letter sent by the Board of Trade requesting instructions to advise on the case involving the company and its director T. M. Thom, according to the Companies Act, 1862 to 1907, the opinion of Mr. Chas H. Sargant, solicitor of the Board of Trade, dated as of 10 February 1909, a reply to this opinion from Mr. R. Ellis Cunliffe, dated as of 11 February 1909, a reply to this opinion from Mr. Sargant dated as of 13 February 1909, a reply to the reply from Mr. Cunliffe, dated as of 15 February 1909.

The case goes as follows. The attention of the Board of Trade was called to the fact that a number of irregularities involving transfer of shares in the company British Stone Marble Company, Limited had occurred. Mr. Thom – the company’s director – according to a return of allotments made on 20 March 1903 had been allotted 6,076 shares, as of 4 to 18 February of that year. The shares had been personally allotted to Mr. Thom (as part of 40,000 shares) regarding a contract dated as of 4 February 1903. They were registered in his name. Yet, between this date and a return made on 19 July 1906, his holding was reduced to 3,247, while his returns from time to time showed that of the difference only about 870 shares had been, in fact, transferred.

An informant to the Board of Trade on this matter explained that when applications for the company’s shares were submitted, Mr. Thom took the opportunity to substitute his own shares. He, thus, dispensed with a transfer in order to conceal that a director was transferring his shares. The Secretary of the Company gave a different explanation. He said that Mr. Thom did not know that shares had been allotted to him, and that he had agreed with the Secretary that certain allotments be made to his nominees.  

Nominee shareholders are not the legal owners of the shares. They hold the shares on behalf of the beneficial owner. This resonates with the French case in which, at least until Law 66.537 of 24 July 1966 (Loi sur les Sociétés Commerciales), managers held a very strong position in the company, almost unremoveable.

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The Board’s view was that the agreement said nothing about allotments to nominees of the director and that it was clear to the Board that Mr. Thom’s explanation was untrue. The Board added that there were no doubts that he had become the owner of the shares and, therefore, he had to be registered as such. The Board of Trade also pointed out that it could not be questioned that he knew he was a member for he had been a director for the whole time. The board also understood that with Mr. Thom’s knowledge, although he never legally ceased to be a member, other people were returned as members in respect of some of these shares while he himself was returned as not the owner of them. The Board of Trade claimed that the loss to the Revenue of the stamp duty properly payable on the transfers was obvious, and investigated whether an offence had been committed under the applicable provisions of the Companies Act, 1862.

d. Directors’ Private Minute Book of the Forest Hill Brewery Company, Limited: What happens when a director is hired without the authority of shareholders?

The Directors’ Private Minute Book of the Forest Hill Brewery Company, Limited is a book where minutes of the meetings of the company’s board of directors were recorded as of 1888 to 1919. The meetings of the board of directors were recorded privately. In other words, arrangements among directors were not made official.303

A fund of the company was created where the directors should pay the sum of £500 to remain on deposit at call bearing interest at the rate of 5% per annum, subject to withdrawal either in part or in full by consent of the Board only, except in the event of the decease, resignation, or retirement from the Board from any cause of any director when under any such circumstances such director is resigning or retiring from the board, or in the event of the decease of any director the executors or administrators of such director should be at liberty to withdraw the said sum of £500 with interest, as aforesaid, made up to take by giving two months notice to the Board in writing.

Nowadays, unless the articles of association provide otherwise, managers are appointed for the duration of the company (Article 223-18, 3rd paragraph of the French Commercial Code). However, back in those days, the law made a distinction between managers holding majority shares and managers holding minority shares, whether by themselves or by nominees. Managers with majority shares were viewed as independent traders with respect to the need to comply with fiscal and social security obligations. Managers with minority shares, on the contrary were perceived as employees of the company. Tax and company law rules were more favorable to employees than to traders. Consequently, it came out as appealing for some managers to appear to be minority shareholders by creating schemes by which her shares were held by others on her behalf. See Le Gall, Jean-Pierre, and Morel, Paul, French Company Law, 2nd ed., London, Longman 1992, p. 49 (explaining this).

303 London Metropolitan Archives, LMA/4453/M/01/003.
At the board meeting held on 14 May 1889\textsuperscript{304} a proposal for purchase of shares of one of the members of the Board of Directors was made. The purchaser tried to show to the Board his capabilities to effectively manage the Forest Hill Brewery Company. The potential vendor explained that in the extent of the arrangement being carried out he would be prepared to resign from his position of managing, but retaining that of chairman at a remuneration of say £150 or £200 per annum. That would imply affecting a saving to the company of about £450 per annum. It was, however, resolved by a majority of the Board not to entertain the proposal as it was thought by the majority to be dangerous to, in any event, interfere with the management of the Brewing department which was being so satisfactorily carried on. This episode illustrates the importance of power, struggle and politics inside a private company. What is interesting is that these agreements are hidden from shareholders, discussed and recorded privately.

Additionally, the reading of the minutes of the Board suggests that discussions were held privately and plans were drawn up on how to convince shareholders to vote for a particular member of the board of directors. Plus, it was agreed that whenever the three members of the Board were present, one of them should always abstain from voting. In the case of an equality of votes the chairman would have the casting vote. It was further agreed in consideration of the chairman and the chairman consenting to the re-appointment of a Board member, that in the event of a vacancy occurring on the Board, the directors would appoint, recommend and support the election of a particular person to fill such vacancy should it be so desired by the chairman. Records of the minutes show that rarely, if ever, did the Board consider whether undertaking these measures would be to the benefit of the shareholders of the company. In this case the Board of Directors acts as an organic institution inside the company, but with no connection to the shareholders.

The case of Hay’s Wharf Cartage Company Limited, the usage of the private company to avoid taxation, the irregular transfer of shares of the British Stone Marble Company, Limited, and the private board meetings of the Forest Hill Brewery Company, Limited show that the perception of the business environment changes dramatically when the focus is rather put on the internal micro-sphere of the private company. Looking at this micro-sphere it allows us to understand that the decision-making process in these companies did not always follow the protocol established in the articles of association, especially if more interests than

\textsuperscript{304} At this point, the private limited company had not yet been accepted by legislators. Data show, however, that in the late nineteenth century, despite the inexistence of a legal regime, members of private companies would define them as such.
those of the members are involved. It also suggests that the private company can act like a player creating effective chains of communication with distinct sectors of the society. The series of narratives given above makes apparent the ability of members of private companies, especially directors, to closely deal with the political and administrative powers. Matters regarding labor, long-term policies of the firm, taxes, and even the healthcare of the community were openly discussed and praise was publicly offered to members of political and administrative bodies who collaborated with the firms and helped them to achieve their goals in business.

I have referred to the private limited company as a ‘third way’ because it constitutes the historical evidence that imaginative skills of lawyers and businessmen have the ability to advance new organizational forms that go beyond legal forms made available by legislators.\(^\text{305}\) The novelty of this finding lies in the fact that it is more than a method where files of companies are analyzed. It is a new method in legal research where social and economic facts are analyzed through the lens of legal knowledge. It involves the realization of a legal ‘due diligence’ by which businesses are evaluated systematically and in context. This is something for which lawyers are particularly ‘vocationed’ and I tend to think that they already were so in the nineteenth century. Private companies are also an example of how spontaneous forms of combining action are still capable of surpassing lengthy court procedures and bargaining failures. Members just create their own practical schemes and try to evade doubtful legal rules to the benefit of their interests in the business they run. (There is a thin line between this and the emergence of agency problems).

The overall social costs, however, and the role this kind of private governance plays in the evolution of legal institutions are reportedly not satisfactory. The political and economic environment as well as cyclical periods of war and peace spiced these business associations up to the point that games of political influence inside and outside the company were essential for the execution of relevant contracting businesses and, consequently, for these companies’ survival. This was so particularly in times of economic hardship.\(^\text{306}\) The many forms of

\(^{305}\) See Macaulay, Stewart, ‘Non-contractual relationships in business: A preliminary study’, American Sociological Review, vol. 28, n.º1, 1963, pp. 55-67 (arguing that, according to his empirical findings, contract and contract law are not always needed. Faced with this preliminary finding, and by providing an answer to the question when contract is then needed, Macaulay attributes to contract a governance nature and explains how it can enable communication \textit{intra} and \textit{inter} firms).

\(^{306}\) Records show that private companies were often able to obtain from some government departments loans at relatively cheaper rates. In many instances, the roles of the Ministry of Labour and Ministry of Transport were important. There was the perception that the plans of the government for dealing with the appalling problem of unemployment could only be met with success if the schemes of financial support and economic development and unemployment relief put forward by local authorities were assisted by the united efforts of all. For a picture of the instrumental use of private companies for the development of infrastructures and the attribution of loans at
private ordering and the context in which they were developed were not always adequate, especially when these companies’ legal framework was not based on laws promoting enforcement, strong property rights, and efficient allocation of resources.

Considering the evolutionary pattern framing this research, the question, then, is whether the third way I have mentioned (the yield capacity private limited companies have to accommodate the interests of corporate constituencies regardless of static legal solutions and functional concerns related to the operation of the legal systems) can be better developed by company law alone or if this field will need to be backed up by contract law, property law and policy considerations favoring jurisdictional competition.

This line of argumentation, however, implies more than a normative argument. Law has the great ability of enabling institutional evolution. Law, however, is as it goes. Therefore, in order to answer the question of the previous paragraph, we need to know first whether we need more or less law, and if it is the case that we need more law than less, how we (or should we) get there. I treat this at a later stage.  

I now turn to the legal features of the private limited company and to the transferability of its shares.

ii. Restriction clauses on transfer of shares established in the articles of association of United Kingdom private limited companies

The United Kingdom has been widely recognized as one of the first countries to provide rules for business associations.  

Crucial reforms in United Kingdom company law in the
nineteenth century were set into motion with the enactment of landmark legislation such as the Joint Stock Companies Act 1844, the Registration Act 1944, the Limited Liability Act 1855, the Joint Stock Companies Act 1856, and the Companies Act 1862 on which United Kingdom companies relied on for most of the nineteenth century. This Act was consolidated by Companies Act 1929, Companies Act 1948, Companies Act 1985, and Companies Act 1989. In the twentieth century, I point out hallmark legislation such as the Companies Act 1907, formally acknowledging the private company. This Act was consolidated by the Companies (Consolidation) Act 1908. In addition, the Limited Partnerships Act 1907 implementing in the United Kingdom the legal framework of limited partnerships was especially significant.309

Today, this engagement of United Kingdom legislators in establishing rules for the operation of companies continues to play a major role. The Companies Act 2006 is yet another example. Private companies are defined therein in Section 4 (1) as ‘…any company that is not a public company’. Section 4 (4) provides that this provision must be read together with the provisions of Part 20 for further distinctions between private and public companies. According to Section 755, a private company must not offer any of its shares to the public. Section 756 provides the meaning of ‘offer to the public’.310 Regarding the nature of shares, Section 541 of Companies Act 2006 establishes that ‘The shares or other interest of a member in a company are personal property (or, in Scotland, moveable property) and are not in the nature of real estate (or heritage)’. Section 544 (1) of the Companies Act 2006 provides that ‘The shares or other interest of any member in a company are transferable in accordance with the company’s articles’. This is not so different from Section 22 of the Companies (Consolidation) Act 1908 which yielded that ‘The shares or other interest of any member in a company shall be personal estate, transferable in manner provided by the articles of the company and shall not be of the nature of real estate’. Apropos the definition of company member, Section 112 of the Companies Act 2006 spells out that

(1) The subscribers of a company’s memorandum are deemed to have agreed to become members of the company, and on its registration become members and must be entered as such

in its register of members. (2) Every other person who agrees to become a member of a
compaign, and whose name is entered in its register of members, is a member of the company’.

This section basically maintains the same wording as previous Section 24 of the Companies
(Consolidation) Act 1908.

I focus on the companies’ articles agreed or chosen by their members. They consist of
the ‘constitutional’ charter of the company by which its members regulate their business. In
the United Kingdom literature, articles of association are drawn as a contract with statutory
nature which links the company to its members and binds the company’s members to each
other. At present, as it has been historically the case, the ‘constitutional rules’ of United
Kingdom companies are spread over their *memoranda* and articles of association. Hence,
technically the company’s ownership structure, the distribution of power between their
members and directors, and the composition of the management body should be possible to
grasp by reading both documents. The difference between *memoranda* and articles is that
*memoranda* are documents which constitute clear evidence of the terms in which members
subscribing them wished to incorporate. Moreover, if the company is limited by shares the
*memorandum* also provides a description of the number of shares and nominal value each
member is subscribing.

I have collected a sample of *memoranda* and articles of association of 29 United
Kingdom companies. Dates of their incorporation range as of 1888 to 2008. By creating this
sample, my main purpose was to learn the type of restrictions on transfers of shares members
introduced in the companies’ articles. Moreover, as research developed and I had access to

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311 In Parts II and III, I develop the term ‘contract for the governance opportunity’ to describe the articles of
association.

312 US courts have yielded a similar understanding. For example, see KANSAS HEART HOSPITAL, L.L.C. v.
IDBEIS 184 P.3d 866 (Kan. 2008) (where the court held that ‘The bylaws of a corporation are self-imposed rules
resulting from an agreement or contract between the corporation and its members to conduct the corporate
business in a particular way, and consequently bylaws are interpreted in the same manner as other contracts’). In
the American literature, see Ribstein, Larry E., ‘The Uncorporation and Corporate Indeterminacy’, *University of
Illinois Law Review*, vol. 2009, 1, 2009, pp. 131-166 (133) (presenting similar arguments regarding the
uncorporation in the United States, that is, limited partnerships (LPs) and limited liability companies (LLCs).
Ribstein argues that ‘Uncorporate business forms rely on specific contractual devices to provide incentives and
managerial discipline, reducing their need to rely on monitoring devices such as owner voting, independent
directors, fiduciary duties, and derivative litigation. The parties, therefore, can tailor their contracts to their
needs, and courts do not need to develop fiduciary duties to deal with a multitude of situations’).

313 Normally, the following formulation is presented in memoranda: ‘We the several persons of whose names
and addresses are subscribed are desirous of being formed into a company in pursuance of this memorandum of
association, and we respectively agree to take the number of shares in the capital of the company set opposite our
respective names’.

314 It is equally interesting to learn how often they do it. However, since this is a qualitative analysis, it only
provides information that enables the reader to glimpse the content of these clauses. It does not provide
quantitative information as a source of statistical analysis.
new data, I became interested in understanding who in these companies has the power to influence the design of rules, and how interests of members and directors can affect the way rules are designed. I created a sample of companies to analyze their memoranda and articles of association through Bureau van Dijk’s database Fame. At a first stage, I designed my own research by selecting on Fame the variables such as country (England and Wales) and type of companies (private limited companies). Subsequently, I streamlined the terms of my search by including other variables such as the company’s name, the registered number, latest accounts dates, latest operating revenue (turnover), number of shareholders, number of employees, number of directors, the company’s status, legal form, date of incorporation, trade and business line description, and BvD independence indicator. I selected 15 companies out of this sample. At a second stage, in order to simplify the search even more, I substituted the variable ‘country’ for the variable ‘city’. I kept all other variables. I singled out 14 companies with registered offices in London. I compared the information I gathered from Fame with the information provided by Amadeus, given that the latter is a pan-European database. Once I sampled these 29 companies, I collected their memoranda and articles of association from Companies House’s records. Information was listed according with the name of the companies, date of incorporation, registered office, number of shareholders, number of current directors, status, employees, BvD independence indicator, share capital, business object and history of the company, and transfer clause. These elements were systematically listed as they were drawn in the constitutional documents of the company at the date of its incorporation. I made an integrated analysis by trying to signal relevant changes to the ‘constitutional’ documents of the companies according with the applicable Companies Acts – Companies Act 1862, Companies Act 1948, Companies Act 1985, Companies Act 1989, and Companies Act 2006. According to the sample above, I clustered transfer restrictions inserted in the articles of association irrespective of whether these restrictions had a procedural nature (e.g., the way consent must be obtained or the terms in which the transfer must be executed) or simply a substantive nature (e.g., the requirement of the unanimous consent of other members). These restrictions, therefore, took several different forms. They can be typified according to the following clusters. It may be the case that

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315 The BvD independence indicator indicates the level of independence of companies with regard to their shareholders. A relevant question as to the BvD Independence indicator is whether these indicators can be split into different categories.

316 Documents of private companies such as memoranda and articles of association are publicly available at the Companies House webcheck: URL: [http://wck2.companieshouse.gov.uk//wcframe?name=accessCompanyInfo](http://wck2.companieshouse.gov.uk//wcframe?name=accessCompanyInfo) (last accessed on 19 March 2014).
1. The board is entitled to refuse, in its absolute discretion, to register a transfer of any share to any person whom it shall not approve as a transferee, without regard to the share being fully paid up or not;\(^{317}\)

2. Any member may transfer her shares subject to the restrictions of the articles;

3. The instrument of transfer of share shall be executed by or on behalf of the transferor and the transferor shall be deemed to remain the holder of the share until the name of the transferee is entered in the register. In the case of a partly paid share the instrument of transfer must also be executed by or on behalf of the transferee;

4. The instrument of transfer shall be executed by or on behalf of the transferor who must sell her share against the payment of a fair value. This value must be fixed between the intending transferor and the directors by agreement, or failing that agreement, the sum will be determined by a chartered accountant (who may be an auditor appointed by the directors);

5. Shares may only be transferred with the unanimous consent of all other holders of ordinary shares;

6. Any share may be at any time transferred by a member to a company which is a member of the same group as the transferor, provided that if the transferee ceases to be a member of the same group as the transferor, it shall forthwith transfer all of the shares held by it to the transferor from whom it acquired them or to another member of the same group as the transferor;

7. The articles recognize that the creation or permission to subsist any pledge, lien or charge over, or the grant of any option or sale, transfer or otherwise disposition of any share (or any interest in the share held by the intending transferor) or if those acts will result in any breach of any of the provisions of any contract the company has entered into (e.g. a loan agreement) they must be forbidden;

\(^{317}\) Prior to the Companies Act 2006, directors could discretionarily refuse to register a transfer. It was, however, well established that a transferee right to be registered as a member remained until and unless the directors actively refused to register the transfer. Moreover, the right of directors to refuse must be exercised without an undue delay. Under normal circumstances this would mean a two-month delay. Now s. 771(2) of the Companies Act provides that ‘If the company refuses to register the transfer, it must provide the transferee with such further information about the reasons for the refusal, as the transferee may reasonably request. This does not include copies of minutes of meetings of directors. This, however, does not diminish the scope of the fiduciary duty of directors acting in good faith (\textit{bona fide}). Also relevant is s. 994 regulating the petition by a company member for an order of the court for instance on the ground that ‘the company’s affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members (including at least himself); or that an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

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8. No share may be transferred or disposed of, and the directors shall not register the transfer of any share unless that transfer and disposal is made in accordance with the terms of any relevant agreement (e.g. between the intending transferor and the directors);

9. Directors must approve the terms and conditions of the transfer in general;

10. The transferor remains the holder of a share until the transferee’s name is entered into the register of members as a holder of it.

First, from the data I collected I learned that most companies in my sample are qualified in Fame and Amadeus under the variable ‘peer group name’ as very large companies (VL). This sample shows that the features of the organizational form do not necessarily coincide with the size. These companies, although private, are not small. This is manifestly different from the reality of Southern European peripheries – Portugal, Spain and Italy – and France. This distinctive trait of United Kingdom private companies is interesting. Often, this group of United Kingdom companies does business beyond the national market’s borders. They have a remarkable presence overseas and are certainly not afraid to show their ‘made-in-the-UK’ logo stamped in the products they export. Additionally, their number of recorded employees ranges from 10 to 6,345 employees. The number of directors associated with the companies is, according with Fame, very high. The highest number of recorded directors of a company in the sample is 166. The number of current directors varies, however, between 3 and 11. The number of shareholders goes from 1 to 3. Moreover, their share capital is generally high, divided into shares of 1£ each.

Second, it became apparent that companies present a low level of independence vis-à-vis their shareholders. The share capital is not widely dispersed due to the low number of shareholders. This is, for the most part, obvious in respect to closed companies. The interesting aspect is that control of the company, at least with regard to the ownership structure and how it can be altered through the transfer of shares, lies with the directors.\textsuperscript{318} In this sample, most directors are individuals who are not shareholders, nor do they have any kind of membership interest in the company.\textsuperscript{319} All these companies have centralized management. This is rather outstanding because normally private companies are recognized

\textsuperscript{318} The articles of association of the company Selfridges Holding Limited included in the sample of United Kingdom private companies provide that shares are under control of directors. By control the articles mean the power to ‘…allot and dispose of or grant options over the same to such persons, on such terms and in such manner as they think fit’.

\textsuperscript{319} The company Total Global Steel Ltd. included in the sample of United Kingdom private companies is one exception given that, according to the articles of association, the director also is a member.
for featuring strong control of shareholders, namely by them taking part of the management of the company. This is the case of Italy, for example, where, as we have seen, PLLCs are strongly dependent on their shareholders and they effectively exert control over the company.

The separation of ownership rights and effective control of the companies suggested by the sample of United Kingdom companies is liable to frame the occurrence of conflicts of interests at the micro-level and agency problems. This is not a new story since Berle and Means. However, they addressed this problem regarding the publicly held company. This scenario in the private company can potentially affect the governance and internal relationships between shareholders and managers in an unexpected way.

III. Market

i. Challenges to property rights of members and their transfer

The internal dynamics of the company and ultimate decision-making power in the United Kingdom private company are emulated by bargaining failures in these companies that fuel contentious disputes. I created a taxonomy based upon 14 cases adjudicated by courts in the United Kingdom regarding restrictions on transfer of shares. Disputes are closely related to the inherently contractual nature of the company’s internal rules. In fact, this contractual approach to the company’s articles is promoted by the Companies Act 2006, and enjoys a longstanding tradition in United Kingdom company law. The Companies Act provides a considerable number of default rules and model articles – Table A or also called ‘optional model constitution’ of the company - which leave much room to members of the company to settle the terms of its internal governance. Most companies, for which memoranda and articles of association were tracked, adopted Table A insofar as it was not altered or excluded by the company’s articles of association. This suggests two things. On one hand, it shows the

320 See Berle, Adolf. A, and Means, Gardiner C., The Modern Corporation and Private Property, revised ed., New York, Harcourt, 1967. Also see Jensen, Michael C., and Meckling, William H. ‘Theory of the firm: Managerial Behavior, Agency Costs and Ownership Structure’, Journal of Financial Economics, October, 1976, vol. 3, No 4, pp. 305-360 (This paper focuses on the behavioral implications of property rights specified in contracts between owners and managers of the firm. It does not work out, however, its application to the very large modern corporation whose owners own little or no equity. Additionally, although this paper refers predominantly to the publicly held corporation, it is of interest to note the contractual approach to agency costs taken by Jensen and Meckling).

321 I address this issue from a normative point of view, in Part II, Chapter 3, where I refer to the need to pierce the ownership veil to understand who effectively controls the company.
contractual nature of the undertaking. On the other hand, it shows that law can actually have a nudging effect.\textsuperscript{322}

The case law I selected covers cases in which the company, its members and directors (in these circumstances often also members of the company) have to face possible changes in the company’s ownership structure. These changes are liable to be brought forth through the transfer of shares in the relevant concerns. Disputes, therefore, are mainly related to the imposition of restrictions on transfers. The nature of such restrictions is signaled by the type of conflicts involving the transferor or intending transferor, other members, directors, and the company. The perception other constituencies such as employees and managers have of the conflict is additionally brought to the fore. These constituencies, like shareholders, also make investments in the company or hold particular interests in it.\textsuperscript{323} The cases cover a range of situations where shareholders’ property rights and their transfer are challenged mainly by contractual frameworks and procedural devices set in the companies’ articles. The legal issues United Kingdom courts had to deal with can be arranged in the same clusters I have used in the previous chapter to treat the market parameter in Portugal, France, Italy and Spain.

1. \textit{Interpretation}
   (i) Cases entailing problems of corporate constituencies, namely members, in interpreting the clause of the articles of association imposing restrictions on transfers of shares.

2. \textit{Functionality of restrictions on transfers}
   (i) Cases dealing with compulsory transfers;
   (ii) Cases dealing with oppression of minority shareholders;
   (iii) Cases dealing with claims of breach of fiduciary duties by members of the board of directors

3. \textit{Un-consented transfer on shares}
   (i) Cases dealing with transfer of shares without compliance of the restrictions imposed by the articles of association.

\textsuperscript{322} This can be compared with the statutory law regulating the LLC in the states of Delaware and New York, which is mostly facilitative. The LLC in the United States, particularly in these two states, is treated below.
\textsuperscript{323} This is in line with contemporary stakeholder theory which tries to analyze how shareholders and other groups in the firm can be residual claimants. See Gelter, Martin, ‘Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debates in a Comparative Light’, \textit{NYU Journal of Law & Business}, vol. 7, 2011, pp. 641-730.
4. **Formalities**

(i) Cases dealing with offers to purchase the shares of the petitioner for a fair value in accordance with pre-emption clauses;

(ii) Cases dealing with the refusal by the directors to register the transfer in the register of members.

It is apparent that parties in a dispute do not know or do not understand the clauses provided by the company’s articles. Parties, or at least one of the parties, happen to ignore the provisions of the articles of association they adopted. For example, directors may disregard the respective rules of the articles of association and delay for an unreasonable amount of time the board meeting to decide on whether to accept or refuse a transfer of shares. In these situations courts have stressed the general principle that a transfer duly lodged should be brought before the board of directors within a reasonable time after it was lodged where the articles of association contained a restriction on transfer. The fact that parties do not understand or ignore the rules of the articles of association is rather surprising since members were the ones who, at the very outset, established the internal rules of the company. Cases collected are anecdotal since they stand for only a small part of the overflowing case law on this matter. Yet, the sample shows how courts have to deal with problems of interpretation. Their standing is clear on this matter. Courts are not supposed to substitute parties in their pleadings. They are not supposed to assume a paternalistic position with regard to the obligations binding the parties as a result of a contract they entered between themselves. Parties, and not the court, are the best judges of their own interests. If that is not so, the court still cannot relieve them of what would be an expectable scenario following the deterioration of their contractual relationships.

There is, however, a point at which the court’s standing gives way to a more interventionist response. That is the point at which public interest is at stake. This may be the case, for example, when a private company doing business in the securities market

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325 See Davies, Paul L., cit., pp. 942-945.
326 See Cheffins, Brian R., ‘Does law matter? The separation of Ownership and Control in the United Kingdom, *The Journal of Legal Studies*, vol. 30, No 2, 2001, pp. 459-484 (468-472) (explaining that the English system did not qualify as a protective jurisdiction for outside investors. Prior to the middle of the 20th century, a ‘hands-off’ approach prevailed in company law. Therefore, neither companies’ legislation, nor relevant common-law principles afforded explicit protection to minority shareholders. Moreover, courts were accused of failing to provide effective protection to minority shareholders against the oppression of majority shareholders).
purposefully hides information from investors as to the fact that shares they were buying could not be traded freely. Courts are likely to intervene if there is evidence of asymmetries of information as to how property rights can be transferred and if there is a deceitful ‘marketing of shares’. It is more difficult to achieve action of the court when the petition refers to private companies where apparently there is not a risk for the public. In these circumstances, it is important, therefore, that records show clearly to whom the shares in any particular certificates belong. So, in these cases it seems that the burden is put on the transferor’s side. She is the one who must ensure, especially if the investment is unusual or speculative, that the contents of her sale documents are not misleading, either as to the nature of her interest as a member, or as to the absence of any restrictions affecting the shares, or as to her connection to the company or otherwise.\footnote{See Re Walter L Jacob & Co Ltd.} In this context, however, how property rights in a share are effectively transferred is questionable.\footnote{See Davies, Paul L., cit., pp. 939-942.} A transfer of a share in breach of the company’s articles of association is not void to the extent that it confers no interest on the plaintiff. Depending on the articles, the transfer between the parties may be complete and effective to confer a beneficial interest in the transferee, even though it will only make the transferee the legal owner of the shares once it is registered. Moreover, ownership of the shares depends on who has the right to be registered as a member.\footnote{See Davies, Paul L., cit., p. 940.} To the extent property rights are put in doubt by the effects of un-consented transfer of shares, this echoes the Portuguese, Spanish, Italian, and French cases.\footnote{See Part I, Chapter 2.} Nonetheless, registration appears in the United Kingdom as the distinctive feature of the United Kingdom legal system of transfer of certified shares. This is treated further on.\footnote{See Part II, Chapters 2 and 3.} For now, I am interested in drawing a preliminary conclusion as to who holds the ultimate control in a company and, consequently, who has the ultimate power to affect the design of rules regulating the company’s internal affairs and ownership structure.

Although shareholders are residual claimants and are parties to the articles of the company, directors have the ultimate power to affect the rules by deciding whether or not to allow a register of the transfer. They provide the framework in which shares can be transferred and ownership altered. However, the reported breach of fiduciary duties and conflict of interests triggered by their position as directors and also as members of the company does not ease the terms in which my conclusions are taken. For example, the company’s articles establish formulas to determine the fair value of the shares. They are applied whenever a
shareholder wants to leave, or when she, whilst being simultaneously a director, is removed from her office. Somehow, this can be used to oppress minority shareholders who are pushed to accept a value which is much lower than the actual value of the share. On the other hand, when minority shareholders do not accept the terms in which that value was determined, and therefore, delegate this task to the court, within the very limits of its jurisdiction, this too can become a means of oppression. The threat of this proceeding by a dissident and possibly a legally aided shareholder in a small company can be used to bring pressure on the majority to accept the price she demands for her shares.

All cases collected show that the imposition of restrictions on transfer of shares of private companies is a random measure. Often, reference to the respective provision in the articles is made by the court. Conversely, cases suggest that the correct interpretation of such provisions is a hard task not only for the judge, but in particular for the members. It might be that members only have to deal with those provisions once they have a dispute. Frequently, model articles are adopted, and shareholders negotiate particulars of the company and their relationships. Yet, if articles are not carefully drafted and are liable, therefore, to drag along intricate questions of interpretation, then provisions establishing restrictions on transferability are likely to fail to achieve their goal.

Furthermore, these cases illustrate that members anyway ignore the restrictions and transfer their shares. Other times, the negotiation process leading to the resignation of the member is as difficult as it is lengthy. This is due to the deterioration of the relationships between members and to the lack of understanding as to the fairness of share values. This makes members simply want to cease investing and leave as quickly as possible. They accept, for example, that the terms of the transfer are dictated by the transferee or a third party. This leaves considerable uncertainty about the effect of the un-registered, or, broadly speaking, un-consented transfer, and thus leaves in doubt the parties’ property rights. It is quite so, especially if clauses are difficult to interpret, if rules operate against parties’ expectations, and there are notorious bargaining failures which must be borne by the parties alone. This implies understanding how freedom of contract is perceived by UK courts, especially in the field of corporate law. UK courts, for the most part similar to US courts, tend to take an objective approach to contracts. They read the disputed facts in light of the terms of the contract. If it is the case that solutions to the contentious dispute cannot be found within the contract, rarely is the case that the court will be a surrogate for the parties’ will expressed in the contract, unless it is warranted by a statutory authority that it does so. *Re Castleburn Ltd*, a case adjudicated
by the Chancery Division, constitutes one good example of the objectivity of UK courts. In this case, the court held that

...having regard to the articles [of association] the petitioner could have had no legitimate expectation that in the event of a breakdown of relations between himself and the team they would not be relied on to require him to sell his shares at fair value. To hold the contrary would not be to superimpose equitable considerations on his rights under the articles but to relieve him from a bargain that he made.

It also is important to understand the degree of autonomy members have in light of the shares they own and the organizational design of the company. Knowing who is truly at the helm, and how this is likely to influence the development of the company is critical information that rests on defining the nature of shares and the rights that inhere to them.

2. THE UNITED STATES

I now turn to US business organizations and, in particular, to the limited liability company (LLC) - the American counterpart of the PLLC in Europe. The emergence and development of the LLC is generally associated with the Wyoming LLC Act, and the relevant tax issues around which the Act emerged. Frequently, LLCs are defined as business organizations which “…provide a corporate-styled liability shield with pass-through tax benefits of a partnership”. This section, however, goes beyond this tax frame, and tries to

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[333] These issues are addressed in Part II, Chapters 2 and 3.

[334] See White v. Longley, 358 Mont. 268, 244 P.3d 753, 760 (2010). In the literature see Macey, Jonathan R., ‘The Limited Liability Company: Lessons for Corporate Law’, Washington University Law Quarterly, vol. 73, 1995, pp. 433-454 (433) (defining the LLC as ‘… a noncorporate entity that provides its owners with protection against liability for enterprise obligations, as well as the pass-through tax treatment traditionally associated with partnerships and Subchapter S corporations. At the same time, the limited liability company form allows investors to remain actively involved in the management of the enterprise’); see Bainbridge, Stephen M., Agency, Partnerships & LLCs, New York, New York, Foundation Press, 2004, p. 7 (defining LLC with reference to tax considerations. In his words the LLC is ‘… an unincorporated business organization providing its members with pass through tax treatment, limited liability and the ability to actively participate in firm management’). But see Ribstein, Larry E., ‘The Emergence of the Limited Liability Company’, The Business Lawyer, vol. 51, 1, 1995, pp. 1-49 (5) (stressing that it is important to keep in mind, however, that LLCs and other types of business associations are not just appendages of tax law’). See Hansmann, Henry et al., ‘Law and the Rise of the Firm’, Harvard Law Review, vol. 119, No. 5, 2006, pp. 1333-1403 (advocating that ‘entity shielding’, that is, the protection of the firm’s assets from the shareholders’ personal creditors, is economically and historically more important than limited liability. For them, entity shielding and not so much limited liability has been historically and economically crucial for the development of business organizations not only in the United States, but also elsewhere (Italy and England). Also see Guinanne, Timothy et. al., ‘Ownership and Control in the Entrepreneurial Firm: An International History of Private Limited Companies’, Yale University
understand what motivated the creation of the LLC in the United States. Was it inspired by the European limited liability company, which was historically imported by Latin American countries such as Panama, Brazil, Argentina, and Mexico? Or does the LLC solely derive from existing domestic laws? Furthermore, this section tries to unveil the appealing elements of the PLLC which, besides the tax issue, are likely to make investors opt for this type of business organization and not for a closely held corporation, for example. Most importantly, I try to understand what it took, and what sort of ‘mutations’ happened in the American legal system such that these companies finally came into the spectrum of business organizations in the United States.

I. State

i. The LLC breakthrough: state experimentation and legal engineering

The history of the PLLC and the story of its breakthrough in the US legal system have been told elsewhere. Hence, what I present here, on this regard, is more of a summary. The novelty of this narrative, however, is that the story is not over yet and, judging by its youth, it seems the best is yet to come for the LLC.

There were early attempts to implement the PLLC in the United States. Reportedly, in 1874 the state of Pennsylvania enacted a statute creating a partnership association whose tradable shares and whose capital would alone be liable for the debts of the partnership.
association. Virginia also passed a similar statute. However, it was repealed in 1918. Michigan, New Jersey, and Ohio adopted similar laws in 1877, 1880, 1881 respectively. In the cases of Portugal and France treated above, the respective legislators referred to the business forms with limited liability in the most industrialized nations in the world, including the United States. This hints at a phenomenon of legal transplantation going on both sides.

Like in the United Kingdom, courts were oftentimes skeptical as to the new forms of business association, and frequently their judgments reduced the likelihood that partnership associations would assert themselves as solid alternatives to the ‘normal’ partnership. The fact is that in the second half of the nineteenth century anything businessmen wanted to do could be done through the corporation. Historically, Portugal, France, Italy, and Spain have had distinct laws for the corporation and the partnership which somehow preceded the adoption of the PLLC in these jurisdictions. The United Kingdom is a particular case because it was not until 1907 that the distinction between private and public companies was made in the law. Still, today, the law does not provide for a clear distinction. There certainly are sections of the Companies Act 2006 that exclusively apply to public companies. However, there is a lot of overlap, more so than in most other countries. The evolution of the LLC in the United States was different. The LLC and the corporation can be very similar, and it seems, at times, that it

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339 I thank Naomi Lamoreaux for her insights on this subject. Naturally, all mistakes and omissions are mine. In 1873, there was a State Constitutional Convention in Pennsylvania in which corporations were discussed. For the most part, this is what happens in state conventions. Some people held up Great Britain as the model to follow. Pennsylvanian law was restrictive. The year after the Constitutional Convention, the Pennsylvanian legislator met up with other stakeholders and spent time discussing a new corporation law. It was still very restrictive. Following this debate and the ongoing discussion about the corporate form, legislators passed, with almost no discussion, the law of the partnership association. It is interesting that after the law of the partnership association was passed, only four states followed suit. Until this day, it is difficult to explain why only four states passed similar laws and there was not a major diffusion of the new business form. My evolutionary argument tries to shed light on this question.

340 See Guinanne, Timothy et al. ‘Ownership and Control in the Entrepreneurial Firm’, cit. pp. 35-36 (providing the results of their own research on this matter).

341 See ‘Nature of the Stock Company’, Wall Street Journal (1889-1922) [New York, N.Y] 11 Oct. 1907: 3 (noting that ‘Limited liability was recognized by the New York Constitution of 1846 in respect to banks issuing notes. It was not until the English Companies Act of 1862 that limited liability became a well recognized part of general law. This Act was followed in many respects by the French Act of 1867 and by acts of the various state legislators in America’). Also see note 335 above referring to the recognition by the American Chamber of Commerce of the British National Export Selling Agency as a limited liability company. This suggests that American legislators were pretty much aware of what was being done in Europe, and that they may not have imported the LLC from Latin American as it is normally explained in textbooks. In fact, Americans have never been alienated from what happened in Europe. There were numerous attempts to codify law in the nineteenth century. A notorious example is the work developed by the American lawyer David Dudley Field II in civil procedure law. The scholarship of Savigny on historical jurisprudence greatly influenced ‘Langdillian’ American legal thought. Realists were also inspired by German academics of the so-called ‘school of free law’. The Uniform Commercial Code, that had Karl Llewellyn as one of the drafters, was influenced by German law. Naturally, legislators of the state of Wyoming might not be aware of these aspects. See Kennedy, Duncan, ‘A Transnational Genealogy of Proportionality in Private Law’, in Brownsword, Roger et al. (eds.), The Foundations of European Private Law, Oxford and Portland, Oregon, Hart Publishing, 2011, pp. 185-220 (explaining further differences between the United States and Europe).
all comes down to the rule of ticking the box for tax purposes. However, in the United States, LLCs are generally seen as a type of partnership. Back in the nineteenth century and even before, partnership associations, and before them, mere partnerships giving form to small companies always brewed in the United States.\textsuperscript{342} Figures dated as of 1898 show new ‘industrial’ companies formed as ‘limited liability corporations’. They suggest that the principle of limited liability had been applied in late nineteenth century to a range of firms during the industrial boom.\textsuperscript{343}

Despite the documented variation in corporate forms,\textsuperscript{344} it was not before the second half of the twentieth century that the LLC was implemented in the United States. There were first attempts to pass legislation adopting the LLC in Alaska in 1975 and 1976 respectively, but these attempts were not successful. Wyoming passed the first US state LLC statute in 1977, which triggered a ‘LLC revolution’ in the United States.\textsuperscript{345} This revolution, however, was not immediate. The Hamilton Brothers Oil Company with registered office in Denver, a company familiar with Panamanian corporations with limited liability (also referred to in the literature as \textit{limitadas}), lobbied with the legislator of the state of Wyoming for the creation of

\begin{itemize}
\item As to R. Hoe & Co, see ‘R. Hoe & Co.’s Establishment, A Day among Machinery’, New York Daily Times, vol. 5, N.º 1275, New York, Friday, October 19, 1855 (noting that R. Hoe & Co was a successful printing business. Its rapid development spoke for the progress of the American industry back in the first half of the nineteenth century. The work force of this company comprised four hundred employees. This company was fairly large and used several facilities to develop what was considered a thriving business. It was, however, a family company, a partnership at a time in which there was as yet no glimpse of the LLC. Robert Hoe came to New York City in 1805, when he was eighteen years old. Considered a genius by many, he managed to foster an important range of businesses in the city of New York by taking up the manufacture of printing presses in 1819, and taking as a partner Peter Smith, his brother-in-law and inventor of the Smith Press. The company clearly had an international profile and it significantly contributed to the extension of the American presses. In 1833, Robert Hoe retired and put the company’s business into the hands of his son, Richard M. Hoe. The latter, together with two others, Sereno Newton and Matthew Smith, were in charge of the operation of the firm. The business grew steadily, and it was lucrative. In 1855 the members of the company were Richard M. Hoe, Robert Hoe, and Peter Smith Hoe. The superintendent of the works was Alfred S. Bowen, who had been connected with the company for twenty-five years. The surnames of the members make explicit the family links among them. The size of the company illustrates how big business in the United States often started out small. It was, as pointed out at the time, ‘…a place worth studying, in all its departments, as an excellent example of what may be accomplished through the channels of American Industry”).
\item A more thorough investigation would have to be made to understand the relationship between the form of these companies and their size. Possibly, learning about their business object would also be helpful to understand the market wherein they do their business.
\end{itemize}
the same type of business organizations in this state. (This case illustrates how the geographic, economic and political proximity of the United States to Latin America may have facilitated the indirect influence of European trends in American corporate law.) 346 The aim of the Hamilton Brothers Oil Company, by pushing forward the enactment of a law that would create the LLC in Wyoming, was to use it as a business form to develop Hamilton Brothers’ oil and gas business activities. Reportedly, this idea was welcomed by the legislature of Wyoming which wanted to attract market agents to invest in oil and gas in the state. 347 As attested by Carney, who was a professor of business law in Wyoming at the time, the law was enacted without great deal of publicity. He, as a professor, only happened to know about it after the law was passed. Carney’s view was that the original Wyoming LLC Act was drawn upon domestic sources such as the Wyoming Business Corporation Act, the Uniform Partnership Act, and the Uniform Limited Partnership Act. 348 Moreover, he argued that the new Act left more questions unanswered than it solved, and for that reason alone it did not constitute a viable alternative for most enterprises. Plus, drafting solutions for the matters which were not covered by the provisions of the Act would be costly.

The lobbying efforts of the Hamilton Brothers Oil Company, surprisingly, did not go a long way. They did not unleash the competitive advantage of the LLC. After passage of the law very few LLCs were created even in Wyoming. Additionally, Florida, which was an exception among all other states, only passed its LLC Act in 1982. This was most likely due to the fact some businessmen there were familiar with Latin American limited liability companies or limitadas. 349 The enactment of the Wyoming LLC Act did not constitute a mutation of the US legal system that market agents thought should be preserved, at least at that moment in time. As a matter of fact, this reluctance to assimilate a mutation also

346 See Spamann, Holger, ‘Contemporary Legal Transplants: Legal Families and the Diffusion of (Corporate) Law, Brigham Young University Law Review, vol. 2009, 6, 2009, pp. 1813-1878 (1840-1844 ) (stressing that Latin American law, including corporate law, was for the most part influenced, at least until the second half of the twentieth century, by French, Spanish, Portuguese, and German laws. Transplantation of legal solutions occurred not only through legal doctrine, but also legal policy. Notwithstanding, countries of Latin America managed to keep a legal speech and solutions of their own. This was the case of Argentina, for example, whose legislation has been copied by other Latin American countries).
348 See Carney, William J., ‘Close Corporations and the Wyoming Business Corporation Act: Time for a Change’, University of Wyoming Land and Water Law Review, vol. 12, 1977, pp. 537-583 (581). While I was a Visiting Research Fellow at Fordham University Law School during the fall semester in 2012, I audited the course Partnerships and LLCs taught, at the time, by Roger Goebel. He thought that the American LLC was based upon the same type of business organization that existed in Costa Rica.
349 The legislators of the several American states always had an eye on Europe and on the legal developments happening there. They would mostly look at developments in England but also in France and Germany. It is curious that it took so long for the law to be adopted in the United States. It might have been the case that, unlike other countries, in the United States the corporation was so entrenched, that its predominance froze out the LLC.
happened in the other jurisdictions. There was always a subsequent point in which a selective sweep occurred and change broke through. A similar phenomenon happened in the United Kingdom with the takeover bid.

In the United States change was apparently triggered by the Internal Revenue Service (IRS) Revenue Ruling dated as of 2 September 1988 (IRS Revenue Ruling 88-76). It addressed the issue that was to know ‘Whether a Wyoming LLC, none of whose members or designated managers are personally liable for any debts of the company, is classified for federal tax purposes as an association and or as a partnership’. In this ruling the IRS provided that a Wyoming LLC could be classified as an association or a partnership for federal tax purposes if it had no more than two of the distinctive characteristics of a corporation - continuity of life, centralization of management, limited liability, and free transferability of interests’. This set of rules is known as the ‘Kinter regulations’ from the case United States v Kinter. These regulations were developed to aid in classifying business organizations that were not incorporated under state incorporation statutes but had certain characteristics common to corporations and were, therefore, subject to taxation as corporations under the federal tax code. In addition, following the tax reform of 1986 corporate taxes had become higher and transfer of stock no longer earned an advantageous tax treatment. Thus, after the

350 See Sgard, Jérôme, ‘Do Legal Origins Matter? The Case of Bankruptcy Laws in Europe, European Review of Economic History, 10, 2006, pp. 389-419 (411) (Even if not analogizing as I do in the text, he explains how the empirical evidence he collected ‘…underlines the extent of joint changes across countries as well as the pattern along which traditions may evolve: they can endure for centuries, but they can also justify rapidly to a changing environment’. He gives as an example the shift toward court-based debt discharge and multiple-entry procedures).

351 See Cheffins, Brian R. ‘Does law matter?’, cit., p. 479 (explaining how the evolution of the takeover bid, in the United Kingdom indicates that increased regulation of disclosure may have influenced the development of features normally associated with the Berle-Means corporation, and how new rules on disclosure together with the erosion of family ownership in United Kingdom publicly held companies may have determined the spread of takeover bids).

352 See Ribstein, Larry E., ‘Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs, Washington University Law Quaterly, vol. 73, No 2, 1995, pp.369 - 432 (407, note 143) in which he points out the importance of understanding the reason why the IRS passed this rulling at this point. In his mind, it was not clear whether there had been an onslaught of requests for rulings or whether LLCs had given rise to a large number of revenue rulings and private letter rulings. Ribstein’s view was that the IRS might have wanted to protect its bureaucratic power by ensuring that the process would be under its control. As a matter of fact, the IRS had extended the scope of the Subchapter S of the Internal Revenue Code. Normally, such expansion would be the prerogative of the Congress.

353 See the case United States v Kinter, 216 F.2D 418 (9TH Circ. 1954).

354 See Littriello v. United States, 484 F.3d 372 (6th Cir. 2007) (clarifying this aspect). In the literature see Ribstein, Larry E., ‘Statutory Forms for Closely Held Firms, cit. pp. 384-388.

IRS ruling, the incentives for businessmen to explore the alternatives of creating a LLC, a hybrid which enabled them to benefit from some of the distinctive features of the corporation and the partnership simultaneously, without having to necessarily adopt any of them, and still gain from the opportunity to be levied as a partnership, all of the sudden loomed larger. We are left with some questions on this matter: If investors could now adopt a hybrid business form and be taxed as a partnership, why did not they just incorporate as partnerships? Why was there the eagerness to incorporate in the form of a LLC? It was said that partnerships ‘…bore the brunt of the 1987 tax revision damage’. It was also stated that ‘Traded partnerships, with certain exceptions, will be taxable as corporations in the future, a move that snares so-called master limited partnerships. Partnerships traded or designed to trade before Dec. 17, 1987 are "grandfathered" and escape corporate treatment through 1997.

Considering the new rules of corporate taxation at the time, lobbying for the enactment of LLC legislation seemed to serve the purposes of those who were conscious of the need to implement new investment strategies. On the other hand, following the 1986 tax reform, for the first time the top individual rate dropped below the corporate rate. Many tax attorneys were advising their small-business clients to reorganize their businesses. Attorneys advised their clients to convert from a corporation to an ‘S corporation’ to benefit from the lower individual rate. An S corporation, regulated in the tax corporate code, is a form of business organization that combines the tax advantages of the partnership and the limited liability features of the corporation. With an S corporation the business itself is not taxed. Instead, all income, deductions, and credits are passed through to the shareholders. Consequently, the S corporation was sold as a way for small businesses to take advantage of the lower individual rates and avoid the much heavier corporate minimum tax of the new law. Furthermore, switching to an S corporation might also be a way to avoid a double tax on the liquidation of corporations when they were sold.

Several other states passed statutes regarding the LLC, and this caused a great deal of state tinkering based upon these statutes’ provisions. However, the Kinter regulations proved to be inadequate to cover new business entities such as the LLC which had developed under the statutes of several states. Not only the LLC, but also other unincorporated business entities such as limited liability partnerships shared characteristics of both the corporation and the partnership. They combined limited liability with flexibility of management; they combined

their *delectus personae* purpose with restrictions on the transferability of shares by default. On one hand, the unincorporation, in particular the LLC, was molded upon the kinter regulations by smart and skillful lawyers who were able to assure members could take advantage of whatever classifications were more advantageous for them. On the other hand, this lead to a case-by-case analysis by the IRS which had to come up with solutions for the tax issues regarding the LLC. There was not a common ground whereupon to bring about a uniform definition of LLC.

In 1996, regulations 26 C.F.R. §§ 301.7701-1 to 301.7701-3, frequently referred to as ‘check-the-box regulations’, were promulgated. They became effective on 1 January 1997. These regulations replaced the Kinter regulations and were meant to simplify the classification of hybrid business associations such as the LLC for federal tax purposes. In practice, by checking-the-box, the taxpayer could elect to be treated as a corporation, or in the absence of such election, to be treated as a partnership for tax purposes (if the company had multiple members), or as a sole proprietorship (if the company had one single member). The LLC was defined upon whether or not its members would check-the-box. Wyoming, for example, foresaw a change in federal tax law, and enacted flexible statutes. They allowed the LLC to be freely drawn on corporations’ characteristics with no major limitations, without becoming a fully-fledged corporation, and still be taxed as a partnership by not checking-the-box.

The fact was that the absence of guidelines such as those provided for by the *kinter regulations*, and the work of lawyers which was tailored to the needs of their clients and corporate law consumers, made it difficult to lay down a common understanding of what an LLC really was. Consequently, the National Conference of Commissioners on Uniform State Laws (NCCUSL) promulgated in 1994 the Uniform Limited Liability Company Act (ULLCA), which was approved by the American Bar Association House of Delegates in

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358 See Littriello v. United States (where the plaintiff-appellant contested the validity of the Treasury Department’s so-called ‘check-the-box’ regulations).

359 See Littriello v United States (explaining that ‘What was avoided by the resulting “check-the-box” provisions was the necessity of forcing those hybrids to jump through the Kinnter regulation “hoops” in order to achieve a desired-and perfectly legal-classification for federal tax purposes’).

360 Currently, in the United States, corporate income is subject to double taxation – at the corporate level according to I.R.C. § 11 (a) and at the individual-shareholder level pursuant to I.R.C. § 61 (a)(7). By way of contrast, partnership income is taxed just once. It is not taxed at the corporate level, but only when it passes through the individual partners and it is taxed as an income to them, given I.R.C. §§ 701-777. Sole proprietorships are also taxed only once.

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At the point the ULLCA came into force, several states had already promulgated their own LLC statutes, and the introduction of the check-the-box rule made some of them amend their laws. The NCCUSL passed the Revised Uniform Limited Liability Company Act in 2006 (RULLCA). The purpose of this Act was to permit the formation of LLCs which provided the members with the advantages of limited liability of the corporation and the tax treatment of the partnership. Despite of the ULLCA and the RULLCA, there still were noteworthy differences among LLC states’ laws.

The LLC is a hybrid, as it features characteristics of the corporation such as limited liability, and those of the partnership such as the taxation benefits or restrictions on transfer of ownership interests. In this sense, its hybridity is not different from the Portuguese, Spanish, Italian and French cases. In addition, in the United States like the other legal systems, the close corporation was initially used to accommodate the interests of small and medium firms which were not sufficiently safeguarded by the legal form of the corporation. Other alternatives were not available and the corporation was ill-fitting for this purpose. As noted by Larry Ribstein, using the form of the corporation whilst restricting the free transferability of shares and providing no right of dissolution at will compelled courts and legislatures to adopt rather awkward and ad hoc oppression remedies in order to provide a right of exit to their members. The LLC was viewed as a panacea in the sense that it was expected to make all these actions undertaken by courts and legislatures unnecessary. In light of the experience of the other selected jurisdictions, it was not a surprise to learn about the success and acceptance of the LLC in the United States. Market agents, as soon as they were convinced of the benefits of adopting this form of business association, started to use it in droves, and this trend continues today.

363 In the United Kingdom the distinction between privately and publicly held companies is less clear. This makes it more difficult to dissect the distinctive elements of each of these business forms and readily learn which of those elements are preponderant in the private limited company.
364 See Carney, William J., ‘Close Corporations and the Wyoming Business Corporation Act’, cit., pp. 537-583 (pointing out some specific difficulties attorneys would have dealing with the Wyoming statute at that time regarding the closely held corporation, and comparing other statutory approaches to those particular problems).
365 See Ribstein, Larry E., ‘Statutory Forms for Closely Held Firms’, cit., p. 431.
366 See Part I, Chapter 1 providing statistical information provided by the European Commerce Registers’s Forum Report, 2013 regarding the number of LLCs created in the United States. The number amounts to almost 900,000 LLCs, based on 2012 data.
Changes in tax law really had a stake in the development of the LLC. There is, however, something intriguing in this whole story. If LLCs can be taxed as partnerships or S corporations by ticking the box, why would anyone care about the LLC? Why was there a move to the LLC? Perhaps, there was a 'mutation' when market agents felt it was advantageous enough to alter the ‘genetic’ frequency or the evolution of the law.

II. Actors

i. The LLC is not just a matter of checking-the-box: Statutory provisions and regulation of the transfer of member interests in the companies’ operating agreements

(i) Types of transfer restrictions

As explained in the section above, there is no uniformity in the statutes or LLC laws of the American states. The United States is formed by fifty-one jurisdictions. Studying the statutes of all these jurisdictions is beyond the scope of this dissertation. I have chosen to concentrate on the ULLCA and RULLCA, and also on the New York Limited Liability Company Law (hereinafter ‘NYLLCL’) and the Delaware LLC Act (hereinafter ‘Delaware Act’). I have a threefold purpose in selecting these two statutes.

First, the state of New York has always been considered the ‘progressive capital of the Nation’. This is indeed true in many aspects, and also in respect to corporate law.

S corporations are corporations which are usually ‘small business corporations’ with fewer than 100 shareholders who are all individuals. They may elect to be taxed at the federal level through their shareholders. This allows them to avoid being double-taxed on their corporate income. 26 US Code §1361 (a) (1) defines S corporation. According with this provision, ‘For purposes of this title, the term “S Corporation” means, with respect to any taxable year, a small business corporation for which an election under § 1362 (a) is in effect for such year’. Section 1362 (a) (1) establishes that ‘… a small business corporation may elect, in accordance with the provisions of this section, to be an S corporation’. Pursuant to § 1363 (a) ‘Except as otherwise provided in this subchapter, an S corporation shall not be subject to the taxes imposed by this chapter’. § 1363 (b) states that ‘The taxable income of an S corporation shall be computed in the same manner as in the case of an individual…’.

An additional reason to select the LLC law of the state of New York is that while I was writing this dissertation, I was a Visiting Research Fellow at Fordham Law School, in New York City.

See Stephen, Labaton, ‘Business and the Law; New York Court’s Significant Cases’, New York Times , Late Edition (East Coast) [New York, N.Y] 29 May 1989: 1.32 (referring to the Court of Albany, New York ‘The court is both confident in its ability and that of the lower courts to handle sophisticated commercial disputes and it sees its mission as a very important contribution to the state's economy’, said Oscar Chase, a civil procedure professor at the New York University Law School. But he added that the court had also in some instances sharply limited its role. ‘It reflects the court's sense of what's important and what courts are best able to do’, Professor Chase said. ‘Personally, I also think it reflects a political outlook’.

In their view, the judges in Albany said, the state had a ‘recognized interest in maintaining and fostering its undisputed status as the pre-eminent commercial nerve center of the nation and the world’). On a different tone,
York together with the state of Massachusetts was the first state to pass general incorporation laws in 1811. Massachusetts enacted it slightly before, in 1809. In comparison, the United Kingdom enacted for the first time legislation establishing general incorporation in 1844.  

Second, in general, statutes can be opted out by the members if they so desire. Statutes provide a number of ‘off the rack’ provisions that consumers of corporate law can use to avoid transaction costs or bargaining failures. This is the case for the NYLLCL and for the Delaware Act. The latter, however, takes freedom of contract to another level, as it creates incentives for the use of well-drafted, detailed and almost litigation-proof operating agreements. In the words of Chandler in R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC ‘For Shakespeare, it may have been the play, but for a Delaware limited liability company, the contract’s the thing.’ This puts the burden of bargaining for the best rules on the side of LLC members. In contrast, the NYLLCL provides more detailed default

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370 See The Joint Stock Act 1844.

371 R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, 2008 Del. Ch. LEXIS 115 (Del. Ch. Aug. 19, 2008). In this context, see in the literature Ribstein, Larry E., and Lipshaw, Jeffrey M., Unincorporated Business Entities, 4th ed., Newark, LexisNexis, 2009, pp. 416 and 422-425 (defining operating agreements as the heart (or at least it should be) of the LLC). In fact, operating agreements control all rights and obligations of the members, economic interests’ owners and managers. According to Unif.Ltd.Liability Co.Act § 101, ‘An operating agreement means the agreement under § 103 concerning the relations among the members, managers, and limited liability company. The term includes amendments to the agreement’. I return to this below. Equally important are what in certain agreements are defined as ‘charter documents’ with respect to the formation or other governing documents, including but not limited to the certificate or articles of incorporation, by-laws, certificate of articles of organization or formation, operating agreement, limited liability company agreement, certificate of limited partnership, certificate of formation and partnership agreement.

372 Other Acts such as the New Jersey Limited Liability Company Act also provide ‘off-the-rack’ rules. See Philip Rabinowitz, Debtor. Podvey Meanor Catenacci Hildner Cocoziello & Chattman, Plaintiff, v. Benjamin Stanziale, Jr. et al., Defendants, and Hank Luwisch, Defendant-Third Party Plaintiff, v. Whitehall Development, LLC et al., Third-Party Defendants, 2011 Bankr. LEXIS 5131 (saying that ‘…the Act is liberally construed to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements”). Delaware courts, however, more than other courts, have always revealed their remarkable expertise in interpreting corporate law rules. See, for example, Achaian v Leemon, 25 A.3d 800; 2011 Del. Ch. LEXIS 118, note 54 (quoting the Commodores, Three Times a Lady, on Natural High (Motown Records 1978) (‘you’re once, twice, three times a lady, and I love you…”).
rules. Also New York’s court decisions tend to be more prescriptive than their Delaware counterparts.

Third, comparing and contrasting both statutes is helpful to understand the underlying policies developed by the legislators in each state. In other words, for the purpose of policy considerations I ask: Had the legislature thought about a particular situation, would it have passed this law? For instance, Delaware’s legislation is manifestly contractarian. Consequently, freedom of contract trumps all, and this certainly is shown by the way operating agreements are drafted and legal advice is given by attorneys to their clients.

The best way to set up the grounds of comparison is to look at the operating agreements structuring the relationships between members and other corporate constituencies, especially when it comes to the transfer of ownership interests and the governance of the company. Operating agreements control which interests a member is permitted to transfer. They differ from the certificate of formation. This certificate is filed in the Office of the Secretary of State and sets forth, among other things, the name of the LLC and the address of the registered office. A LLC is formed at the time of the filling of the certificate of formation in the office of the Secretary of State or at any other date as established in the certificate of formation. Unlike the operating agreement, the certificate of formation is a public document. I have examined a sample of 34 operating agreements. I collected some of them from WestlawNext. However, LLC agreements are not widely disseminated through Westlawnext. Thus, I have additionally collected these documents through public companies and US Securities and Exchange Commission (SEC) filings that are provided by EDGAR (Electronic Data Gathering, Analysis, and Retrieval system). Public companies, for reasons that have to do with capital market transactions such as an offer to exchange or mergers and acquisitions, will often file together with a prospectus a large number of LLC agreements for subsidiaries. These larger companies which must file specific forms with the SEC amend their operating agreements significantly. Consequently, where possible, I tried to gather all the respective

374 See Benintendi v. Kenton Hotel, 294 NY 112 (1945) (where the court rather assumes a prescriptive position and enforces statutory law. This is often the case with disputes regarding dissolution and liquidation of the company).
375 See DLLCA §18-1101 (b) providing that ‘It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability companies agreements’.
376 See Ault v Brady, 37 F. Appx. 222 (8th Cir. 2002) and Achaian, Inc., on behalf of itself and derivatively on behalf of Omniglow, LLC, Plaintiff, v. Leemon Family LLC, and Ira Leemon, Defendants, and Omniglow, LLC, Nominal Defendant, 25 A.3d 800; 2011 Del. Ch. LEXIS 118.
377 See DLLCA §18-201.
interactions of the respective LLC agreement.\textsuperscript{378} Those collected from Westlawnext in their amended and restated versions often contain an ‘entire agreement’ clause. Hence, I used them as events of my sample. In respect to the companies whose LLC agreements I found through SEC filings it was interesting to note that in spite of the frequency with which companies filed a considerable number of LLC agreements for subsidiaries, the operating agreements were only a small part that normally acquired the form of an exhibit.\textsuperscript{379}

In order to refine my search on WestlawNext, I introduced into the research engine the words ‘transfer of shares’ and ‘Limited Liability Company’. These terms alone yielded around 10,000 results. I then culled the agreements wherein it was expressly stated they were LLC operating agreements. This selection was not done in a random manner. In order to analyze the LLC agreements, I used the same method I used for studying the articles of association of PLLCs of other selected jurisdictions. I have broken down my analysis to twelve variables: the company’s business name, date of the operating agreement, governing law or consent to a specific jurisdiction, the office of the Secretary of State in which the company’s certificate of formation was filed with, the parties to the agreement, the number of shareholders or members of the company, the number of members of the managing board, share capital or capital contributions, business object of the company, transfer clauses, and other relevant clauses including allocation of profits and losses, distributions, ownership and taxation. This information was augmented with data provided by Bureau van Dijk’s database \textit{Orbis} \textsuperscript{380} regarding size and group information, key financial and employees, controlling shareholders, BvD independence indicator, and legal and account information.

The operating agreements I have scrutinized are extremely detailed, lengthy, and drafted in a way that reflects the awareness that all relevant issues which, if not carefully regulated by contract, may be earnest sources of contentious disputes. § 18-702 of the Delaware LLC Act and § 603 of the NYLLCL provide that a LLC interest is assignable in whole or in part except as provided in the LLC operating agreement.\textsuperscript{381} Both NYLLCL and the Delaware LLC Act

\textsuperscript{378} This was the case of the Amended and Restated Limited Liability Company Operating Agreement of the Chrysler Group LLC included in the sample of American companies.

\textsuperscript{379} This was the case of Huntsman International LLC, which filed annual, quarterly and other reports with the SEC jointly with its ‘parent’ company Huntsman Corporation within an offer to exchange. I analysed the prospectus, which was composed of 795 pages. For more on this, see Part I, Chapter 1.

\textsuperscript{380} This database provides worldwide information about private companies. It is available at the Arthur W. Diamond Law Library of Columbia Law School.

\textsuperscript{381} §18-702 of the Delaware Limited Liability Company Act (Assignment of a limited liability company interest) provides the following:
(a) A limited liability company interest is assignable in whole or in part except as provided in a limited liability company agreement. The assignee of a member’s limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in a
All LLC agreements in the sample set forth restrictions on transfers. This is the case because

limited liability company agreement or, unless otherwise provided in the limited liability company agreement, upon the affirmative vote or written consent of all of the members of the limited liability company.

(b) Unless otherwise provided in a limited liability company agreement:
(1) An assignment of a limited liability company interest does not entitle the assignee to become or to exercise any rights or powers of a member;
(2) An assignment of a limited liability company interest entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned; and
(3) A member ceases to be a member and to have the power to exercise any rights or powers of a member upon assignment of all of the member's limited liability company interest. Unless otherwise provided in a limited liability company agreement, the pledge of, or granting of a security interest, lien or other encumbrance in or against, any or all of the limited liability company interest of a member shall not cause the member to cease to be a member or to have the power to exercise any rights or powers of a member.

(c) Unless otherwise provided in a limited liability company agreement, a member's interest in a limited liability company may be evidenced by a certificate of limited liability company interest issued by the limited liability company. A limited liability company agreement may provide for the assignment or transfer of any limited liability company interest represented by such a certificate and make other provisions with respect to such certificates. A limited liability company shall not have the power to issue a certificate of limited liability company interest in bearer form.

(d) Unless otherwise provided in a limited liability company agreement and except to the extent assumed by agreement, until an assignee of a limited liability company interest becomes a member, the assignee shall have no liability as a member solely as a result of the assignment.

(e) Unless otherwise provided in the limited liability company agreement, a limited liability company may acquire, by purchase, redemption or otherwise, any limited liability company interest or other interest of a member or manager in the limited liability company. Unless otherwise provided in the limited liability company agreement, any such interest so acquired by the limited liability company shall be deemed canceled.

§ 603 of NYLLCL (Assignment of membership interest) states as follows:
(a) Except as provided in the operating agreement,
(1) a membership interest is assignable in whole or in part;
(2) an assignment of a membership interest does not dissolve a limited liability company or entitle the assignee to participate in the management and affairs of the limited liability company or to become or to exercise any rights or powers of a member;
(3) the only effect of an assignment of a membership interest is to entitle the assignee to receive, to the extent assigned, the distributions and allocations of profits and losses to which the assignor would be entitled; and
(4) a member ceases to be a member and to have the power to exercise any rights or powers of a member upon assignment of all of his or her membership interest. Unless otherwise provided in the operating agreement, the pledge of, or the granting of a security interest, lien or other encumbrance in or against, any or all of the membership interest of a member shall not cause the member to cease to be a member or to cease to have the power to exercise any rights or powers of a member.

(b) The operating agreement may provide that a member's interest may be evidenced by a certificate issued by the limited liability company and may also provide for the assignment or transfer of any of the interest represented by such a certificate. A member's interest may be a certificated security or an uncertificated security within the meaning of section 8-102 of the uniform commercial code if the requirements of section 8-103(c) are met, and if the requirements are not met such interest shall, for purposes of the uniform commercial code, be deemed to be a general intangible asset. The existence of the restrictions on the sale or transfer of a membership interest, as contained in this chapter and, if applicable, in the operating agreement, shall be noted conspicuously on the face or back of every certificate representing a membership interest issued by a limited liability company. Any sale or transfer in violation of such restrictions shall be void.

(c) Unless otherwise provided in an operating agreement and except to the extent assumed by agreement, until the time, if any, that an assignee of a membership interest becomes a member, the assignee shall have no liability as a member solely as a result of the assignment.

382 These statutes are enabling statutes, and they first and foremost provide the tools to fill gaps in a LLC operating agreement.
LLCs, like their European counterparts, have a closed nature. Moreover, in view of the fact that many companies in the sample are private equity funds, real estate investment funds, investment management companies, and special purpose vehicles (SPVs) their units are not supposed to be freely transferred to third-party investors outside the company, unless members agree otherwise. In general, restrictions on transfers provided by the LLC agreements may be clustered according with the following categories:

(i) Pre-emption rights or rights of first refusal (which may include a right of first offer), tag-along rights, rights of co-sale, sale purchase rights or ‘compelled sales’, buy-sell agreements, put-rights, and similar rights provided to the company and the other non-transferring members upon a member’s expressed intention to sell her share.

(ii) The prior written consent of all other non-transferring members, the granting or denying of which consent shall be in their sole and absolute discretion.

(iii) The consent of the majority shareholder or managing-member which must be obtained for the transfer of shares to third parties outside the company. This consent may be withheld in the sole and uncontrolled discretion of the majority shareholder or managing-member and may comprise not only transfers of managing, but also economic rights.

(iv) Clauses listing prohibited transfers.

(v) Limitations regarding the transfer of certain types of units or series of units.

(vi) Vesting requirements, forfeiture provisions, minimum retained ownership requirements or other similar provisions with respect to any interests in the

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384 For example clause 9.5 (a) of the Amended and Restated Limited Liability Company Agreement of Exco/HGI GP, LLC, a Delaware Limited Liability Company, which is included in the sample of American companies establishes the following:

‘If any Member proposes to Transfer all or any portion of its Units to any Person other than through a Permitted Transfer, Bona Fide Pledge or Foreclosure (a “Tag-Along Sale”), such Member (the “Initiating Holder”) shall provide to each Founder Member Group holding the same class of Equity Interests of the Company that are subject to the Tag-Along Sale (except, if the Initiating Holder is a member of one of the Founder Member Groups, its own Founder Member Group) notice of the terms and conditions of such proposed Transfer (the “Tag-Along Notice”) (which notice may also be given concurrent with any Seller’s Notice) and offer such other Founder Member Groups the opportunity to participate in such Transfer with respect to their Units of the same class of Units that are subject to the Tag-Along Sale in accordance with this Section 9.5 (each such electing Founder Member Group, a “Tagging Holder”) by including in the proposed Transfer a number of the Tagging Holder’s Units not to exceed the Tagging Holder’s pro rata portion (based on the Percentage Interest of Units that are subject to the Tag-Along Sale) of the Units being Transferred in the Tag-Along Sale. No Tagging Holder may (i) Transfer a greater percentage of its Units than the Initiating Holder is Transferring or (ii) Transfer a class of Equity Interests of the Company different than the Initiating Holder’.
company which are outstanding as of the date the Agreement was entered into and were created thereafter. (These requirements need not be uniform among holders of interests in the company, and may be waived or released by the managing member in its sole discretion with respect to all or a portion of interests in the company owned by any one or more members at any time and from time to time).

(vii) Non-transferable provisions by means of which the rights and obligations spelled out in the relevant agreement, and referring specifically to any founder member or founder member group will be personal to such founder member or founder member group or member of a founder member group, and may not be transferred without the written consent of the founder member, the founder member group or of the member of the founder member group.

(viii) The approval of a super-majority of the management.

(ix) The consent to the transfer given by a majority-in-interest of a certain class of unit holders, such consent to be not unreasonably withheld.

(x) Clauses limiting the possibility to transfer shares to competitors.

(xi) Lock-up provisions.  

(xii) Clauses establishing regulatory prohibitions by means of which no member shall take or permit any action to be taken with respect to itself (including without limitation, any change in its shareholders, members or partners) that would cause:

(i) transfer or administrative fees be paid in connection with a transfer or assignment; (ii) that advance notice of a transfer or assignment is not given and documentation evidencing such transfer is not executed (including documentation setting forth representations from either or both the transferor or transferee as to compliance with any restriction or requirement established in the agreement or other company’s governing documents); (iii) that the company be regulated under

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385 Lock-up provisions bind certain shareholders to sell their shares to a designated party. For instance, clause 7.7. (called ‘Lock-up’) of the Third Amended and Restated Limited Liability Company Agreement of ViSalus Holdings, LLC included in the sample of American companies foresees the following:

‘Each Member that is not also a party to the Registration Rights Agreement agrees, severally and not jointly, that, if requested by the Company and an underwriter of Common Units (or other securities) of the Company, not to sell or otherwise transfer or dispose of any Common Units (or other securities) of the Company held by such Member (other than those included in the registration, if applicable) during a period not to exceed one hundred and eighty (180) days from the effective date of the first registration statement of the Company’s securities; and to enter into an agreement to such effect regardless of whether such Member is participating in the offering to which the registration statement relates; provided, however, that all executive officers of the Company, directors of the Company, and Members holding one percent (1%) or more of the Common Units (or other securities) of the Company on a Fully Diluted Basis who are subject to this Section 7.7 must enter into similar lock-up agreement as well. The Company may impose stop-transfer instructions with respect to the Units (or securities) subject to the foregoing restriction until the end of said period’.
the Investment Company Act 1940,\textsuperscript{386} the Investment Advisors Act of 1940 or the Employee Retirement Income Security Act of 1974 (ERISA) and the US Internal Revenue Code of 1986,\textsuperscript{387} or (iv) the transfer either result in the termination or reclassification of the company for Federal or state tax purposes or in the breach of any state or Federal statute, regulation, court order, judicial decree, or rule of law.\textsuperscript{388}

(xiii) Clauses determining administrative procedures which establish an effective date, or an event such as the completion of the offering, prior to which a transfer will not be effective.

(xiv) Any other limitations on transfers which are not created by the issuer of the units.\textsuperscript{389}

Besides these restrictions, there are other important contractual aspects drawn in the LLC agreements in respect to transfers. The share sale and purchase agreement is often viewed as a formal contract. Therefore, it shall be in writing. It may be foreseen that the transferee must assume and agree to perform all the agreements and obligations to which the transferor is bound. On the other hand, the transferor may also be required, as a condition of any transfer to which members, the majority member or managing-member consents, to bear all the costs incurred by the company in connection with the transfer. It may be stipulated that each member remains responsible for the performance of the respective agreement by each permitted transferee\textsuperscript{390} of such member to which membership units were transferred. Furthermore, it may be established that no transferee of the whole or a portion of a member’s LLC interest shall have the right to become a substituted member in place of its transferor unless and until all of the following conditions are satisfied: (i) the transferor and transferee have executed and acknowledged such instruments as the manager may reasonably deem necessary or desirable to effect such transfer; (ii) a duly executed and acknowledged written

\textsuperscript{386} This law applies to investment companies which are considered to be affected with a national public interest.
\textsuperscript{387} In general, the companies analyzed do not permit any investment by benefit plan investors in order to avoid becoming fiduciaries of those investors. By imposing restrictions on transfers, members find a way to monitor investments made by benefit plan investors and avoid the fiduciary and prohibitive rules of ERISA and the Internal Revenue Code.
\textsuperscript{388} Generally, equity funds adopt the legal form of limited partnerships, LLCs or offshore companies which are not taxed as entities for the purpose of US federal income taxes. Consequently, LLC operating agreements are drafted by taking this into account so that there is not an alteration of the company’s tax status.
\textsuperscript{389} The prohibition of withdrawal is not among these limitations. It is safe to say that in most agreements it is agreed that the mere withdrawal of a member will not cause the dissolution of the company. So, unlike what happens in partnerships, dissolution at will seems not to be a credible threat, unless it is established in the LLC agreement.
\textsuperscript{390} A permitted transferee is often described in the agreements as an affiliate of a member or any third party(ies) to which members may transfer all or a portion of its membership interests as permitted by the operating agreement.
instrument of transfer has been filed with the company setting forth the intention of the
transferor that the transferee become a substituted member in its place; (iii) the transferee
accepts and agrees to be bound by all the provisions of the agreement by executing and
delivering a counterpart signature page to the agreement; (iv) the transfer would not
materially and adversely affect the treatment of the company for tax purposes under the code
or the tax laws of any state in which the company does business; (v) the transferee
demonstrates and agrees, to the satisfaction of the manager determined in its sole and absolute
discretion, that it has complied and shall comply with certain provisions such as those of the
USA Patriot Act.

In particular situations, members may sell their shares to each other, for instance, once a
certain transaction is entered into or an investment is made by the company. Operating
agreements often present clauses, which work very much as contractual guarantees, by means
of which members acknowledge that no public market exists for the membership units and
that it is uncertain whether a public market will ever exist for the membership units. In
addition, members represent and warrant that they are capable of evaluating the merits and
economic risks of their investment in the membership units; that they are able to bear the
economic risks of its investment in the membership units and that they are an accredited
investor, for purposes of Rule 501 under the Securities Act of 1933. In some agreements,
members are dispensed to obtain other members’ consent to the transfer if they only intend to
transfer economic interests.

There are situations in which no restrictions on transfers are introduced. For instance, members may agree that: (i) a member's entire interest in the Company is transferable either
voluntarily or by operation of law. The member may sell, assign, convey, exchange,
mortgage, pledge, grant, hypothecate or transfer all or a portion of such membership’s
interest. In the event of the transfer of less than all of such member's membership interest, the
transferee shall become a member of the Company on such terms and conditions as such
member, the applicable member and the Company shall agree upon. In the event of the
transfer of the member's entire membership interest, the transferee shall succeed to all of the
member's rights under the agreement. Upon the transfer of the member's membership interest,
the transferee shall become a member of the Company upon the completion of the transfer
without further action. (ii) Without limiting any of the foregoing, upon the sale, transfer or
other disposition of any member's entire membership interest pursuant to any pledge thereof
to any lender (or any agent, trustee or other representative for any lender or group of lenders),
the transferee of such membership interest shall become a member of the company and shall
acquire all right, title and interest of the member in the company, including all rights under
the agreement, and the member should be withdrawn as a member of the company thereunder,
and shall have no further right, title or interest in the company or under the agreement.

In principle, the following transfers are permitted in the agreements: (a) transfers by a
particular member of all or part of its LLC interests (normally the majority shareholder); (b)
transfers by a member of all or any part of its LLC interests to: (i) an affiliate or member of
such member so long as such affiliate or member is an accredited investor; (ii) a trust for the
benefit of the transferor or a trust for the benefit of a member of the transferor’s family, or
(iii) a particular organization; provided that such transfer does not breach the provision of any
loan documents to which the company (or its subsidiaries) are bound. Formally, it is usually
agreed that the non-transferring members be provided in advance with a notice of the
proposed transfer, which notice shall identify the transferee and the interests to be transferred
to the transferee and at all times the maximum number of investors holding units in the
company shall not exceed a number established in the LLC agreement.

Clauses in the LLC agreements are extensive and complex. Often agreements are
drafted to ensure that if a transfer is permitted pursuant to the agreement, the transferee that
acquires the LLC interest of a member shall not be recognized by the company as a member
and shall only receive economic interests to which the transferor of such units would
otherwise been entitled, except upon compliance with the terms of the agreement providing
the rules regarding permitted transfers. Additionally, it is frequently agreed that a member
who transfers all of her LLC interests to a permitted transferee (other than other member) in
accordance with the provisions of the agreement shall, nevertheless, remain a member of the
company subject to all the duties and obligations imposed on her under the agreement until
such time as the transferee of such LLC interest is admitted to the company as a substitute
member. Upon any permitted assignment of an LLC interest, the transferor and transferee
shall file with the company an executed or authenticated copy of the written instrument of
assignment or transfer.

Additional restrictions are frequently mentioned. The LLC agreement may establish that
LLC interests are not registered under the Securities Act of 1933 or under the securities laws
of any jurisdiction. Consequently, and in addition to any and all other restrictions on
transferability set forth in the respective agreements, the LLC interests may not be sold,
assigned, pledged, hypothecated or otherwise disposed of or transferred, except in accordance
with the provisions of the 1933 Act and State Acts. On the contrary, there are situations in
which no restrictions are imposed. If the company is terminated as a result of the transfer,
members often agree that the transferring member should indemnify the non-transferring member and 'save it harmless' on an after-tax basis for any increase in taxes to the non-transferring / non-terminating-member caused by the termination of the company. However, at times, members expressly agree that damages at law would be an inadequate remedy for a breach or threatened breach of the restrictions set forth in respect of transfers of units in the company. In some agreements it is specifically stated that the transfer of shares is included in the limitation of liability operated by the agreement if it is a transfer or attempted transfer of all or a portion of a membership interest within a prohibited transfer. Finally, there are LLC agreements foreseeing that shares can only be transferred through the delivery of the LLC certificate, which evidences the ownership of the units.

All these aspects of the operating agreements show how relative rights, privileges, powers, preferences, limitations, duties and obligations of holders of units in the companies of the sample are designed carefully, and shareholders are called to warrant and represent the type of investment they make. Restrictions on transfers are safety valves that help assure the integrity of the company, the control over the investment, and high(er) returns which, in many cases, can only be achieved by locking up investors’ capital for long(er) periods.

(ii) The effects of un-consented transfers

Operating agreements often refer to the effects of breaching a clause providing for restrictions on transfers. In some cases, the LLC agreement establishes that any attempt to make any sale of, or create, incur or assume any encumbrance with respect to any membership units will be null and void and ineffectual and shall not be binding upon the managing member, if there is one, or the company. Non-transferring members will have all rights and remedies available under the agreements. Additionally, it is sometimes submitted that the purported transferee will have no rights or privileges in or with respect to the company, and the company will not give any effect in the company’s records to that attempted sale or encumbrance. Alternatively, there are operating agreements in which it is established that in case shares are transferred against the provisions of the agreement they should be redeemed. Furthermore, in some cases it is also agreed that any transfer, assignment, encumbrance, pledge, hypothecation or transfer which shall result in the termination of the relevant company for federal income tax purposes will be null and void ab initio and of no legal force or effect whatsoever. Other contractual clauses stipulate, in addition, that after a transfer of any part of a membership interest is executed the membership
interests transferred shall continue to be subject to the terms and provisions of the relevant agreement and any further transfers are required to comply with all the terms and provisions of the agreement.\textsuperscript{391} At times, it is also set forth that a transfer of any units in the company entitles the transferee of such units to receive only the economic interests. The transferee obtains no right to vote or participate in the management of the business and affairs of the company. Notwithstanding the foregoing, a transferee shall be included within the term ‘member’ for the respective purposes of the agreement, except for purposes of the rights of a member to purchase units of other members. The transferor remains a member of the company with all rights to vote and manage unless and until non-transferring members owning a majority of the outstanding units in the Company (other than the units held by the transferor or the transferee) consent, in their sole discretion, which can be unreasonably withheld, to make the transferee a member.

The contractual profile of these clauses is diverse and can certainly vary depending on the purposes of the company and the protections investors may or may not be individually searching for. There is, however, a common denominator to these clauses when it comes to regulate the un-consented transfer. First, agreements are more elaborated than the default provisions of the NYLLCL and the Delaware LLC Act. Members and their attorneys do not just stick to the wording of the defaults and draft the contracts with the necessary safety nets and protections. Second, these agreements do not bring along the same kind of issues regarding the relative unenforceability of the un-consented transfer of shares as we have seen in the cases of Portugal, Italy and France, where courts have been discussing whether an un-consented transfer is valid between the parties even if unenforceable toward the company.\textsuperscript{392} With the assignment or transfer of shares in a LLC, economic rights which are related to a membership interest can be exclusively transferred to the transferee. This gives members of the company flexibility. Management rights, however, are influenced by property-rights principles. Therefore, the free transfer of managing rights is restricted pursuant to the way the concept of transfer is tailored in the agreement. The agreements, in general, adopt a broad concept of transfer. For example, transfer means ‘sell, assign, convey, contribute, distribute, give, or otherwise transfer, whether directly or indirectly, voluntarily or involuntarily, by

\textsuperscript{391} Instead of shares, LLC agreements refer to units or membership interests. According with some of these LLC agreements, membership interests may be defined as ‘…a Member's entire interest in the Company including the Member's Economic Interest, the right to vote on or participate in the management, and the right to receive information concerning the business and affairs of the Company’.

\textsuperscript{392} See Vicente, Lécia, ‘Un-consented Transfers of Shares: A Comparative Perspective’, \textit{European Company Law Journal}, December 2012, vol. 9, 6, pp. 300-304. In the case of the United Kingdom, the registration gives effect to the transaction. So, it seems that, while it is not registered in the register of members, the transaction produces effects between the parties, but not toward the company.
operation of law or otherwise, or any act of the foregoing, including any transfer upon foreclosure of any pledge, encumbrance, hypothecation or mortgage. The terms ‘transferee’, ‘transferor’, ‘transferred’, ‘transferring member’, ‘transferor member’ and other forms of the word ‘transfer’ shall have the correlative meanings’. The reason why restrictions on transfers and members rights are so detailed in the agreements has largely to do with this broad concept which encompasses several forms of bargaining. Members enjoy management rights and economic rights which they have to account for each and every time they transfer their units. The effects of the un-consented transfer of shares determined in the agreements echo this dual structure of the shares (units). Besides, they are reflective of the multiple layers of bargaining covered by the concept of transfer.

(iii) The contractual governance of the companies

The restrictions mentioned above delineate, in the words of the agreements, the rights, powers, preferences, limitations, duties, liabilities and obligations of the holders of the units in the respective companies. Additionally, they specify the outstanding role played by the management in its diverse forms (board of directors, board of representatives, board of managers, management board, or management committee). Many of the companies whose LLC agreements I analyzed are equity funds. All of them have identical contractual structures, and are drafted in similar ways. Being equity funds is not what makes these companies interesting. Their intriguing aspect rests on the fact that their members are relatively passive, and rely heavily on the management to make investments and generate liquidity. If seen the other way around, the managers are quite active, and sometimes even have the right to act discretionarily. However, the managers’ actions may be subject to the oversight of a management committee or any other sort of collective board.

There are other examples in which the management and operation of the company and the determination of its policies are vested exclusively in the respective sponsor or managing member. They are authorized and empowered to carry out and implement any and all of the objectives and purposes of the firm. However, depending on the agreement, members may hold the power to unilaterally take any and all actions regarding major transformations of the company such as capitalization, mergers and acquisitions, consolidation, liquidation or

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393 This definition is provided for in the Amended and Restated Limited Liability Company Agreement of PBF Energy Company LLC, dated and effective as of 12 December 2012.

394 See Part II, Chapter 2 for a definition of share.
dissolution of the company, admission of new members, and changes in the membership percentages. The power to manage and operate the company as well as to determine its policies regarding strategic operations including mergers and acquisitions and capital structure may be exclusively held by a sponsor or managing member. They are authorized and empowered to carry out and implement any and all of the objectives and purposes of the firm. Still, their actions are subject to investors’ oversight. In certain circumstances, the sponsor shall not have the authority to act without the consent of investors holding a certain percentage of units.

The management of these companies resembles in many instances the board of directors of corporations, and substantially functions like a corporation. They may be composed of officers,\textsuperscript{395} (who are directly dependent upon the management)\textsuperscript{396}, chief executive officers (who are subject to the control of the manager and to the restrictions that the manager may impose, may have general supervision, direction, and control of the business and affairs of the company), vice presidents (who can substitute chief executive officers), secretaries (who keep or cause to be kept at the principal business office of the company, or such other place the manager may order, a book of minutes of all proceedings of the members and the manager), assistant secretaries, treasurers, assistant treasurers, and chief compliance officers. This may be different for standard LLCs which do not give legal form to equity funds, for example, and thus do not foresee the figure of the sponsor with all the powers to direct and control the business it implies. In these LLCs managers may be more limited on their powers and, therefore, shall have no authority to take actions on behalf of the company without obtaining the written consent of all the members. Among such actions may be the sale, financing, conveyance, assignment, transfer, disposing or refinancing of all or a substantial portion of the assets of the company; merger or consolidation of the company; change of the name of the company or location of its principle office; amending or cancelling the certificate of formation of the company or change the state of organization of the company; admit a new member or add an additional manager; incur any lease (as lessee) conveyance, mortgage or other indebtedness not included in any budget approved by the members; make loans on behalf of the company, except in the terms determined in the LLC agreement; incur or enter into any lease, conveyance, mortgage or other agreement or indebtedness on behalf of the company.

\textsuperscript{395} The power of the officers may be set forth not only in the respective operating agreement, but also in side agreements (e.g., employment agreements or even memoranda of understanding (MOU)). In some of the selected operating agreements, officers as well as managers are expressly identified as agents of the company for the purpose of the company’s business and the actions of the officers taken in accordance with such powers shall bind the company.

\textsuperscript{396} Sometimes managers additionally delegate their authority to a board of trustees.
which requires the personal guarantee of any member or any affiliate of any member; settle any claims or lawsuits against the company or commence or overtly threaten any law suit or other action on behalf of the company against a third party; contravene the LLC agreement or any other agreement to which the company is a party; act in a way that would render it impossible to carry on the business and affairs of the company; do any action that would cause the company to be treated as a corporation for federal income purposes; or take any action that would cause the dissolution of the company but as determined in the agreement. When the management is drawn as such it almost resembles the way management is designed in French PLLCs without prejudice of the specificities of the American LLC.

The manner in which LLCs are contractually governed is interesting and complex. The agreements show that managers are often elected by one of the members. This is different from those situations in which members are vested with managerial authority in proportion to the shares they hold in the share capital. Also curious are the confidentiality clauses in these agreements establishing, for instance, that the identity of any person with whom the company may be holding discussions with respect to any investment, acquisition, disposition or other transaction, and all other business, financial or other information relating directly to the conduct of the business and affairs of the company or the relative or absolute rights or interests of any of the members is confidential and proprietary information of the company. I have not had access to any original side letter agreements, due diligence executive summaries, nor to correspondence with or among the investors of the companies in the sample. Most of these documents are kept private. However, it is often the case that in such ‘side letter’ agreements the management and investors agree on specific terms, conditions, protections, and special consents on the transfer of these investors’ shares.

The LLC is indisputably a very flexible form of business organization. It is used as a business vehicle and as a contractual instrument to design the rights and obligations of the members and the governance of the company pursuant to its business purpose, its members’ interests and the protections they expect to come along with their investment. Hence, these companies’ profile is contractually asymmetric in the sense that on one hand members’ rights and obligations, the managers’ role and all other sorts of specifications as to distributions, allocations of profits and losses, and so on are all set out in the operating agreements. On the other hand, many issues in need of bargaining are not included in the LLC agreement. There are clauses of some LLC agreements that exhort members not to file a particular action with a court since that would likely tear apart the business enterprise (this means that disputes are
settled aside the LLC agreement). Besides, the LLC itself lies on a contractual web whose lines connect side agreements and several bargaining layers (not all of them comprising matters dealt with by the LLC agreement). In these circumstances, transfer restrictions work as guarantees of contractual integrity and companies’ governance.

III. Market

i. The LLC at the crossroads: The case of contentious disputes over membership interests in the LLC

The way restrictions work as guarantees of contractual integrity and governance is not crystal clear. The analysis of 14 cases adjudicated by US courts regarding assignments or transfer of shares illustrates this idea. Courts decided on legal problems which are clustered as follows.

1. **Interpretation**
   
   (i) Problems of the parties interpreting the respective operating agreement, and in particular, the transfer clause establishing the restrictions on transfers (it is often the case that this clause is the heart of the contentious dispute);

   (ii) Doubts as to which interests were transferred with the execution of the share sale and purchase agreement;

   (iii) Problems understanding the validity and effectiveness of ‘handshake agreements’ freeing particular transfers such as those made to spouses and children of members from any restrictions, particularly after the company was transformed into a LLC.

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397 The LLC agreement of the Delaware company Inland Diversified Dayville Killingly Member, LLC dated as of 3 October 2012 sets forth that ‘The members agree that irreparable damage would be done to the good will and reputation of the company if any member should bring an action in court to dissolve the company’.


(iv) Problems understanding how to frame and interpret the transfer clause which was drafted whilst the company was still a partnership and not yet a LLC. Furthermore, parties dispute whether the scope of the clause encompasses the situations in which there is a change in control of one of the companies, which are in turn partners of the LLC.  

(v) Members, as they admit in the judicial proceedings, are not familiar with the mechanisms of transferring membership interests, but are only aware of the big picture.

(vi) Difficulties in distinguishing management and economic rights, and clarification of the circumstances in which members are entitled to exercise one or the others in the context of the assignment of membership interests of the bankrupt minority member to the majority member.  

(vii) Problems in understanding on which grounds a transfer was un-consented or not, considering that not only the LLC agreement was entered into, but also several other agreements of distribution, property management, purchase agreements, loan agreements, license agreements and so forth were entered into. (Courts tend to adopt an objective approach to contracts and interpret and apply their terms just as they are included in such contract).

2. Functionality of restrictions on transfers

(i) Situations of deadlock in 50-50 LLC when the LLC agreement has no ‘reasonable exit mechanism’ or other way to break the deadlock.  

(ii) Buck-passing and violation of fiduciary duties under the respective operating agreement.

(iii) Predatory practices inside the firm against certain shareholders, especially if they also are employees of the company. The imposition of restrictions on transfers may indirectly serve this purpose.

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404 ACHAIAN, INC. et al. v LEEMON FAMILY LLC et al. 25 A.3d 800; 2011 Del. Ch. LEXIS 118. Also see EUREKA VIII v. NIAGARA FALLS HOLDINGS Del.Ch., 899 A.2d 95 (2006).
Oppression of minority shareholders by majority shareholders. (One of the ways minority shareholders have to defend themselves is to file a motion so that courts intervene to enforce their rights of first refusal or first offer over the sale of shares to non-members of the LLC). 406

Opportunism of the members. They are supposed to know what needs to be done if they want to change the company’s ownership. They just do not do it, or they do it in a deceiving way. 407

3. Un-consented transfer of shares

(i) Breach of the relevant operating agreement. In other words, parties do not follow the rules they themselves have established in the operating agreement. 408

(ii) Claims made by the transferee against non-transferring members and their attorney accusing them of tortious interference with contracts and civil conspiracy for having sold part of the membership interests the transferee was assigned through an un-consented transfer. 409

4. Formalities

(i) The existence of intricacies within the LLC which are closely linked to its closed nature or with the fact it is a family-owned company. As a result, at times, formalities and queries are omitted. For example, requests for the change of the company’s ownership structure are liable to not be taken seriously in these circumstances, and instead to be taken as mere administrative requests to change the payee’s name or the name of the beneficiary of the company’s contributions. At first blush, these requests to change the ownership structure are not viewed by the non-transferring shareholders as formal transfer proposals, neither are they treated as such.

Additionally, due to the family nature of the company, the understanding that due diligences are not needed prevents a clear perception of what transfer requests/proposals are all about in these companies.\textsuperscript{410}

(ii) The calculation of the fair value of membership interests upon withdrawal of a member or termination of the LLC agreement.\textsuperscript{411}

The contractual basis of the LLC as well as the contractual web involving its dynamics, given the number of agreements members enter into and between themselves and third parties, make it difficult, in some cases, for restrictions on transfers to accomplish the purpose for which they are generally drafted. This is, perhaps, the case because the LLC is at the crossroads of rights and obligations arising from different contracts and unwritten compromises.

3. Conclusions

This chapter draws upon the three stories that have been leading this historical excursion: (i) the story about interest groups interfering with legislative outcomes and policies; (ii) the story of law as a byproduct of private ordering; and (iii) the story of legal evolution of the PLLC in the United Kingdom and the United States. As in the previous chapter, these narratives are clothed in three parameters – state, actors, and market.

In respect to the first parameter, the private company was legally accepted in the United Kingdom in 1907. This process of legal acceptance, however, is not exclusive to the United Kingdom. It happened in Portugal, France, Italy, and Spain as described in Chapter II. The narratives I relate here suggest that the formation of these companies went hand in hand with market structures, even when they were not formally acknowledged by legislators. This explains their steep increase every time they are accepted by law. They are no longer underground. This also affects statistical results given that these companies are included into statistical surveys after their legal recognition.\textsuperscript{412} Naturally, the statistical treatment yields results which could not be reached by making an account of their evolution at a time when they were looked at, but not really seen. Because private and public companies were not traditionally differentiated by legislatures in the United Kingdom, it is difficult to establish a


\textsuperscript{412} Statistics and state-organised surveys may have been, in fact, one of the most efficient state-driven promotions of the new business form.
solid date such as 1844, 1855-56 or 1862 as of which the private company started to blossom in the United Kingdom.\footnote{In the United Kingdom the motto ‘think small first’ always was taken seriously. However, this motto makes most sense in the legislative history of UK company law, given that reforms were mainly directed at private companies.} This takes us to the second parameter, the actors. The distinctive features of these companies cannot be grasped without an examination of these companies’ constitutional documents, their governance and ownership structures, and the web of transactions the companies as well as their members entered into at a lower level. The way market agents interact at the lower level affects the evolution of these business organizations. The market parameter reveals the numerous circumstances fleshing out bargaining in these companies. The starting point in the Companies Act 2006 is that shares are freely transferable, unless articles of association say otherwise. Historically, there have been no major legislative changes to this rule. However, given their contractual purpose, restrictions on transfer of shares have been widely accepted by United Kingdom courts. In fact, judgments of contentious disputes over transfers are not an exception to the positive contractual approach of United Kingdom courts. Courts are sensitive to the market’s structure and put the responsibility of the contractual choices on the shoulders of the parties. Judges will look at restrictions, and will not make any particular judgments because such restrictions are an encroachment of the principle that shares are freely transferable. Additionally, the provision of a considerable number of default rules and Table A from which parties can opt out reveals the contractualist approach taken by UK legislatures. Freedom of contract has been the dominant approach in UK corporate law, which pinpoints crucial points such as careful drafting. Nevertheless, default rules and Table A are great safety nets. Considering the dimension of these companies, the question is whether there are any public interests legislatures should call back. This is an increasingly topical debate in the United Kingdom.

In the United Kingdom, private companies were historically ‘downloaded’ by legislatures, and restrictions on transfer played a special role in defining their form. It was assumed that those who ‘owned’ and managed the company were capable of doing it underground. The United Kingdom case shows that where the line between private and public was blurred, contractual flexibility served different purposes. It also suggests that contractual flexibility has been used to this day to strengthen the control of directors over private companies. According to the memoranda and articles of association analyzed, as well as case law, this corporate constituency seems to be in a privileged position to affect the design of rules governing the private company and its enforcement.
In the United States, the LLC is relatively young, and it has been looked upon as a panacea. It shares the same advantages of flexibility and adaptability to small and medium enterprises which made it a success in the other selected jurisdictions. Additionally, adopting a LLC may be a smart way to avoiding double taxation, which comes along with being taxed as a corporation. However, when we have a look at the first parameter, historically, the United States lagged behind when it came to enact its first LLC law. This was so even when, in practice, business people counseled by their attorneys would likely tailor by contract their firms so that they fit their interests and guarantee the kind of protections they were seeking by investing in that business. However, traces of path-dependence were blatant to the point that it had to be a legal decision altering the rules on corporate taxation, and finally defining the LLC status for tax purposes to make the new business form break through.

At the level of the second parameter, an assessment of LLC agreements clarifies that drafting a contract in particular a LLC agreement implies taking chances and making multiple choices. This encapsulates the economic problem inherent in the LLC. The LLC agreement tries to tackle it either through complex clauses regarding the status of the company for tax purposes, through clauses that specify the ownership and governance structure of the company, and in particular through clauses restricting the transfer of shares.

Regarding the third parameter, the case law I collected showcases scarcity and asymmetries of information, transaction costs, ‘ramifications of bounded rationality’ and opportunism of members and weak(er) property rights of certain members clashing with what was supposed to be a durable investment in the company. Stronger property rights and adequate and contractually well-defined governance mechanisms are in order. But I envision something bridging the property rights and the transaction costs literatures. Not only are strong(er) property rights crucial to overcoming the lack of incentives to invest and

414 Tax rates in the United States are one of the highest in the world.
416 See Easterbrook, Frank H. and Fischel, Daniel R., ‘Close Corporations and Agency Costs, Stanford Law Review, vol. 38, N.º 2, 1986, pp. 271-301 (287) (stating that ‘Ordinarily, if the number of contracting parties is small enough and property rights are well specified, the parties will dicker to the optimal solution no matter what the legal rule may be’).
safeguard the investment in the companies, but also contract governance mechanisms are key for this purpose.\textsuperscript{418} In other words, not only mechanisms to overcome ex-ante contractual inefficiencies matter, at the level of contractual regulation, but so do mechanisms to surpass ex-post inefficiencies at the level of implementation.

Still, there are situations in which legislators, courts, and most importantly law consumers prefer to cut off their noses despite their face and opt to keep a legal status quo, or to accommodate their contracts to the legal fixity and doctrinal path-dependence which characterize many of the solutions already entrenched in the law.\textsuperscript{419} I think that the evolutionary process of the law can be responsive to competition, for market agents, by competing and cooperating at the lower level, force legal change. The balance between competition and cooperation is, however, delicate. It is a dynamic. The PLLC, not only in the United Kingdom and the United States, but also in the other selected jurisdictions is an illustrative instance. I believe that competition challenges claims of legal gradualism and the sanctity of protectionist devises that become embedded in the law for years, decades, and even centuries. This is where my middle position comes in.\textsuperscript{420} I explore this in the forthcoming chapters.

\textsuperscript{418} See Sund, Lars-Göran, and Bjuggren, Per-Olof, ‘Family-Owned, Limited Close Corporations and Protection of Ownership’, \textit{European Journal of Law and Economics}, vol. 23, 2007, pp. 273-283 (273) (arguing that ‘The incentives to make long term investments are strengthened if ownership rights are protected and freedom of contracts is a basic element in the process of efficient allocation of scarce resources’).

\textsuperscript{419} Guinanne, Lamoureux, Harris and Rosenthal (GLHR) in their work do not seem to take the road of doctrinal and political economy path-dependence. They explain how it was that the partnership prevailed in Germany, France, the United Kingdom and the United States even at a time when general incorporation laws had been enacted and the corporation had been made available for all and not just for a few. It is true that businessmen, especially in Germany and France, avoided the corporation because there were other business forms that better satisfied their needs. However, it is also true that change is not immediate and that people, even businessmen, tend to stick to what they know. All things being equal, they tend to use the legal forms with which they are familiar. There must be an incentive that drives them to break with the status quo and adopt something new. The fact is that the PLLC was adopted with success in all six jurisdictions. This is most likely due to its contractual nature and fewer regulatory handcuffs that were enough to trigger a ‘mutation’ in the respective legal systems. Guinanne et al.’s argument is valid for the United Kingdom where, despite the legal acceptance of the private limited company, the partnership was still used in high numbers. The reason for this may be that there is not a straightforward structural distinction between private limited companies and public limited companies in the United Kingdom, and partnerships, which are basically tailored by contract, still provide fewer regulatory burdens than the other two.

PART I OVERVIEW

The historical approach is, in fact, a storytelling of a number of events. It tells a story of interest groups interfering with legislative policies; a story of law as a byproduct; and a story of the evolution of business associations in six countries: Portugal, France, Italy, Spain, the United Kingdom and the United States. Each story is contextualized by three parameters – state, actors and market. Together, the stories address two points: why some countries lag behind others when it comes to introducing legislative innovations, and what has been the role of state policies in affirming these business organizations, in particular private limited liability companies. Moreover, the cross-country historical and legal overview and empirical evidence gathered throughout these pages helped disclose PLLCs’ legal regime in the selected jurisdictions and shed light on the micro-sphere of these companies.

As to the reasons for countries lagging behind others, my findings reveal that the three southern peripheral countries – Portugal, Spain and Italy – and France were influenced by exogenous factors which compelled their legislatures to adopt a new corporate form. Such exogenous factors are as diverse as the challenges offered by colonial enterprises, by the demands of businessmen and trade associations, and the missionary and moralizing commitments assumed by the political movements in force at the time. With respect to the United Kingdom, endogenous factors rooted in the business environment such as customary practices of businessmen contributed to the legal acceptance of the private limited company. The United States constitutes an intermediate case, wherein endogenous and exogenous elements are coupled. Its specificity lies in the fact that this is a geographically big country, a federal country with fifty-one jurisdictions and a country not only driven by inter-state competition, but also driven by a market in which the individual and not so much the state takes matters into her own hands by lobbying with legislators whenever she feels that her business needs more and better laws. This was the case with the Wyoming LLC Act.

Despite of the influence of exogenous or endogenous elements, in all six jurisdictions legislatures and courts (state parameter) played a decisive role as to the creation and implementation of the new business form. Moreover, the above narratives show that the passage of laws depends more on the popularity of the issue that is being lobbied (position and resolve of politicians and legislators) than on the resources available (lobby power). The need for new forms of business organizations was mostly felt in the second half of the nineteenth century. Lawyers, notaries and courts helped disseminate the PLLC in different
degrees, and turn it into a popular business form in the selected jurisdictions, even if not legally consecrated yet. Companies and individuals also lobbied to get alterations implemented (actors parameter).

For instance, data show that Portugal was quicker than the rest of the countries in adopting the PLLC. The Portuguese legislature imported the *GmbH*, which had been created by the German legislature slightly before. This peripheral European country is far from being an economic leader. In the United Kingdom, the number of contentious disputes (some of them emblematic) and political strategies paved the way for the acknowledgement of the existence of these companies. The reluctance to take legal notice of their existence seems to be linked to the great value placed on freedom of contract in the United Kingdom and to the idea that parties are the owners of the contract.\footnote{This expression portrays the contract itself as the object of ownership rights.} Chronologically, the vogue of reform started in the United Kingdom in 1844 when the Parliament passed legislation establishing general incorporation without limited liability. In 1855-56, legislation was passed providing for limited liability. The Companies Act 1862 consolidated existing legislation. This is not surprising considering that, at that time, the United Kingdom was the world stage for the Industrial Revolution. However, the private limited company had not been acknowledged by the United Kingdom legislator yet. The Companies Act 1907 and, subsequently, the Companies Act 1908 consolidated the legal framework of the private company. In Italy the concept of limited liability company appeared for the first time in the Commerce Code of 1882. This code provided for the joint stock company and the joint stock company with shares. The latter did not flourish due to the unsatisfactory regulation of the Commerce Code. Attempts of legal reform finally came, following the annexation of Venezia Giulia and Tridentina where there were plenty of limited liability companies which had been incorporated under Austrian law. The Spanish case is similar to the Portuguese and the Italian. The PLLC informally existed in this country for a long time. Business people would create private companies by contract totally outside the legislator’s reach. This was acknowledged by doctrine and legislators, but it was only in 1953 that the SRL was created following the implementation of the legal regime for the publicly held company, and the aims of the prevailing political regime at the time. The Spanish law, like that of the United Kingdom, stresses the contractual nature of the SRL. Its legal framework is mostly constructed out of default rules.\footnote{It is interesting to note that in this regard the United Kingdom is more similar to Spain, Italy and Portugal in the sense that most of the rules regulating the private company are default rules and, therefore, freedom of}
Italy, the differences between the SRL and the publicly held company are defined in Spanish law. This distinction has not traditionally been made in the United Kingdom and, currently, the Companies Act 2006 does not present a clear-cut differentiation in the regime of the private limited company and the public limited company. This particular aspect, which is highly related to the fact this difference has never historically gained much ground, explains, I believe, the ownership structure in the United Kingdom private company, the role of directors, and their relationship with the members of the company. As to France, French legislators decided to implement the SARL in the post-war period, after Alsace-Lorraine reverted to the French territory. Still, French legislators wanted to ensure that the SARL was a business form of its own with singular features that would not owe much to the German GmbH adopted in 1892 and to the United Kingdom private limited company adopted in 1907. Its ownership and governance structures are more rigid than the PLLCs of other selected jurisdictions due to the unanimity and majority requirements for which the law has historically provided. Lawyers, notaries and for the most part jurisprudence, which was less conservative and skeptical than in the selected common-law countries, had a big stake in downloading the new form. Yet again, the SARL has the stamp of flexibility in its form and versatility in its legal framework ranging from corporate to tax law. Finally, the United States formally welcomed the LLC in the second half of the twentieth century. At first blush, one might say it is the laggard jurisdiction among all selected. To a certain extent it is. It is also true that the rapid development of the LLC calls for a better definition of the property rights that members hold in their shares (this is the reason I claim that for the LLC the best is yet to come). However, the LLC carries with it the heritage of different business forms which, legally consecrated or not, have sustained and boosted American industry for centuries.

Post-war periods are historically times of great economic development in many fields and sectors of civil society. According to a French legislator, ‘The insufficiencies of business forms were essentially felt as of the second half of the nineteenth century due to the imminent changes resulting from the commercial and industrial methods’. See Journal Officel de Republique Française, 1925, No. 1, Senat – Séance du 17 Fevrier 1925, p. 117. Furthermore, it was said that the limited liability company was a truly international institution, meant to satisfy the identical economic needs in all countries that had reached an advanced state of commercial and industrial development.

From the evolutionary point of view it would be fair to ask: is law still evolving? Many legal solutions not only in the field of corporate law, but also in other fields of law, have altered the way private ordering is manifested. However, for the most part, these private ordering manifestations constitute the 'DNA' which is entrenched in the law, and even the legislators, whilst coming up with new rules have to deal with it.
The analysis of historical data showed that some countries are more likely than others to take up opportunities to legislate. Cultural nuances showcased by the law, the prior existence of other business forms, the importance of the banking system and bankruptcy law in these countries are all possible explanations. Had there been an open market for law would these jurisdictions have created the PLLC earlier? It is difficult to say. All six cases suggest, however, that legislators and courts are liable to respond to incentives to change their policy. The responses are highly contingent upon the availability of the 'right' incentives. This is so possibly because markets were less mature, or they did not feel the need to adopt new business forms. In this context, the role of lawyers and legal practitioners has been crucial. They have a privileged sense of the market and helped 'download' these organizational forms.

As to the micro-sphere of these companies, if we closely look at their historical profiles and to the relationships between corporate constituencies we are likely to discover that they are the product of an open-ended process of bargaining and disputes (market parameter). Many of them are kept silent, either because it does not pay off to go to court (courts move extremely slowly and are cost-intensive, as in Italy, Portugal, and Spain), or because turning conflicts in the company into contentious disputes would just break the commercial enterprise apart. This helps us understand how each constituency views itself and others in this process of construction, deconstruction and regeneration of the company.

Looking at the micro-sphere of these companies also made it possible to discern the several traits of their ownership and governance structures and the interaction of their

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425 See Part I, Chapter 1 where I refer to this apropos measures and policies that could be implemented in different countries, but legislatures opted not to do it. At that point, I called the attention of the reader to how this can actually affect the availability of data concerning these business organizations.


427 In respect to the German case, see Eckert, Georg, and Kalss, Susanne, *Zentrale Fragen des GmbH-Rechts: Entwicklung, Perspektiven, Materialien*, Wien, Linde Verlag, 2005, p. 48 (stating that 'Geschichte und Entwicklung des GmbH-Rechts sind völlig anders als die des Aktienrechts, Sie ist kürzer, überschaubarer und mit klaren Markierungspunkten zu verorten. Während das Aktienrecht aus verschiedensten Quellen mehrerer Länder Schritt für Schritt zu einer eigenständigen Gesellschaftsform verschmolz, beruht das GmbH-Recht auf analytischer Mangelherbung, rechtspolitisch-konzeptionellen Vorüberlegungen und bedarfsorientierter wirtschaftspolitischer Argumente; umfangreiche Enquennten und Bedarfserhebungen sowie mehrere private Entwürfe veranlassten den Gesetzgeber zu konkreten legistischen Maßnahmen' ) ('History and Development of the (limited liability company) law are completely different from the stock market exchange law. If [the development] is shorter, easier to follow and can be traced to clear (stages) of development. Whereas stock exchange law emerged out of very different sources from different countries step by step into an independent (form of company/law), the limited liability company law result from an analysis of (the lacks in the then current legal order), political-conceptual considerations and economic necessity. Detailed surveys and analyses of necessity, as well as several private draft versions, lead the legislator to make the concrete law').

428 The analysis of the sample of court decisions revealed that the lapse between the moment a petition is filed in a Delaware court and the moment it is decided may be up to one month. This is radically different from the decision on timing in Portuguese, French, Italian, Spanish and even United Kingdom courts. In the Southern countries it may take years to arrive at a court decision as of the moment the petition is filed.
elements through the contractual design of their articles of association. The analysis of case law complemented the endeavor of historically profiling these companies. It allowed a close look at the behavior of their members and managers and an understanding of the different layers of bargaining which are not necessarily comprised within the ‘four corners’ of the company’s articles of association. Bargaining, however, even if not comprised in the ‘four corners’ of the companies’ articles was liable to affect the structure of property rights of shareholders in their shares. The several layers of bargaining to which one is exposed also hint at a paradox which in private companies is not always obvious. Dependence of the company on its members is high, but managers and directors are contractually empowered. Where the line separating ownership from control is typically murkier, often articles of association were designed to empower managers or directors (United Kingdom and United States). If it was not the case that articles of association were designed this way, in practice, managers and directors succeeded in capturing such power, especially if they were majority shareholders (Portugal, France, Italy and Spain). This was clearer to see through the ‘doctrinal clusters’ of legal issues that courts in these countries had to decide on. The four clusters – interpretation, functionality of restrictions on transfer, un-consented transfer of shares and formalities exposed governance problems in PLLCs that require instances of ‘diagnosis’. They result from the mutual or reciprocal action or influence of corporate, contract, and property rights laws framed by the political, and socio-economic contexts in which these companies evolve.

Trying to ‘download’ the PLLC through this parallel historical research makes apparent how law is a byproduct of normative solutions or, in biological terms, an extended phenotype. The political process, cycles of economic development of the countries, cultural patterns of behavior, gender and the law matter for shaping standards of investment, compromise and liability. The biggest challenge for law, however, is to keep up with this open-ended process of bargaining and struggles within companies and to provide incentives for reciprocity and for an enduring system of exchanges to take place. Nevertheless, law itself, as is more clearly revealed by the parliamentary debates and related documents, is subject to struggles and negotiations which manifestly determine the contents of legal provisions. Law itself is contingent upon and vulnerable to decisions to maintain the status quo. Consequently, while law as a byproduct is not certain to affect the many forms taken by these business associations, it is definitely liable to do so. History shows that state policies have a facilitative role, and this is the crux of this matter.

Another good example of law being a byproduct is the legal consecration of the right of members of American LLCs to bring derivative suits. This right was first created by courts and later adopted by legislatures.
The dovetailing of the three parameters (state, actors, and market) translated, in practice, into the yoking of state policies, multiple forms of private ordering, and the economy. Indeed, law operates in a very organic way.\textsuperscript{430} Its development is strikingly similar to that of a living organism, and this fact establishes the grounds upon which the analogy between legal evolution and evolutionary biology can be set forth. I offer an analogy with the gene-selection view presented by Dawkins. He defines a gene as: ‘…any portion of chromosomal material which potentially lasts for enough generations to serve as a unit of material selection’.\textsuperscript{431} As he puts it, ‘The gene is the basic unit of selfishness’.\textsuperscript{432} This is so because genes compete directly with their alleles, that is to say, other genes, for survival. Their alleles in the gene-pool are rivals for their slot on the chromosomes of future generations. Any gene that behaves in this way (i.e., selfishly) in order to increase its chance of survival at the expense of its alleles will tend to survive.

This explains how genes depend upon the environment which is also formed by other genes. The environment is the climate or background, modifying and influencing the effects of any particular gene.\textsuperscript{433} My analogy can be set in the following terms. Legislators are part of this 'environment' and have the ability to shape it by artificially selecting from within it certain elements. This is different from the process of 'natural selection', which in this context operates on what market agents do in the wild. Other legal stakeholders like judges, lawyers, and notaries are potential occupants of the same slot along the legislative process. This is made possible either through the formation of interest groups which lobby for the enactment of legislation, or through a creative process of adjudication in the case of more activist judges, or even through the adoption of certain customary practices by lawyers and notaries which end up prevailing over inefficient legal provisions. Hence, legislating efficiently to build up a coherent and efficient body of rules is tantamount to creating a solid law that will survive in

\textsuperscript{430} See Smith, Stephen A., \textit{Atiyah’s Introduction to the Law of Contract}, Oxford, Oxford University Press, 2006, p. 21 (noting that one general feature of the historical development of the law is its organic development. He points out the legal education of judges in common law which is based in practice and inherited craftsmanship. Judges previously were successful practicing lawyers. He also points out that until very recently judges and lawyers alike did not receive any academic training in law nor did they take advantage of the scientific literature. It was not until the late nineteenth century that the common law was first taught in the universities. It appears this picture is very similar in the United States).


\textsuperscript{432} See Dawkins, Richard, cit., p. 39.

\textsuperscript{433} See Dawkins, Richard, cit., p. 64 (stating that ‘Genes are the primary policy-makers; brains are the executives. But as brains became more highly developed, they took over more and more of the actual policy decisions, using tricks like learning and simulation in doing so. The logical conclusion to this trend, not yet reached in any species, would be for the genes to give the survival machine a single overall policy instruction: do whatever you think best to keep us alive’).
the future.\textsuperscript{434} The environment in which rules develop is important, for it can create the conditions for legislators and other stakeholders to come together and cooperate. Genetically speaking, private ordering manifestations are part of the law’s DNA. Contractual solutions are achieved through natural selection which is fueled by competition. Competition can bring legislators and legal stakeholders together for mutual compatibility. There may be, of course, inherently bad genes, or in other words, genes that are not able to collaborate well with others in the same gene-pool. This makes it difficult for legislators to keep up with the genetic predisposition of some legal solutions, which, at the end of the day, she must necessarily deal with.

As I intend to explain why law is how it is, I concentrate on private ordering and on how it influences legislative policies and the design of legal rules. At this level, the analogy can be further extended to describe how law can play a role in adapting to new circumstances. Natural selection operates in the sense that each gene is naturally chosen for its capacity to cooperate with its environment composed of other genes. The cornerstone of Dawkin’s argument is based upon the idea that genes are ‘immortal’.\textsuperscript{435} This assumption, in turn, rests upon two facts: the cross-over of genes and individual mortality. As to the first fact (i.e., cross-over of genes), history shows there is a tendency in legal systems for crossing-over and mutual engagement.\textsuperscript{436} This is what market agents do. They facilitate the crossover and engagement of legal systems. According to their needs and contractual practices, they lobby with legislators so that specific legislation is passed. Thus, there is this tendency for the reproduction of legal solutions which take bits and bytes of existing rules (pleiotropy). The narratives I have told in this chapter illustrate this and show how, in some cases, legislators and other stakeholders are liable to behave in the making of the law. As to the second fact (i.e., individual mortality), natural selection will favor genes which have the effect of postponing the operation of other lethal genes,\textsuperscript{437} and will also favor genes which have the effect of preserving the effects of good genes. It is in this context that law and the artificial

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\item \textsuperscript{435} I am putting aside the hypothesis that no organism with a specific gene survives.
\item \textsuperscript{436} See Ribstein, Larry E., The Rise of the Uncorporation, New York, Oxford University Press, 2010, p. 9 (stating that ‘There is reason to believe that a similar process involving tension between regulated and flexible business forms is occurring throughout the world’).
\item \textsuperscript{437} Lethal genes or alleles are genes that prevent the reproduction of an organism because they cause its death.
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selection done by legislators are not irrelevant. Legislators, working as selective agents through the laws they enact, have the potential to cause a change in gene frequency. This is why law should not be seen as static: it has a considerable margin of evolution. The question is to know how law will deal with all this genetic complexity which makes the interactions between genes and environment extremely important. In fact, some would say that the difference between genetics and environment is the different time scale at which they operate. It is certain that there is a relationship between genes and environment, but how the environment influences genes and how social information is transferred is an open question.

Law as an aggregate of genetic manifestations of private ordering on one hand, and as a catalyst of change on the other, begs the following question. Structurally, what comes before the gene? In biological parlance, the gene is like a recipe in a book on making protein. Proteins build up the human body. The words of this book are the codons. Codons specify the aminoacids which form the protein. The nucleotides, which form the basic constituent of DNA, are the letters. This is what comes structurally before the gene. The recipe of this book can be altered provided there are mutations that have the potential to be preserved by natural selection. The analogy with law boils down to the fact that legislators and other stakeholders have the ability to favor genetic changes and in this way affect the evolution of bodies of law and the development of rules and legal institutions. Survival of rules is an important argument in favor of efficiency as a normative standard in assessing the quality of law. In other words, a rule which is not avoidable is likely to be efficient because grossly inefficient rules will not survive. I am considering a scenario of natural selection that is contingent upon cooperation.

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438 See Davydenko, Sergei A.; and Franks, Julian R., ‘Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany, and the U.K., The Journal of Finance, vol. 63, No. 2, 2008, pp. 565-608 (disclosing that their research unveiled that banks significantly adjust their lending and reorganization practices in response to the respective country’s bankruptcy code. They also note that the referred adjustments mitigate, but do not eliminate the effect of bankruptcy codes on defaults. Another finding is that differences in practices across countries do not always conform to expectations. Parenthetically, this idea goes hand in hand with my idea that legal institutes from different fields are genetically linked in unexpected ways. They also emphasize the importance of understanding broader institutional considerations in the task of perceiving the effects of bankruptcy law). Also see Sgard, Jérôme, ‘Do Legal Origins Matter? The Case of Bankruptcy Laws in Europe, European Review of Economic History, 10, 2006, pp. 389-419 (arguing that ‘Perhaps evolutions observed across countries are less reflective of past institutional legacies than of the explicit attempts by lawmakers to affect microeconomics behaviours’).

439 See, however, Cheffins, Brian R. ‘Does Law Matter? The Separation of Ownership and Control in the United Kingdom’, The Journal of Legal Studies, vol. 30, No. 2, 2001, pp. 459-484 (arguing that ‘…the UK’s legal system did not have a pivotal influence on the evolution of the country’s corporate governance patterns’. Instead development of such patterns as well as the Berle-Means corporation, where the principle of separation of ownership and control prevails, was very much pushed by the London Stock Exchange during the later half of the twentieth century. The LSE was a private institution without any formal proxy from the British government. Cheffins notes that self-regulation was much more important in the United Kingdom than the law).

440 For example, the minimum share capital requirement survived in many European countries for a long period until it no longer was a requirement due to jurisdictional competition. Because it did not ultimately survive, some
of legal genes in the same gene pool (I am metaphorically speaking of market agents in a given legal system), and competition. This is where economics, biology and law come together.

There is a process of progressive evolution that echoes in two ways what seems to have happened in the selected jurisdictions in respect to the adoption of PLLCs laws. First, market agents enter into transactions by their own merit. Nevertheless, their actions and what they can really do is evaluated against the background of the ‘evolutionarily stable set’ – the gene pool – they are in. The interaction between legislators of different legal systems is something that we can see. This is relevant, but not exclusively so. Most significant interactions within a legal system, that is to say, interactions in the microsystem between market agents, legislatures, judges, lawyers, notaries and other stakeholders of that particular legal system, are frequently invisible to the public eye. I tried to capture a sense of this by following Duncan Kennedy on the creation of ‘doctrinal clusters’ of legal issues disputed in the courts of the six jurisdictions. In the field of biology, it can be difficult to establish a correlation between genes and proteins, even though this correlation, in fact, exists. Similarly, the evolutionary path of law is not always easy to trace. Some changes in law are not made in the public eye. This was reportedly the case with the passage of the Wyoming LLC Act in the United States. Second, the analogy with evolutionary biology underscores the idea that when change finally comes and a mutation occurs, this change is sudden and unpredictable. Mutations break through when they are advantageous or, in other words, they favor survival and cross-over or reproduction. Nevertheless, mutations do not only occur when they are advantageous. They may happen by chance, irrespective of potential for advantage or detriment. Disadvantageous mutations, however, are eliminated from the population – the gene pool – because in these circumstances genes carrying such mutations do not survive or they do not reproduce. This is inherent to the process of natural selection. It can also happen that a mutation is not advantageous, but neutral (it is not good or bad) and there can still be a genetic drift. In these circumstances, change moves from one generation to the other.

could fairly argue that such requirement was inefficient. However, I do not rest my argument on jurisdictional competition. My argument is broader than that.

441 The gene pool in the text stands for the legal system.
443 See Ribstein, Larry E., ‘Statutory Forms for Closely Held Firms’, cit., p. 391 (saying that ‘…legislators may resist adopting LLC or other statutory provisions that are consistent with the public interest criteria…because such provisions would reduce their expected rents from future laws relating to closely held firms…’).
444 A genetic drift is the arbitrary fluctuation of the frequencies of two forms of a gene (that is to say, the fluctuation of a normal form and a mutant form or neutral). To be precise, neutral mutations are subject to genetic drift.
depending on whether or not variations are extended efficiently. This idea may provide the grounds to explain why legal systems took so long until they adopted their respective PLLC laws. They gathered momentum once favorable conditions for the adoption of the law were met.

However, there are situations in which mutations are subject to limitations and change does not happen or, when it does occur, does not go a long way. Nature works with prime matter (*materia prima*). This means that there are physical limitations to evolution. For example, as useful as it could be, humans could never have evolved to float in the air because gravity would drag them down. Furthermore, in the course of evolution all intermediary forms must be advantageous. It is not possible to go from point A to point B if, along the way, point AB is not functional. Take the example of an aircraft propeller. The inventor can quit the project of a propeller and start the new project from scratch. Evolution works differently: to create a jet plane using the principles of evolutionary biology, one would have to take the propeller of an airplane and progressively introduce minor alterations to it, bit by bit, step by step, and screw by screw until it became a jet airplane. The problem is that all minor alterations would have to improve the ability of the airplane to fly, or there would be no evolution at all.

Legislators face similar difficulties. As much as legal evolution may be desired, the fact is that legislators can only go from point A to point B if the intervening manifestations of doctrinal and socio-economic path dependence are pulling in that direction.

Even if alterations to the law are introduced to reflect what in practice notaries, lawyers and courts are doing (this includes the creation of new business forms), the narratives I have told suggest that not all of them are efficient. Not all of these alterations are liable to improve the efficiency of the law. However, if there are some limitations that are insurmountable (for instance, there are no animals with wheels instead of legs because that is simply impossible) there are others which can be overcome. The riddle is: why is that some limitations to

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445 Path-dependence has not only been discussed in biology and law, but also in economics and economic history. See David, Paul A., ‘Clio and the economics of QWERTY’, *The American Economic Review*, vol. 75, No. 2, Papers and Proceedings of the Ninety-Seventh Annual Meeting of the American Economic Association, 1985, pp. 332-337 (333) (exploring the Qwerty world and explaining the Qwerty became historically locked-in as the dominant keyboard arrangement, despite other offers in the market. In an enlightening passage of his paper he affirms that ‘…while they [the agents engaged in production and purchase decision in today’s keyboard market] are, as we now say, perfectly “free to choose”, their behavior nevertheless is held fast in the grips of events long forgotten and shaped by circumstances in which neither they nor their interests figured”...).  
446 Flying animals are one of the best examples that limitations to evolution can be overcome. Flying is difficult. Therefore, flying animals are rare. They appeared only four times in history – insects, pterosaurs, birds and bats. Insects are also interesting examples of physical limitations. Given their proportion, they could not be much
evolution are transposable and others are not? The answer does not necessarily derive from a genetic point of view. Sometimes, it is just a question of engineering, that is to say, a question of finding the right model to solve design problems in the law. The theory of corporate default rules proposed by this dissertation rests upon this understanding.\footnote{See Ribstein, Larry E. ‘Statutory Forms for Closely Held Firms’, cit., 391 (arguing that ‘Even statutory default rules can impact legislators’ power. Complex and detailed default provisions increase legislators’ opportunities to change existing contracts by changing default rules. This in turn invites contracting parties to pay rents to legislators rather than investing in private renegotiation of contracts. Elaborate formal requirements for changing statutory defaults, such as detailed amendment and merger procedures similarly lend themselves to legislative manipulation’).} This being said, the overall measure of success in legal evolution remains an open question. In nature, success is measured by reproductive outcome. (Some things may not develop because the costs would not be justified by the possible benefits in terms of reproductive capacity). In my view, success in legal evolution should be assured by the degree to which market agents accept the implementation of a new law and do not feel a desire to deviate from it because it is advantageous to do so. In this case, the benefits of adopting the law are higher than the costs. Hence, because it is considered advantageous, if market agents deviate from the law they did not contract around (e.g., default rules), there will be a subsequent counter-movement pushing for its implementation (e.g., market agents will not ignore the rule; rather, they will strive for its best interpretation). Every time there is a deviation forcing the reestablishment of efficient legal solutions or legal reform, a bit of legal evolution happens. Ultimately, the measure of success will be the survival of the fittest PLLCs and their growth in numbers due to the legal infrastructure.\footnote{There are other economic factors in the survival of firms. The ultimate one might be the ability to make profit. If the firm does not make non-negative profit in the long-run, it cannot stay in the market. Profit means returns that are above zero-risk return.}
PART II

RESTRICTIONS ON TRANSFER OF SHARES IN THE LAWS OF PORTUGAL,
FRANCE, ITALY, SPAIN, THE UNITED KINGDOM AND THE UNITED STATES:
A LEGAL AND ECONOMIC ANALYSIS

(Diagnostic phase)
CHAPTER I

THE LAW AND ECONOMICS OF RESTRICTIONS
ON TRANSFER OF SHARES:
TAMING PROPERTY RIGHTS IN SHARES AND THE SILVER FOX\(^{449}\)

‘...when we compare the dray-horse and race-horse, the dromedary and camel, the various breeds of sheep fitted either for cultivated land or mountain pasture, with the wool of one breed good for one purpose, and that of another breed for another purpose; when we compare the many breeds of dogs, each good for man in different ways; when we compare the game-cock, so pertinacious in battle, with other breeds so little quarrelsome, with ‘everlasting layers’ which never desire to sit, and with the bantam so small and elegant; when we compare the host of agricultural, culinary, orchard, and flower-garden races of plants, most useful to man at different seasons and for different purposes, or so beautiful in his eyes, we must, I think, look further than to mere variability’.


Introduction

In Part I, I concluded that law is a byproduct of normative solutions, or a sort of extended phenotype. Facing the emergence of new forms of business organizations, legislators have created systems of property rights in order to ensure equilibrium not only within the corporate structure, but also among the interests and protections each corporate constituency claims for itself.\(^{450}\) One of the ways to facilitate this equilibrium is by providing

\(^{449}\) This chapter was presented in the Visiting Scholars and Visiting Research Fellows Seminars Series at Fordham University School of Law, on 27 February 2013. It was presented at the 30\(^{th}\) conference of the European Association of Law and Economics on 26 September 2013 in Warsaw. I generally thank the participants for the comments I received and the questions I was asked. I am particularly thankful for the comments I received from Christophe J. Godlewski while discussing the paper. This chapter was also presented at the Society for Evolutionary Analysis in Law 15\(^{th}\) Conference on 4-5 April 2014 at the University of Illinois College of Law. I thank the participants for their comments.

\(^{450}\) By equilibrium I mean a balance between influences that enables the maintenance of a stable system.
default rules that restrict transfer of shares or give leeway to company members to introduce such restrictions in the articles of association.

Thus, in this chapter, I look, from a bottom-up perspective, at markets, their dynamics and evolution, and compare them to evolution in nature by looking at the environment within which this evolution occurs. It has long been claimed that evolution in nature is different from institutional evolution. However, I look at law as providing tools for institutional engineering just as biology supplies the scientist with the necessary cognitive equipment to undertake her experiments based upon the artificial selection of species. The output of this comparison should be one that, normatively speaking, enables legislators, regulators, and courts, in particular those in common-law jurisdictions, to create optimal legal solutions that are able to break engrained status quo and manifestations of socio-economic and doctrinal path-dependence, or situations of pleiotropy in the law, if necessary.

Using transfer restrictions as a ground for experimentation, the first section tries to unveil the legal and economic purposes of setting such restrictions. There, I present a three-level model that provides legislators, regulators and courts with methodological tools for implementing optimal legal solutions. In addition, I expose the contractual features of the articles of association by defining them as a ‘contract for the governance opportunity’ provided by the law. I give an overview of the most important possible restrictions within a comparative perspective. I also look at combinations of these restrictions. This is, I believe, a first in the literature. In the second section, I put forward an explanation for the effects restrictions may have on the configuration of property rights in shares, similar to the effects of the taming process on the silver fox. I not only advance a thesis of path-dependence of legal solutions, but also develop the idea of pleiotropy in law. In the third section, I inquire into the normative justification of restrictions considering the relational element prevailing in the PLLC. I conclude by disclosing my view of corporate and contractual evolution through an

451 See Pratt, John W., and Zeckhauser, Richard J., ‘Principal and Agents: An Overview’, in idem (eds.), Principals and Agents: The Structure of Business, Boston, Harvard Business School Press, 1985, pp. 1-35 (35) (saying that ‘…the evolutionary processes for institutional structures are quite different from those for species. Desirable contracts are impossible to draw. Human environments change swiftly. Hence, there is no assurance that the institutions we observe are best’).

452 In common-law systems, law is based on case law developed by courts. Courts are, thus, more likely to adopt an activist role than in civil law systems.

453 See Sund, Lars-Göran and Bjuggren, Per-Olof, ‘Family-owned, limited close corporations and protection of ownership’, p. 274 (asking ‘Why should we impose restrictions on transfers?’).

454 When I first presented an early draft of this chapter at Fordham University Law School, I intuitively came up with the concept of ‘organizational contract’. I, however, dropped the concept. I believe that referring to the articles of association as contracts for the governance opportunity illustrates better the possibility of governing PLLCs and the relationships between corporate constituencies through contract. It also alludes to a particular view of default rules, by which legislators give an opportunity to members to govern their company’s articles of association. On this, see Part III, Chapter 1.
equivalent principle of artificial selection similar to that which took place with the selective breeding of the silver fox. My view is that legislators have the ability to shape market agents’ behavior. They can do it in a dynamic way, by providing efficient default rules that are liable to change social phenomena of path-dependence. This implies legal engineering and experimentation at different levels. It also implies a new theory of defaults that sees default rules as commodities that can be used to achieve the best contractual solutions within an evolutionary framework.

1. The law and economics of restrictions on transfer of shares: uncertainty and legal policy

Articles of association, contracts that they are, are necessarily incomplete: They cannot encompass all possible situations that shareholders, as ‘residual claimants,’ will have to manage throughout the life of the firm. Hence, uncertainty and incomplete information in these circumstances are basic elements informing the so-called ‘theory of incomplete contracts’. Uncertainty is effected by several phenomena such as incomplete information, asymmetries of information, and opportunism in its different expressions. Uncertainty is an essential variable that must be used and the implications of which understood in order to explain the purpose of market agents’ behavior, especially when it comes to apply or to make good law. I view the market as a system where the Darwinian principle of natural selection can be analogously applied, like in biological evolution. This approach is based upon a model of legislative policy which is intended to overcome the limitations of uncertainty in bargaining, markedly when what is at stake is the negotiation of property rights. Ultimately, this model should carry within it the potential to favor the development of the firm, and strengthen the property rights of members in situations of weakness. I distinguish between

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455 This is almost intuitive in respect to the corporation which in most cases is based on a long-term contract. See Ribstein, Larry E., ‘Close Corporation Remedies and the Evolution of the Closely Held Firm’, *Western New England Law Review*, vol. 33, 2011, pp. 531 – 565 (548) (claiming that ‘No statute or agreement can cover all the contingencies involved in a complex and open-ended contract like a business association’).

456 For a definition of uncertainty, see Alchian, Armen A., ‘Uncertainty, Evolution, and Economic Theory’, *Journal of Political Economy*, vol. 58, n.º 3, 1950, p. 212, f. 5 (saying that uncertainty is ‘… the phenomenon that produces overlapping distributions of potential outcomes’).

457 I will not draw here on the definition of market, much less in particular on the definition of European Internal Market. However, it is easy to find in the literature conceptual references to ‘market’. For example, see Berle, Adolf. A, and Means, Gardiner C., *The Modern Corporation and Private Property*, revised ed., New York, Harcourt, 1967, p. 313 (mentioning an economic organism typified by the corporation). On this see, Part III, Chapter 2.
three levels of the legal system. The first level is that of the society. The second level is the level of the legislator, the regulator, and the courts. The third level is the level of the market.

Level 1 is characterized by a degree of ‘social embeddedness’ caused by traditions, customs and culture that is difficult to cut through.\textsuperscript{458} It has, nevertheless, a pervasive effect on the economics of law. Therefore, the welfare effects of legal solutions must be considered. Level 2 – the level Oliver Williamson would probably call the ‘institutional environment’ - \textsuperscript{459} features legislatures, courts, regulators and politicians.\textsuperscript{460} They act as selective agents with the ability to shape the environment wherein rules shall apply. Level 3 is filled with ‘impersonal market forces’.\textsuperscript{461} This model emphasizes the interwoven nature of the second and third levels. It also shows how their interaction can affect the first level. It illustrates my perception of the often-discussed bottom-up approach to law, and sustains a springboard for legal policy.\textsuperscript{462}

Designing articles of association by including restrictions on the transfer of shares of company members is one way for lawyers to avoid the uncertainty that accompanies the inclusion of a third party in the company’s business. A distinction should be made at the outset between restrictions imposed by default rules provided by the legislature, and particular restrictions agreed by the members and settled in the articles of association or operating agreements. The distinction is important because default rules established by a legislator fall within her work of selective agent (level 2).\textsuperscript{463} On the other hand, rules established by members in the articles of association are manifestations of private ordering which are subject to natural selection (level 3).\textsuperscript{464} This is a metaphor, a sort of analogy that I use throughout the


\textsuperscript{460} Courts are more interventive in common-law countries than in civil-law countries when there are lacunae in the law.


\textsuperscript{462} This evolutionary approach is simultaneously very Ribsteinian. See Ribstein, Larry E., ‘Close Corporation Remedies and the Evolution of the Closely Held Firm’, \textit{Western New England Law Review}, vol. 33, 2011, pp. 531- 565 (560) (arguing while discussing the potential of judicial dissolution that ‘Legislatures should reject close-corporation-type language such as that found at the Revised Uniform Limited Liability Company Act § 701 (a) (5), which provides for judicial dissolution based on ‘illegal’, ‘fraudulent’, or ‘oppressive’, without a clear reference to the agreement’. This is clearly a call for legal policy that is able to take ‘contractual technology seriously’ and for legislatures to ‘…invite the courts to bring those contracts to bear …’).

\textsuperscript{463} The selective agent is an environment agent which can influence the process of natural selection. It determines the desirable features to be inherited. In biology, some examples can be mentioned such as the selective breeding of pigeons, cows, horses and dogs theorized by Darwin in the \textit{Origin of the Species}.

\textsuperscript{464} I must clarify that I am aware that claims that human behavior is genetically determined tend to be extremely controversial. A case in point is the field of evolutionary psychology and the debates about it. Similar concerns appeared among anthropologists and others in respect to the research work developed by Napoleon Chagnon among the tribe Yanomani. In this case, accusations were highly inflamed and were not limited to genetic determinism. See URL: \url{http://www.nytimes.com/2013/02/17/magazine/napoleon-chagnon-americas-most-...
dissertation to illustrate that law, like nature, is the result of complex relationships that evolve over time and space. I suggest that there is a genetic component (e.g., market elements) which legislators have necessarily to deal with. Market agents tend to agree upon rules with the genetic predilection to survive, and this should be relevant for matters of legal policy.\textsuperscript{465}

This chapter demonstrates that even though historically most articles of association introduce restrictions on transfer (even when the law adopts a liberal principle of free transferability) the fact is that there is a status quo shareholders prefer to maintain regarding the company’s ownership and governance structure. This holds true even when it may not be in the economic interests of the company and may in fact harm its competitive position. Case law and empirical data showcase shareholders often ignoring restrictions they have set up and frequently not understanding the law and rules they themselves have included in the articles of the company. Why, then, do members set up restrictions on transfers in the first place?

Uncertainty, as I stressed above, is the key answer. Members adopt restrictions as a safety balloon for naturally incomplete contracts. One might think that if contracts are kept unchanged it means that they are somehow beneficial for market agents and, therefore, efficient. In principle, there should be no uncertainty here. One might think that the competitive purpose of markets always causes agents to make optimal choices, and this behavior is, for the most part, what nurtures market evolution. Nevertheless, this is not quite the case. Despite the principle of natural selection, there are circumstances where mutations (or economically speaking, innovations) are subject to limitations. Change is unlikely to come about, and, if it does come, it is not consistent. First, there are physical limitations to evolution. Second, as I have explained in Part I, Overview, in the course of evolution all intermediary forms must be advantageous. It is not possible to go from point A to point B if, along the way, point AB is not functional. Legislators face similar difficulties. As much as evolution is desired, the fact is that legislators can only go from point A to point B if the intervening manifestations of doctrinal and socio-economic path dependence are pulling in that direction.\textsuperscript{466}

\textsuperscript{465} The term selective breeding is used by Darwin in reference to the farmer selecting the horses that are used for breeding. Level 2 is an allusion to the idea of the farmer selecting the animals. Level 3 is an allusion to the process of natural selection.

\textsuperscript{466} Path-dependency has not only been discussed in biology and law, but also in economics and economic history. Apropos see David, Paul A., ‘Clio and the economics of QWERTY’, \textit{The American Economic Review}, vol. 75, No. 2, Papers and Proceedings of the Ninety-Seventh Annual Meeting of the American Economic Association, 1985, pp. 332-337 (333) (exploring the Qwerty world and explaining the Qwerty became historically locked-in as the dominant keyboard arrangement, despite other offers in the market. In an enlightening passage of his paper he affirms that ‘…while they [the agents engaged in production and purchase
I now return to the model. Even if alterations to the law are introduced to reflect what is being undertaken at level 3 of the market, not all of them are efficient. Some phenomena survive at level 3, despite the enactment of new legislation. One example worth mentioning is the persistence of insider trading in American corporations even after it was banned in 1961 by the Securities Exchange Commission (SEC). It was only in the wake of new technological developments by which computers began to be used to track these unlawful practices that firms became available to police the application of the rule banning insider trading. This was so because costs of enforcement decreased due to technological developments. Yet, not all limitations are insurmountable. Some can be overcome. The fact that some limitations to evolution are transposable and others are not is a puzzle that most likely can only be solved through legal engineering. Given that survival does not always occur for optimal reasons, there is a window of opportunity for legislators who, through cognitive awareness, imagination and some courage to break with manifestations of path-dependence in both levels 2 and 3, have the possibility to create efficient laws. Legal engineering is, in this way, deeply rooted in the market’s dynamics. This is where level 2 and level 3 meet.

The scheme I present here may be more obvious to economists who, in the face of uncertainty, are trained to make assumptions and create models that, with mathematical and economic tools postulate certainty. However, I think that legislators can also take up the position of ‘outside observer’ and cause a change into the legal system when and where it is needed. Additionally, it is a scheme that reconciles the ‘institutional environment’ with ‘governance structures’ established in the market. It reconciles property-rights literature and transaction-costs economics. It does this by setting out a middle ground. Here, legislators can create property rights to overcome contractual inefficiencies ex-ante and facilitate the creation of governance mechanisms to resolve contractual inefficiencies ex-post.

The type of restrictions included in the articles of association, either by literal transcription of the default rule or designed by their members and lawyers, varies depending on decision in today’s keyboard market] are, as we now say, perfectly “free to choose”, their behavior nevertheless is held fast in the grips of events long forgotten and shaped by circumstances in which neither they nor their interests figured”…).  

467 There are limitations to selective breeding. Zebras, for example, have never been domesticated. Several factors play a role in determining the feasibility of selective breeding. The social structure is one of them.  
469 See Easterbrook, Frank H., 'Insider Trading as an Agency Problem', cit., pp. 81-100 (90-95).  
470 Some lawyers and some economists may think this is a misunderstanding of the function of mathematical models.
on the approach taken by legislators to the transfer of shares,\footnote{Legislators may take a contractualist or statutory approach to the transfer of shares. This is illustrated by the historical evolution of the PLLC and the respective legislation. See Part I.} and on the size of the company, governance, business purpose and other factors which might be germane to the regulation and operation of the company. I listed in the three chapters of Part I the sort of transfer restrictions contained in the articles of association and LLC agreements. It helped me understand legislators’ approaches toward transfer of shares. The restriction to which I am referring is the requirement of consent of all shareholders, directors, or of one particular member (in principle, the majority member). Resolutions at the companies’ general meetings providing for the consent of the company are either taken by majority or unanimous consent of the members. Other restrictions that articles of association in all six jurisdictions provide for can be mentioned, without prejudice of their own specificities.\footnote{Clauses foreseeing pre-emption rights can be very specific. The clauses of the articles of association of the Spanish Srl are a case in point. Moreover, triggering factors of restrictions (e.g., pre-emption rights or rights of first refusal) vary pursuant to the size of the company (i.e. the number of members, governance structure, and business purpose of the company (i.e. equity funds are different from traditional family firms).} They are pre-emption rights and rights of first refusal, clauses prohibiting the pledge of shares, liens or any charges over the shares, and their usufruct, formulas determining the price of sale of shares, which are especially associated with the exercise of pre-emption rights by the company and the members, and administrative corporate procedures prior to which a transfer will not be effective.\footnote{Indeed, corporate law doctrine has come a long way since the old debate about the validity of restrictions on stock that is defined as personal property. On this, see Painter, William H., ‘Stock Transfer Restrictions: Continuing Uncertainties and a Legislative Proposal, Villanova Law Review, vol. 6, 1, 1961, pp. 48-68.} The LLC agreements, which are considerably longer than the constitutional documents of companies in all other six jurisdictions, also establish tag-along rights, rights of co-sale, sale purchase rights or ‘compelled sales’, buy-sell agreements, put-rights, and similar rights.\footnote{All these terms can be found by reading the clauses of the respective agreements.} Similar to the UK private companies, management boards or managing-members of US LLCs have wide powers to discretionarily or reasonably consent or refuse the transfer. There are, however, situations in which transfer, especially of managing rights and the admission of new members, depends on the consent of the members. Vesting requirements, forfeiture provisions, minimum retained ownership requirements or other similar provisions, clauses limiting transfers to competitors, and lock-up prohibitions are other kind of restrictions that can be found in the companies’ articles. The analysis of these types of transfer restrictions backs up a broad concept of consent (consent \textit{lato sensu}). It basically spells out the idea that transfers or changes in ownership require some sort of acceptance or approval.
Additionally, I adopt a restricted concept of consent (consent *stricto sensu*) which refers to the variety of restrictions embodied in the companies’ articles and LLC agreements.\textsuperscript{475}

In general, restrictions established in the articles of association of the companies of all six jurisdictions are very similar. One might think in this situation of a phenomenon of crossover of legal solutions. This is certainly true in the case of legal transplants.\textsuperscript{476} In the particular case of restrictions on transfers, there is, at least, some of it. Some restrictions established in the law cross over jurisdictions. In other words, these restrictions share the same genetic material, despite of the distance between the jurisdictions, their legal institutions and stakeholders. They share the same historical origin as opposed to a later transplant. The fact is that the more closely related the two jurisdictions are, the more they will share. For example, companies in the same legal family or with the same legal origin share ‘genetic’ material by virtue of their shared ‘ancestry’. (In this context, one can question whether there is a clear-cut way of distinguishing between a shared genetic origin and convergent evolution. For example, both insects and birds have wings).

This shared genetic material results in recombinant legal formulas.\textsuperscript{477} Rather than innovation or exchange of new policies, legal solutions are inherited. There can be, however, mismatched alignments of policies, or unbalanced recombination of legal rules. If this is the case, there will most likely be a genetic rearrangement of legal solutions from one country to another, a translocation of legal solutions from one body of law to the other (e.g., from corporate law to securities law) or an inversion of legal solutions.\textsuperscript{478} This idea, I think, surmounts the scarcity of explanations provided by specialized literature for the timing in

\textsuperscript{475} See Brownsword, Roger, ‘Contract, Consent, and Civil Society: Private Governance and Public Imposition’ in Odell, Peter and Willett, Chris (eds.), *Global Governance and the Quest for Justice*, vol. 3: Civil Society, Oxford and Portland, Oregon, Hart Publishing, 2008, pp. 5-37 (presenting the concept of ‘originating consent’. It means the agreement parties give to the application of a rule-set to govern the deal they are making).


\textsuperscript{477} This is a metaphor alluding to chromosomal crossover which is an exchange of genetic material between homologous chromosomes.

\textsuperscript{478} See Hansmann, Henry, and Kraakman, Reinier, ‘The End of History for Corporate Law’, *Georgetown Law Journal*, vol. 89, 2001, pp. 439-468 (advocating the convergence of corporate law into a uniform standard model – evolutionary convergence). Those that propose the idea of convergence think that global competition will determine an overall change in companies worldwide. There is the inherent assumption that states can change the law when they please, without limitations. I challenge this understanding with the idea of path-dependence and that mutations do not always occur in the same way. See Roe, Mark, *Political Determinants of Corporate Governance*, Oxford, Oxford University Press, 2003 (arguing that there still are significant differences between the corporate governance in different jurisdictions, caused by differences in their political orientation. He shows there is a correlation between a social democratic form of government and certain corporate governance patterns). There are other arguments in favor of path-dependence closely linked with politics, economics, culture, social and commercial norms, and legal doctrines. I advance an argument of path-dependence based on an analogy with biology. Additionally, I look at the ways legal systems have historically responded to change, and this is something that neither side of the argument (pro-convergence v path-dependence) clarifies.
which a follower country adopts law coming from a leader country.\textsuperscript{479} This sort of inheritance suggests that there are some genetic traits in the law likely to cross over jurisdictions and generations of legal rules. Change occurs when there is a mutation. As we have seen in Part I, mutations occur when market agents feel that it is advantageous to alter the genetic frequency or the evolution of the law, and that mutation is favored by natural selection.\textsuperscript{481}

The following sections develop these issues. They particularly focus on the role of legislators as selective agents. The experiment of selective breeding of the silver fox fits here. They also point out the many ramifications of uncertainty of contractual relations within the firm. They do that by establishing a link to situations of equilibrium or stable strategies in the company, and to the relational element prevalent in these business organizations. Before moving on, however, some words should be offered as to the features of the articles of association. They are genetically contractual and a good showcase of private ordering (level 3).

\textsuperscript{479} See Spamann, Holger, ‘Contemporary Legal Transplants: Legal Families and the Diffusion of (Corporate Law), \textit{Brigham Young University Law Review}, vol. 2009, 6, 2009, pp. 1813-1878 (1871) (saying that ‘Allowing a considerable lag between adoption in the leader country and adoption in the follower country is to recognize that other, complimentary forces affect the timing of adoption in the follower country. Such modesty, however, is a feature shared by all theories attempting to explain differences between legal families, which are obviously just a fraction of the variance between countries around the world. For example, the almost universal adoption of insider trading laws in the first half of the 1990s in both common and civil law countries cannot be explained by any theory focused on differences between common and civil law countries. What might be explained by such theories, however, is why the details of the laws adopted differ between common law and civil law countries’).

\textsuperscript{480} This idea, expressed in the text, also tries to overcome the limitedness of criteria used by La Porta, Lopes-de-Sinales, Shleifer and Vishny (informally known as LLSV) in explaining their legal origins theory, especially because I understand that legal systems cannot be understood as ahistorical, exogenous, immutable variables.

\textsuperscript{481} One could say that in their theory ‘legal origins’ is the gene. However, the gene does not always express itself in the same way in each organism (each country) because there are different environmental factors. Some civil law countries may still have better investor protection than some common law countries. This can be related to the nature v nurture debate. See Sgard, Jérôme, ‘Do Legal Origins Matter? The Case of Bankruptcy Laws in Europe, \textit{European Review of Economic History}, 10, 2006, pp. 389-419 (411) (saying that ‘‘Legal Origins’ are a proxy for a social entity whose shape, structure, and quality remain elusive’

\textsuperscript{482} Also see La Porta, Rafael et al., ‘The Economic Consequences of Legal Origins’, \textit{Journal of Economic Literature}, vol. 46, 2, 2008, pp. 285-332.

\textsuperscript{483} Di Martino, Paolo, ‘Lobbying, Institutional Inertia, and the Efficiency Issue in State Regulation: Evidence from the Evolution of Bankruptcy Laws and Procedures in Italy, England, and the United States (c. 1870-1939)’ in Battilossi, Stefano, and Reis, Jaime (eds.), \textit{State and Financial Systems in Europe and the USA: Historical Perspectives on Regulation and Supervision in the Nineteenth and Twentieth Centuries}, Farnham Surrey, England; Burlington, USA, 2010, pp. 41-54, p. 42 (noting that the persistence of sub-optimal legal institutions remains a puzzle. Referring to the adoption of new bankruptcy laws, he says that ‘Despite the general phenomenon of convergence towards similar principles and instruments, this evolution was not uniform across countries. Diversity did not necessarily manifest itself in the formal characteristics of the various laws, but more often either in the use of specific counterbalances, or in the timing of the introduction of various pieces of legislation. In terms of the efficiency of various bankruptcy systems, these differences were not neutral. In fact, specific procedures or norms failed to be adopted, or were introduced with a substantial lag, even when substantial agreement among contemporaries existed on their superior level of efficiency’).

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i. The articles of association as ‘contracts for the governance opportunity’

Corporate legal theory has been dominated by a powerful contractarian view for more than three decades, since the publication of the seminal article of Jensen and Meckling.  

There are several reasons for this. First, commentators who have significantly influenced the field have embraced this view. Second, the contractarian view espoused with the methodological approach of law and economics has created a strong platform, particularly in the United States, where traditional legal views have been debated, contested and reformulated in line with welfare considerations. Third, contractarianism had the ability to reconcile conservative and liberal views of the market, in particular following the movement of deregulation of the 1970s in the United States, and establish the foundations for superior normative constructions tackling the relationship between corporate constituencies. Europe is developing its own system of law and economics even though the gap between the two sides of the Pond has still to be filled.

Perhaps, this has not happened yet because there still has not been a selective sweep by which change broke through.

I too adopt a contractarian view of corporate law. However, my contractarian view is mitigated by the opinion that property rights have an important (and often underestimated) role to play in the development of corporate law and its foundational principles. Therefore, I try to avoid any sort of contractual determinism to provide a normative account of articles of association which is able to accommodate the introduction of contractual clauses establishing restrictions on transfers. I call the company’s articles a 'contract for the governance

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485 For an opposition to the contractarian theory, see Miller, Sandra K., ‘Fiduciary Duties in the LLC: Mandatory Core Duties to Protect the Interests of Others Beyond the Contracting Parties’, *American Business Law Journal*, vol. 46, 2, pp. 243-278 (271) (showing herself against the ‘nexus of contracts approach’; and advancing a Theory of Mandatory Core Duties’. With this theory she stresses the importance of fiduciary duties to overcome the limitations of the contractarian theory. She recommends a vision of the ‘…LLC as a social entity that must be subject to mandatory fiduciary duties in the interest of public policy’). Additionally, see Armour, John and Whincop, Michael J., ‘The Proprietary Foundations of Corporate Law’, *Oxford Journal of Legal Studies*, vol. 27, 3, 2007, pp. 429-465 (stating clearly the importance of property law in complementing the economic theory of the firm).
opportunity' (hereinafter also referred to as the company’s contract). I use this expression to escape from the determinism of the ‘nexus-of-contracts’ theory. The articles of association of a private limited company are not just a contract or a bundle of contracts. The ‘nexus-of-contracts’ theory should be mitigated with an adequate theory of property rights. The term ‘contract for the governance opportunity’ is a reference to contract governance or, in Williamson’s words, ‘governance of contractual relations’. There is, however, one peculiarity. I try to reconcile transaction-costs economics (TCE) and the property-rights literature by creating mechanisms to solve contractual inefficiencies ex-ante and contractual inefficiencies ex-post. TCE views the transaction as a ‘basic unit of study’. Assuming that contracts are incomplete due to transaction costs, private ordering is seen as an essential element to overcome ex-post contractual inefficiencies. Property-rights literature centers on creating incentives such as ‘residual rights of control’ to overcome ex-ante contractual inefficiencies. Therefore, I assume a middle position in the transaction-costs v property-rights debate. The term ‘opportunity’ in this context is related to the purpose of default rules. By providing a default rule, legislators and courts, where they are allowed to by law, give market agents the opportunity to contract around a default rule. One can fairly ask whether this cannot be said of almost any contract. This question has to be answered in the affirmative. The problem is that when default rules are not provided by legislators or courts, lawyers tend to use their imagination to draft the contract. When default rules are provided, the tendency is to use them and not to contract around them, unless the client really wants something different. The point is: when default rules are provided, members and their respective lawyers should seriously take the opportunity to govern their relationships either by keeping the default rule or by adopting some different legal framework as long as it is Pareto efficient. In this sense, the definition of ‘contract for the governance opportunity’ is broader than ‘organizational contract’ because it implies a theory of defaults as commodities that can be used to steer contractual relations within an evolutionary framework. This means that defaults become tools for the regeneration of contractual relations. In this context, not only property rights are relevant ex-ante, but also their governance by contract is important ex-post.

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486 See Easterbrook, Frank H., and Fischel, Daniel R., ‘The Corporate Contract’, Columbia Law Review, vol. 89, N.º7, Contractual Freedom in Corporate Law, 1989, pp. 1416-1448 (1416) (referring to the corporate charter as ‘contract of adhesion’). In French law and doctrine, articles of association are referred to as the contrat de société. This nomenclature also is used in French-based legal systems.


488 On this, see Part III, Chapter 1.

489 See Hart, Oliver, and Moore, John, ‘Property Rights and the Nature of the Firm’, Journal of Political Economy, vol. 98, 6, pp. 1119-1158 (1122) (arguing that ‘First, the incompleteness of contracts means that the
I tend to look at principles of corporate law through the lens of contract. This is consistent with the idea of law as a byproduct of private ordering manifestations or extended phenotype presented in Part I. I concede, however, that there are basic principles of corporate law theory which cannot be developed by contract. Cases in point are limited liability, capital lock-in and even fiduciary duties. These core features of business associations are not contractual in their essence. They are conceived to protect the investors and third parties (i.e., creditors, the tax administration, or any other persons to whom the payment of compensation is due). This is why they are regulated by organizational law. Furthermore, contractual freedom is, paradoxically, liable to create deadlocks, problems of interpretation, asymmetries of information and difficulties in combining action. (This is not to demonize freedom of contract, which I praise, but simply to point out the paradox.) These problems are future return on an individual's current action will depend on his “marketability” or bargaining position tomorrow in ways that cannot be controlled via the original contract. Second, the existence of asset specificity means that an agent’s marketability or bargaining position will depend on which assets he has access to and hence will be sensitive to the allocation of asset ownership). Also see Rajan, Raghuram G., and Zingales, Luigi, ‘Power in a Theory of the Firm’, The Quarterly Journal of Economics, vol. 113, 2, 1998, pp. 387-432 (refining Grossman, Hart and Moore's work on property rights by providing a framework that promotes the ability to retain power in a firm or organization as a form to create ex-ante incentives to investment. The ability to retain power is particularly important in a scenario of contract incompleteness).

Larry Ribstein, who has provided a considerable contribution to the normative understanding of the ‘uncorporation’ in the United States, stands out in the literature as a contractarian. In the jurisprudence see, for instance, Fisk v Segal, Civil Action No. 3017 – CC, 2008 Del. Ch. Lexis 158 (Del., 7 May 2008) (where in the context of a dispute on breach of fiduciary duties and of the relevant LLC agreement, the court held that limited liability companies are creatures not of state but of contract). Furthermore, this is in line with the ideas promoted by advocates of transaction-costs economics. On this, see Williamson, Oliver E., The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting, New York, The Free Press, 1985, p. 398 (stating that contract is a unifying concept of organization that illuminates areas such as antitrust, regulation, corporate governance, and labor).


This paradox may echo another paradox heeded by Polanyi: the existence of self-regulated markets and the opposite move towards needed state intervention. It also may resound another debate regarding state intervention in building and shaping the market through the idea of ‘embedded autonomy’ treated by Peter Evans. See Polanyi, Karl, The Great Transformation, Boston, Beacon Press, (1985) 1994; and Evans, Peter B, Embedded Autonomy: States and Industrial Transformation, Princeton, N.J, Princeton University Press, 1995. By using the micro-organizational structure of the firm as a springboard for the main argument of this dissertation, I am not here advocating such interference of the state.
particularly enhanced when property rights are weak or poorly defined ex ante.\textsuperscript{495} Additionally, the exercise of freedom of contract is not able to undo per se bilateral monopoly-like situations or hold-ups in the company (in particular companies with fifty-fifty partners) and to overcome the challenges often created by inefficient laws.\textsuperscript{496}

Consequently, for the above-noted reasons, my commitment to contractarianism is more normative than positive.\textsuperscript{497} The paradigm of the company as a ‘nexus of contracts’ is frequently presented in its positive feature in the sense that it does not give theoretical insights as to the type of rules corporate law (or the standard contract Easterbrook and Fischel refer to) should provide for the development of business associations.\textsuperscript{498} It does not provide a

\textsuperscript{495} See Scott, Kenneth E. ‘Agency Costs and Corporate Governance’, in Newman, Peter (ed.), The New Palgrave Dictionary of Economics and the Law, New York, Palgrave, 2002, p. 26 (asking ‘Why are shareholders’ property rights so poorly defined?’ His argument then runs like this: ‘The usual answer is that the stockholders’ essential function necessitates that condition. They are the bearers of the residual risk of the firm, enabling debtholders and others to contract with it on more definite terms; their claims come last, after all the other various contingencies and claims are satisfied, and hence it is impractical to try to spell them out in detail under all states of the world. The status of stockholders provides a paradigm of the (highly) incomplete contract’). See Hansmann, Henry and Kraakman, Reinier, ‘The Essential Role of Organizational Law’, cit., p. 440 (claiming that the contractual functions of organizational law such as default rules or even mandatory rules protecting the interests of the parties who would otherwise be disadvantaged in the contracting process are undoubtly useful. They are not, however, essential ‘...in the sense that modern firms could not feasibly be constructed if organizational law did not perform them. A far more important function of organizational law is to define the property rights over which participants in a firm can contract’). Also see Whincop, Michael J., ‘Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law’, Oxford Journal of Legal Studies, vol. 19, 1999, pp. 19-50 (referring to the improvement of the contractarian theory by supplementation with a richer theory of entitlements and property rights); and Nicita, Antonio and Rizzolli, Matteo, ‘Hold-up and externality: The firm as a nexus of incomplete rights?’, International Law Review of Economics, vol. 59, 2012, pp. 157-174 (159) (suggesting that ‘the missing step in the Coasean legacy is a theory of the firm as a transaction cost – minimizing institution with reference both to incomplete contracts and to incomplete property rights’).

\textsuperscript{496} See Libecap, Gary D., ‘Property Rights in Economic History: Implications for Research’, Explorations in Economic History, vol. 23, 1986, pp. 227-252 (244) (saying apropos private contracting to limit oil production that the investigation undertaken by Libecap and Wiggins in the field of unitization in Oklahoma and Texas from 1926 to 1935 showed that ‘private agreements were uncommon. Examination of bargaining on seven fields in Texas reveals that agreement took from 4 to 8 years, with contracts completed only late in field life after most common pool losses had been inflicted’. He goes on saying that ‘These findings temper the optimistic belief of some economists that private solutions will emerge to prevent serious efficiency losses’).


\textsuperscript{498} See Easterbrook, Frank H. and Daniel R. Fischel, cit., p. 34 (enquiring ‘...why law? Why not just abolish corporate law and let people negotiate whatever contracts they please? The short but not entirely satisfactory answer is that corporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting’).
normative account as to the role each corporate constituency has or should have in the development of the corporation.\textsuperscript{499}

I do not think that corporate law is an extension of contract law.\textsuperscript{500} However, corporate law should enable interrelationships between corporate constituencies in the most efficient way. (This idea includes creating the most efficient tools to prevent the occurrence of agency problems and hold-ups). For instance, the case of the United Kingdom explored in Part I shows that, historically, shareholders’ primacy in terms of influence in the company is a myth. Often, decisions are taken by directors even though the level of dependence of the corporation on its shareholders is high.\textsuperscript{502}

\textsuperscript{499} To be fair, I am not sure whether law will necessarily provide information as to the role each constituency must have in the development of the company. Legal rules, however, should be designed to bear out the evolutionary paradigm of the sort I assert throughout this dissertation.

\textsuperscript{500} The PLLC in the selected jurisdictions is more ‘contractarian’ than the publicly held corporation. The fact that the Spanish Companies Law (\textit{Ley de Sociedades de Capital}) specifically foresees in its Article 28 the principle of freedom of contract is noteworthy. It states that ‘En la escritura y en los estatutos se podrán incluir, además, todos los pactos y condiciones que los socios fundadores juzguen conveniente establecer, siempre que no se opongan a las leyes ni contradigan los principios configuradores del tipo social elegido’ (‘All the agreements and conditions which the founding shareholders deem necessary to establish may be included in the deed of incorporation and articles of association, if they are not contrary to the law and they do not contradict the principles of the type of business association selected [by the shareholders]’). However, it is important to stress the differences between countries regarding the evolution of these business organizations and the extent of influence of the state. For example, whilst in the United Kingdom the private company derived from a sort of ‘license’ granted by the state, in the United States, the LLC developed from partnership law.

\textsuperscript{502} Differently, in the Portuguese literature see Almeida, Carlos Ferreira de, \textit{Contratos I: Conceitos, Fontes, Formação}, 3.ª ed. Coimbra, Almedina, 2005, p. 28 (This commentator adopts a broad concept of contract. He considers, therefore, that articles of association of business associations are indeed contracts). Also in the United Kingdom case the explanatory notes referring to the Companies Act 2006 (c.46) explain that the articles of association ‘form a statutory contract between the company and its members, and between each of the members in their capacity as members, and are an integral part of a company’s constitution’. This idea is captured by s. 33 of the Companies Act 2006 stating that ‘the provisions of the company’s constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe it’. Additionally, see Davies, Paul L., \textit{Gower and Davies: Principles of Modern Company Law}, 8\textsuperscript{th} ed., London, Sweet & Maxwell, 2008, pp. 65-76 (considering that the articles constitute a rather particular form of contract. He calls them a ‘multi-party contract’). Also interestingly, see Penner, J.E. ‘Voluntary Obligations and the Scope of the Law of Contract’, \textit{Legal Theory}, 2, 1996, pp. 325-357 at 344 (arguing that ‘...examples from English law show that it may be important to find a ‘doctrinal home’ for some kinds of agreement or relationships that are, at present, rather ill-suited to their present accommodation’. I quote this passage because I consider it can be used for the articles of association of a company.

As to the Italian case see, for instance, Caringella, Francesco, and De Marzo, Giuseppe (eds.), \textit{Codice Civile Annotato con la Giurisprudenza}, 7 ed. Roma, Simoni, 2004, p. 2681 where in the comments to Article 2247 (\textit{contrato di società}) articles of association have been defined as a genre of plurilateral associative agreements (\textit{contratti plurilaterali di tipo associativo}). This designation translates the idea that the scope of the corporation does not end in a general purpose of revenue; it also consists of the distribution of dividends among shareholders.

\textsuperscript{502} This is interesting because, in general terms, corporations in Europe display a higher level of shareholders’ autonomy and control vis-à-vis the company. This is not the case, for instance, in the United States where boards of directors are quite strong. They are known for their insulation vis-à-vis shareholders and other non-shareholders constituencies. I concede, however, that it is important to distinguish private from public companies, and understand the kind of influence shareholders are liable to have in the former. See Gelter, Martin, ‘The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance’, \textit{Harvard International Law Journal}, vol. 50, No. 1, 2009, pp. 129-194, p. 147 (distinguishing explicit from implicit shareholders’ influence in public companies. The comparison, I
Therefore, I use the rhetoric of contract to understand how, in fact, corporate constituencies interrelate, and how this interrelation may contribute to better corporate law rules. I use this kind of rhetoric to express the significance of contractual aspects of the company without wanting to be understood as conveying the message that the company is a contract. It is not. Consequently, the expression ‘contract for the governance opportunity’ in the title of this section tries to capture the importance of both shareholders and non-shareholders in the company. It also attempts to avoid ‘one size fits all’ type of answers as to the nature of the articles. Above all, the reference to ‘contract for the governance opportunity’ illustrates my view of the articles as instruments reconciling the interests of the corporate constituencies in accordance with the organizational structure of the company.  

The use of this rhetoric does not imply that the company is based on a cluster of arms-length contracts. Instead, it means that the company is the background for never-ending processes of negotiations and bargaining. Often, such processes are related to the adoption of institutional solutions and compromises or related to the decision-making process as it takes place at the company’s general meetings or board of directors meetings, or even related to the ex-post definition of property rights. Although this discussion about the contractual nature of the company has lost much of its glow regarding the publicly held company, it makes complete sense with regard to the private company or unincorporation. In fact, the premises listed in the comparative matrix designed in Part I, and which as I said therein are the thread that pulls together the pieces of this comparative research, are tackled from this contractual perspective of corporate law theory.
ii. The many purposes of setting forth consent *stricto sensu* in the articles of association of the company

In principle, people enter into contracts that they deem to be optimal. For some members of PLLCs, restrictions on transfer of shares are optimal. Perhaps, they hold a common social capital that cannot be produced or enforced by law if they cooperate with outsiders. Part I, however, disclosed bargaining failures with regard to transfer of shares of PLLCs where there existed this common social capital. Interestingly, bargaining failures adjudicated by the courts in the selected jurisdictions were similar. This gave me enough leeway to organize the problems at issue into four clusters: (i) interpretation; (ii) functionality of restrictions on transfers; (iii) un-consented transfers and (iv) formalities. The reader may legitimately ask: if there are bargaining failures where there is a social capital, what is the purpose of these restrictions? As I explained above, there are different restrictions and they are perceived differently in each country. Restrictions on transfer of shares have many purposes, but in general they are set forth in the articles of association to

1. Guarantee the quality of human capital and that contractual commitments in this regard are complied with.
2. Protect the day-to-day operations of the company.
3. ‘Tame’ property rights of shareholders by internalizing through contract the risks inherent to owning property rights in shares. Shareholders in these companies do not want to take major risks. If they had, they would have gone public.
4. Guarantee tax obligations are met and the company status for tax purposes is kept, that is, it is not taxed as a corporation.
5. Ensure that the company’s members can operate anonymously.
6. Avoid regulatory restrictions.

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506 See Part I.
507 This suggests basic principles, such as the principle of *tipicity* in property, should be revisited.
7. Combine the PLLC structure with the closed nature of the company, and in this way enable the respective members to insulate themselves from passive investors acquiring control over their investments.

8. Prevent the ‘introduction of a stranger into the contracting parties’ relationships and to assure the performance by the original contracting parties. In some business relationships the continued personal involvement of an original contracting party is a material premise of the contract itself. In such cases any assignment is problematic. In other cases, the parties fear the assignee will perform inadequately, in which case what is problematic is not the assignment per se but the identity of the assignee’.  

9. Preserve the identity of the company or managers who exercise ultimate control over the business partners. 

10. Prevent the transfer of a controlling interest in a partner entity because such transaction effectively transfers a partner interest to the party acquiring the controlling interest of the partner entity.

11. To define members’ contractual rights and limit the authority of courts to redo their deals.

12. Preclude a third party from assuming, at least, those parts of the contract granting special rights and particular obligations to the member. This is so because the operating agreement is viewed as an executory contract that makes the member a key element of the company and also of its management on a going-forward basis (to use an expression widespread in the jurisprudence).

13. Facilitate the succession of the business to future generations, considering that most investors do not take during the lifetime of the company the necessary steps to initiate, plan and carry out the succession in due time.

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511 See Re Swaledale Cleaners [1968] 1 All ER 1132, [1968] 1 WLR 432. This case was adjudicated by United Kingdom courts. In respect to the definition of members’ rights this case is interesting because it stresses the general principle that a transfer duly lodged should be brought before the board within a reasonable time after it was lodged where the articles of association contains a restriction on transfer. If it is not the case directors lose the right to refuse the transfer which was attributed to them by the articles of association and Table A which, in this case, was adopted even if with some alterations.


14. Facilitate the transmission of ‘idiosyncratic knowledge’ created within the family. This knowledge can be most easily given to the next generation within a family.\textsuperscript{514}

15. Control minority shareholders. ‘Poison pills’ which are normally used as defensive measures can also operate as restrictions. This comes along with oppression of minority shareholders.\textsuperscript{515}

16. Keep the special competitive advantages (e.g., idiosyncrasies) of the family business, especially when the firm is a family business.\textsuperscript{516}

17. Protect the family ties of the business to allow members to be part of a ‘transaction cost reducing social network’.\textsuperscript{517}

18. Avoid the complexities arising from the death of the owner of the shares either she is a single owner, a majority or a minority owner.\textsuperscript{518}

19. To create an ‘internal market’ among shareholders that aims at circumventing the lack of liquidity as a result of the inexistence of an external market for the shares of the PLLC.\textsuperscript{519}

20. Prevent a successful business team from being changed in an unwanted way.

21. Reduce transaction costs.\textsuperscript{520}

22. Set up a corporate governance strategy for the company.

23. Guarantee that those who manage are compatible managers.\textsuperscript{521}


\textsuperscript{515}See Ebay Domestic Holding, Inc. v Newmark. In this case the board of directors of Craigslist, Inc approved a rights plan (poison pill). Craigslist, Inc is a close corporation with a control group formed by the following shareholders: Craig Newmark, James Buckmaster and Ebay Holdings, Inc. Both Newmark and Buckmaster served as two of the three members of the board of directors. Ebay brought an action claiming that the effects of the rights plan restricted Ebay from purchasing Craigslist’s shares and it prevented Ebay from freely selling the shares it owned in Craigslist to third parties.

\textsuperscript{516}See Bjuggren, Per-Olof, and Sund, Lars-Göran, ‘Strategic Decision Making in Intergenerational Successions of Small – and Medium-Size Family Owned Businesses.


\textsuperscript{518}See Bjuggren, Per-Olof, and Sund, Lars-Göran, ‘Strategic Decision Making in Intergenerational Successions of Small – and Medium-Size Family Owned Businesses’.


\textsuperscript{520}See Perdices Huetos, Antonio B., Clausulas Restrictivas de la Transmision de Acciones y Participaciones, Madrid, Editorial Civitas, 1997, p. 26 (stating that ‘La verdadera causa de la existencia de restricciones a la transmisión de las participaciones sociales se encuentra, a nuestro juicio, en el marco del problema general de reducción de los costes de transacción, y en concreto, en los costes de aseguramiento del cumplimiento de las obligaciones asumidas en un contrato de colaboración duradera como el de sociedad’) (The reason for restrictions on transfer of shares rests, in my opinion, on the general problem of reduction of transaction costs and, in particular, the costs to assure the compliance with the obligations accepted from a long-term contract of collaboration such as that of a corporation).
24. To achieve a balance between managers and shareholders’ power so as to turn the company into a shared enterprise.\textsuperscript{522}

25. To exclude investors who may ‘upset the apple cart’ either because they have conflicting interests such as a stake in a competitor firm, or different investment goals, or are just difficult to do business with.\textsuperscript{523}

26. To control who becomes a fellow member in the company, especially if it is a 50%-50% company and one of the members invested a large amount of money in a risky, long-term project.\textsuperscript{524}

27. To avoid registration of units of American LLCs under the Securities Act 1933 or other stringent federal or state securities or blue sky law.\textsuperscript{525}

The variety of reasons for establishing restrictions on transfers suggests a strong presence of a relational element in these companies and ever-changing needs of the business environment.\textsuperscript{526} The fact is that it is difficult for legislators to keep up with this. I have submitted that not only legislators, but also courts, lawyers and other stakeholders are liable to shape the environment in which rules are potentially applied. However, agreements change much faster than do legislators. This is particularly true given the fact that the relational element is prevalent in these business associations. So, why do legislators create default rules restricting transfers (level 2 of the model)? Legislators are in a position to ‘choreograph’ through default rules those events which can potentially destabilize the development of the company. The selection of the events that should be protected by the law and the creation of rules for that purpose are liable to trigger fundamental changes in legal solutions and rules already embedded in the legal system. By setting forth defaults restricting transfer of shares,

\begin{footnotesize}

\textsuperscript{522} See Bruner, Christopher M., ‘The Enduring Ambivalence of Corporate Law’, *Alabama Law Review*, 59, pp. 1385-1449 (1422-1423) (focusing on the ambivalence of what he calls power constituencies, stresses that Delaware courts have achieved a balance between board and shareholders’ power in publicly held companies through takeover jurisprudence similarly to what they did in respect to other transactions such as mergers).

\textsuperscript{523} See Dent, George W., Jr., ‘Business Lawyers as Enterprise Architects’, *The Business Lawyer*, vol. 64, No 2, 2009, pp. 279-328 (305).

\textsuperscript{524} See the case adjudicated by the Court of Chancery of Delaware Eureka VIII v. Niagara Falls Holdings Del.Ch., 899 A.2d 95 (2006).

\textsuperscript{525} This was included in the transfer clause of one of the companies in my sample of American LLCs - Ellington Financial Operating Partnership LLC. This company was incorporated on 1 January 2013 in Delaware.

\end{footnotesize}
the legislator is taming property rights in shares. This way it keeps the closed nature of the company, assures that transfers or changes in the companies’ ownership structures are approached from an entitlements (property rights) perspective, and affects the behavior of market agents as to their perception of the investment they have made in the company, and the relationships of power between members and managers or directors of the corporation. However, it is important to note that artificial selection is not always successful. It may find resistance at the level of social structures (level 1 of the model) and market structures (level 3 of the model). I deal with this process of artificial selection by the legislator below, and suggest an explanation for the effects that restrictions may have on the configuration of property rights in shares. Again, we may return to the taming of the silver fox.

2. The domestication of property rights and the silver fox

The Russian geneticist Dmitry K. Belyaev kicked off, in the late fifties, what became a long standing set of experiments based upon the domestication of the silver fox. His hypothesis was that changes in the physics and morphology of dogs and other domesticated animals could be the result of the selection for friendliness towards human beings. Putting it more straightforwardly, the action of taming dogs would directly affect the way they looked and the structure of their bodies. This was also true of the silver fox. According to Belyaev, domestication would determine that silver foxes behave in the same manner as dogs and develop similar morphological and physical traits such as the color of the fur, the shape of the teeth, the size of the ears, skull, legs and tails, barking, and submission as opposed to their wild forebears. In fact, silver foxes develop a pattern (white) spot in the forehead not only like dogs, but also like cats and horses. This is a sign of domestication. One may wonder if a similar evolutionary pattern can be found in law. The crossover of legal solutions mentioned above regarding the introduction of restrictions on transfer of shares, which was spelled out by almost 200 articles of association of companies included in my samples, suggest that there is a similar evolutionary pattern in respect to the configuration of property rights in shares.

527 I use the word ‘taming’ to refer to domestication. Domestication is undertaken through selective breeding or artificial selection. This is a process by which desirable characteristics in a living organism are selected to be inherited by future generations. Artificial selection determines a change in the phenotype of the characteristics of an organism such as morphologic and physiologic traits, and behavior. In my analogy, the legislator may be compared to the farmer selecting animals for breeding which Darwin talked about in The Origin of Species. 528 Similarly, in nature, not all animals can be domesticated.
The story of the silver fox is not new. Darwin in his acclaimed *Origin of Species*, while discussing the probable origin of domestic pigeons, stressed that there are differences between several races of pigeons. There are differences that have been accumulated for many successive generations. Variations in pigeons are the result of selection. Darwin wrote that ‘The key is man’s power of accumulative selection: nature gives successive variations; man adds them in certain directions useful to him. In this sense, he may be said to have made for himself useful breeds’.\(^{530}\) As Darwin suggested, this principle of selection is not a modern discovery. ‘Works of high antiquity’ have acknowledged the importance of the principle.

By setting up this analogy, I am dressing law in hand-me-down principles of other fields such as biology to explain its evolution, which in many instances takes place in a very organic way. Hence, the story of the silver fox illustrates how legal institutions and fields are connected in an unexpected fashion. It tries to show the unintended consequences of this interconnection. The way market agents behave is liable to be regulated by reaching a balance between endogenous elements, which are engrained in the market and which transmit signals from a market’s sensitive area to targeted agents. These endogenous elements also transmit the signals or messages sent by certain market agents which will have an effect on other market agents. The way the signals of the market are conveyed can be controlled by the law.

The analogy rests on the fact that the introduction in the articles of association of restrictions on transfer of property rights in shares has far-reaching effects. The related biological term is ‘pleiotropy’.\(^{531}\) It not only determines property rights in shares be analyzed differently from intellectual property rights or property rights in real estate for example, but also means that corporate law, due to its specificity, tames property rights, and their features such as the right owners hold to determine the use of their own assets, the return from those assets, and to freely transfer their assets so that they are adapted to the nature and purpose of the business form. Corporate law, contract law and property law are linked in an unexpected way.\(^{532}\) In the PLLC context this can be illustrated with an example. Let us think of a case where PX sells 5 shares in the company to her mother MX. In her turn, MX transfers the shares to her daughter MMX. As a consequence, the company files a suit against MMX claiming the invalidity of the transfer. However, the articles of the company foresee that


\(^{531}\) Pleiotropy happens when one gene affects several phenotypic traits. In the silver fox, the genetic unexpected connection between physical and behavioral characteristics is a manifestation of pleiotropy.

\(^{532}\) This explains why restrictions on transfer of property rights in shares are generally valid, even though shares are frequently defined as personal property. See Painter, William H., ‘Stock Transfer Restrictions: Continuing Uncertainties and a Legislative Proposal’, *Villanova Law Review*, vol. 6, 1961, pp. 48-68 (dwelling on this issue).
transfers are free between ascendants and descendants. Hence, the court considered that the transfer of shares of PX to her mother MX and, subsequently, the transfer by the latter to her other daughter MMX were lawfully executed. The company claims that these transactions were a fraud since their ultimate goal was to circumvent the transfer clause established in the articles of association. Still, the court held that the concomitance of two transfers was not enough to define these transfers as fraudulent, or to determine that the transferors were acting in a deceitful fashion. Therefore, it would be unjustified not to consider MX a shareholder with the right to transfer her share to her daughter MMX. The company appeals to a higher court. The court of appeal validates the decision of the lower court, but not without explaining that if there had been evidence that the concomitant transfer of shares entered into and between MMX and her mother MX did not have any affectio societatis, and did not have as a sole objective to allow the transfer of shares to MMX, but rather to subsequently transfer them to third parties outside the company, and by doing so avoid the articles of association, then the lower court’s decision would not have been justified. This is an example among several others that shows how the exercise of property rights (property law) can be limited by a previous agreement entered into by the members of a business organization (contract law), and by what is defined as the affectio societatis of the company (corporate law). This shows how there can be manifestations of pleiotropy also in law for, in this case, property rights in shares are differently configured in their physiology and morphology due to the restrictions imposed on their transfer.

Moreover, there are manifestations of path-dependence in the development of the relevant legal provisions in each field. Nothing new is created. This is something certainly true in the biological context. For example, the organs of certain mammals were retooled when they developed. This was the case of whales and dolphins whose limbs were reshaped into fins. The analogy in comparative law is doctrinal path-dependence. The analogy in the PLLC is organizational path-dependence. Changes overlap with previous solutions. There is no real mutation or genetic drift. This is what the metaphor of the silver fox is all about.

534 For a similar case, see Appeal 94-19016, Cour de Cassation / Chambre Commercial, Financiere et Economique, Public audience 21 January 1997.


536 Darwin pointed out the importance of breeding for the inheritance of good and bad qualities. This connection between breeding, adaptation and heritance is obvious to him. See Darwin, Charles, ‘Variation under Domestication’, cit., p. 21 (stating that ‘On the view given of the important part which selection by man has
The holder of property rights in shares of a PLLC is vested with management rights and economic rights which they cannot transfer freely if restrictions are set forth. The case law collected shows that in many instances, this is not an ex-post efficient solution. However, even in these instances members seem not to have incentives to change the regulatory framework of their agreement. Still, change in the way corporate defaults are provided, even slight ones, will inevitably affect the channels of communication among market agents and between them, the legislator and other stakeholders. This means that members would be more likely to change the regulatory framework of their agreement as well as be more active in respect to its implementation if an adequate model policy of default rules is implemented.

3. The relational element in PLLCs and the concept of equilibrium: an enquiry about the normative justification of restrictions

The analysis of the overall amount of almost one hundred Portuguese, French, Italian, Spanish, United Kingdom and United States court decisions regarding transfer of shares, revealed several problems worth mentioning. These problems were clustered into four groups strategically titled (i) interpretation, (ii) functionality of restrictions on transfers, (ii) un-consented transfers, and (iv) formalities. These clusters suggest that shareholders have problems combining their actions (this is rather surprising considering the strong contractual basis of these companies). There is an inherent status quo shareholders want to keep in PLLCs. They, therefore, do not contract around those defaults, even when it would be desirable to do so. One of the reasons for this status quo bias is the fact that shareholders, and

played, it becomes at once obvious, how it is that our domestic races show adaptation in their structure or in their habits to man’s wants or fancies’). No mistakes, however, should be made. Changes introduced by this selection are gradual, slow, varying and insensible, to use Darwin’s words).

537 See Re Copal Varnish Co. Ltd. [1917] 2 Ch. 349 where the United Kingdom court quoted Lord Cozens-Hardy M.R. in In re Bede Steam Shipping Co. (submitting that a shareholder has ‘a property in his shares, a property which he is at liberty to dispose of, subject only to any express restriction which may be found in the articles of association of the company’). This is different in US law, as we shall see, where there is a dual concept of the share or units, and economic rights may be transferred separately and freely. 538 Yet, it could have been ex-ante efficient because parties enter into contracts they find optimal.

often managers, are too risk-averse. In line with arguments of behavioral economists, people tend to more heavily weigh changes that will likely make things worse than changes that will most likely make things better, even if taking both decisions has the same expected economic value. This, in part, may explain why members of these business associations restrict transfers.

This returns us to the question of uncertainty. However, these members often do not understand or do not know the rule-set they have chosen (probably because they were badly advised). They often transfer their shares in breach of the articles of association, including the defaults they have selected. Default rules are weakly enforceable and members do not have strong or well-defined property rights. Defaults demonstrate weak enforceability because sanctions foreseen therein are not sufficient to deter shareholders from transferring. For example, in the Portuguese case, by default, un-consented transfers of shares are valid between the parties, but have no effect towards the company. Surprisingly, this problem has not been thoroughly discussed in this country’s literature. The problem of relative unenforceability has been discussed in Spanish and French literature and jurisprudence. Default rules demonstrate that members do not have strong or well-defined property rights because their property rights are not sufficient to give them a competitive advantage in the bargaining process. There are other problems. Parties collude to achieve the purposes they established with the execution of the share sale and purchase agreement in disregard of the company and non-transferring shareholders. For example, the transferor may act as an agent

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541 See Williamson, Oliver E., ‘The New Institutional Economics: Taking Stock, Looking Ahead, Journal of Economic Literature, vol. 38, N.º 3, 2000, pp. 595-613 (607) (noting that the importance of risk aversion to commercial contracting has been placed in doubt). Risk aversion is, however, a fact in respect to the PLLC. For example, in the sample of LLC agreements clauses restricting the situations where members can file for a suit are frequent. This is understandable, for litigation threatens the relational element and closed nature that characterize these business organizations.

542 See Bainbridge, Stephen M., ‘The Business Judgment Rule as Abstention Doctrine’, Vanderbilt Law Review, vol. 57, pp. 83-130 (123) (‘Behavioral economists have demonstrated that people evaluate the utility of a decision by measuring the change effected by the decision relative to neutral reference point. Changes framed in a way that makes things worse (losses) loom larger in the decision-making process than changes framed as making things better (gains) even if the expected value of the decisions is the same. Hence, a loss averse person (as are most people) will be more perturbed by the prospect of losing $100 than pleased by that of gaining $100. A bias against risk taking is a natural result of loss aversion, because the decision maker will give the disadvantages of a change greater weight than its potential advantages. Hence, the so-called status quo bias’).

543 See ‘Business and Suing Lawyers on Malpractice’ New York Times, Late Edition (East Coast) [New York, N.Y] 25 May 1987: 1.34 (saying that ‘The malpractice crisis swirling about the legal profession will not soon subside, according to lawyers and insurance experts’). Also see Gilson, Ronald J., ‘The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants not to Compete’, New York University Law Review, vol. 74, 3, 1999, pp. 575 – 629 (599) (pointing out that ‘When lawyers design procedures that are inconvenient for those who actually must implement them, the procedures tend to be ignored’).


545 See the treatement of each one of the selected jurisdictions in Part I.
of the transferee in the company to circumvent the existence of restrictions on transfer. This means that in these circumstances, non-transferring shareholders of PLLCs will have to deal with ‘rival claims’ (e.g., claims regarding the distribution of dividends) in respect to the shares they hold in the company.\textsuperscript{546} For instance, the transferee, who is entitled to economic rights, may instruct the transferor to vote in a certain way in the company’s general meeting. The question is: given all these circumstances, why do members of these companies choose to restrict transfer of shares in the first place? This question goes beyond the purposes for which restrictions are set forth. They are listed above. It also goes beyond the idea of a status quo bias. It is indeed part of the story, but it is not the whole story. This question delves into the need of consent for the formation of legal obligations given the relational element and the fact that legislators inflict environmental changes by taming property rights through default rules providing restrictions. As I have submitted above, these changes do not create anything new or provoke any genetic sweep. They build on previous legal solutions. Thus, since manifestations of behavioral and doctrinal path-dependence are blatant, I focus in the sections below on providing a normative justification for restrictions on transfer of property rights in shares. Considering the crossover of legal solutions suggested by the empirical data and the relational element that stands out in the list of purposes for setting restrictions on transfers, I try to understand why different contractual practices (level 3 of the model) do not evolve in these companies over time when it is the case that members end up not abiding by the rules they agreed upon in the articles of association. One could legitimately wonder why it would be expectable for people to abide by the rules. There can be many reasons one can think of for them not to. It does not necessarily imply that the rules are inefficient. For example, pursuant to the efficient breach theory, parties should be free to breach a contract and pay damages, if applicable, provided that breaching the contract is more efficient than performing it. Nevertheless, there can be welfare costs sliding through the three levels of the model policy if corporate rules are not the best market agents can have.\textsuperscript{547} In other words, if rules are bad because they are not efficient, the market (level 3) and the legislative process (level 2)
become inefficient. This would negative implications for the welfare of the whole society (level 1).

i. The concept of equilibrium

   I said in the introduction to this chapter that, facing the outgrowth of new forms of business organizations, policy-wise legislators have created systems of property rights in order to assure there is equilibrium not only within the corporate structure, but also among the interests and protections each corporate constituency claims for itself. Equilibrium in this context is a balance between the influences that enable stability in the company. There is an idea that when a population is in stable equilibrium it will tend to return to it if disturbed. A stable equilibrium is like a spring that regains its initial form after being pressured or extended in one way or another. This is a stable equilibrium not because it benefits any particular individual, but because it is immune to ‘treachery from within’. This notion does not hold true with contracts or agreements such as articles of association and LLC agreements, which as a result of parties’ opportunistic behavior are precisely subject to ‘treachery from within’. Thus, because in this regard stable strategies in the sense given above are hardly adopted, it becomes harder to trace a line through which contractual strategies could evolve. A certain behavior favors a stable equilibrium if it cannot be invaded by other behaviors. That is to say, other rival behaviors will not succeed. This stable equilibrium may be broken if the environment changes. Environmental changes determine that the types of behavior favored by natural selection (level 3 of the model) change as well. Hence, a stable equilibrium depends on the circumstances. The analogy, if applied to the PLLC and in particular if the relational element prevalent therein is sticky, suggests that if the design of default rules changes or shareholders feel any market incentives to change, their strategy to restrict transfers to maintain an enduring state of stability in the company also is likely to change.

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548 See Part II, Chapter 4 below.
551 The text explores this dilemma between opportunistic behavior or ‘treachery from within’ that is inherent to the contractual nature of the PLLC and the stickiness of the relational element that favours the status quo and the mummification of legal solutions. The adequate design of rules is liable to overcome such dilemma.
Part I shows that PLLCs, unlike publicly held companies, are more likely to encompass manifestations of what is classically defined as private ordering, or is currently labeled as private governance. These phenomena, some of them described in Part I, are intrinsically linked to the closed nature of these business associations. I believe that they are also related to the fact that these business associations, at least in the selected jurisdictions, were created ahead of the law, the law being a byproduct of such manifestations of private governance. By the time the law was implemented they already had institutionalized dynamics that organically pulled together shareholders’ and non-shareholders’ constituencies. Moreover, PLLCs’ legal regime, being mostly composed of default rules, is inherently flexible and contractual. Data also shows that their socioeconomic structure indisputably rests on relational elements. These elements are easier to spot when the companies’ dimension is smaller and the ownership is less dispersed. Also, because these relational elements exist, corporate constituencies do not feel the need to enter into complex contracts. Contracts are often incomplete and the bargaining process does not end with the parties’ consent to a particular set of rules.

In many instances, parties ignore default rules especially if circumstances allow them to bargain informally. When they care about defaults, they often enforce these rules through non-legal mechanisms of governance. The analysis of operating agreements of American LLCs allows me to illustrate this. Parties introduced clauses through which members agreed that irreparable damage would be done to the good will and reputation of the company if a member should bring an action in court to dissolve the company. In some cases, it was further agreed that each member acknowledged and agreed that in the event that an investor or

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552 See Macneil, Ian R., ‘The Many Futures of Contracts’, *Southern California Law Review*, vol. 47, 1974, pp. 691-816 (760) (referring to articles of incorporation and to their general incorporation statutes as relational agreements. Moreover, Macneil perceives the corporation as a relational vehicle which has been historically capable of overcoming the dichotomy between ‘promise’ and ‘market’).

553 See the case of family companies in Italy depicted in Part I, Chapter 2.


555 See Penner, J.E. ‘Voluntary Obligations and the Scope of the Law of Contract’, *Legal Theory*, vol. 2, 4, 1996, pp. 325-357 at 342 (stating that ‘In the same way bilateral agreements provide the basis for notions of good faith or fair dealing, which is quite outside the unilateral coincidental promises model of contract, the relational analysis emphasizes this aspect [the maintenance in long-term economic relations of relations engendering good faith, give-and-take, cooperation, the mutual sharing of burdens and benefits and so on] to the point where the notion of agreement itself becomes attenuated’. He goes on by saying that ‘These norms [default norms] give rise to obligations quite outside the precise terms of any agreement recognized by classical contractual analysis’).
member seek or attempted to seek, to take any action in violation or inconsistent with the provisions of the LLC agreement, the company should be permitted at any time, at its sole and absolute discretion, to redeem that investor’s units and to thereupon immediately cause the company to purchase such investor’s LLC interest. Yet, empirical data suggest that in certain cases, parties do not spend much time on trying to understand the legal framework applicable to a deal much less the rules of the articles of association or LLC agreements. They do not engage in time-consuming inquiries about the accuracy of the words they should use to close a deal. They just close it by shaking hands, and both parties know exactly what that means. Still, members of these companies enter into PLLC agreements even when they have not fully understood or do not know the rules they have decided to agree on. This may be the case because they have been badly advised or they give a proxy to their lawyers to take care of the legal issues whilst they concentrate on making the firm operational.

Legal culture is largely transmitted by imitation, with one of the most vivid examples being the practice of law. Often, by-laws, charters, companies’ articles of association and operating agreements are imitated by lawyers. They draft minutes based on previous ones and send them to the client who simply puts her signature at the bottom of the final page and signs each page in the corner to provide written evidence of her agreement. This does not mean that clients do not read documents sent to them. Nevertheless, at times, the choice of defaults seems more an imposition than a clear choice by the parties. If parties to a contract chose

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556 The LLC agreement of the Delaware Company Inland Territorry, LLC mirrors what is said in the text. This company was included in my sample of American companies.

557 See STEVE A. McKENZIE a/k/a TOBY McKENZIE, Debtor, 2011 Bankr. LEXIS 4828 (where “Under the acts, the court notes that there is an exception for effectiveness of the restrictions on transfers. The restrictions may not be effective against a person without knowledge of the restrictions if the restrictions are imposed by a written resolution adopted by all the members, or by a written agreement among, or other written action by, all the members as opposed to being contained in the articles or operating agreement”. American courts, in particular Delaware courts, tend to adopt an objective approach to contracts. However, it is interesting to read Richard V. BRUNS, Ernest E. Bruns, and Sherman Plaza, Inc., a Wisconsin corporation, Plaintiffs-Appellants, v. RENNEBOHM DRUG STORES, INC., Walgreen Janesville, Inc., n/k/a Rennebohm Drug Stores, Incorporated, and Walgreen Co., Defendants-Third Party Plaintiffs-Respondents, v. John L. SONDEREGGER, and The Oscar Rennebohm Foundation, Inc., Third Party Defendants-Respondents (submitting that “Courts are beginning to support the proposition that the state has little interest in refusing to enforce agreements among shareholders in close corporations”. In the words of the Court: “We consider that the rule of strict construction of a share transfer agreement between shareholders in a close corporation is anachronistic”).

558 This was reported to me by a young entrepreneur while I was attending a conference about venture capital and entrepreneurship in NYC on 19 November 2012. She had had recently launched a start-up company.

559 See Part I, Chapters 1, 2, and 3 where I explain the methodology to analyse legal documents of the companies in my samples. The investigation also included the analysis of Portuguese, Brazilian and French rulebooks.

560 See Brownsword, Roger, cit., p. 14 presenting a concept of default rules that is tilted towards contractualising business agreements (e.g., business-to-business agreements and business-to-consumer agreements). These rules treat parties as if they have an intention to create legal relations and are coupled with the option of expressly opting out. The problem with this rule is illustrated in this passage: “the twin default rules tilting towards and against contractualisation are problematic. Most obviously, the effect of these rules is that some persons (probably most consumers) will walk into a contractual relationship without realizing it – and this will happen
the law because they were badly advised, what ‘bite’ do freedom of contract and sanctity of contract really have? Isn’t this equivalent to a ‘pathological’ case of consent in which parties did not truly agree on the set of rules governing the deal? This idea challenges concepts such as ‘ostensive originating consent’561 and other theories of consent which view the contract as a framework that reveals the relationships among contractual principles.562 These theories place a heavy and unrealistic cognitive burden on the parties. They also do not take into account the situations in which parties’ intentions change or the law works against their expectations. The same criticisms hold as to some doctrinal constructions that perceive the principle of contractual freedom in the context of markets guided by competition.563 The fact is, however, that as much as competition has the potential to create better rules and to optimize economic activity, it does not forthwith provide the parties with information as to the set of rules they must choose in order to demonstrate their consent. There must be an external mechanism liable to push parties to compromise in a competitive scenario. This is so because even though parties give their consent to a particular contract, they do not always have the intention to create legally enforceable obligations.564

561 See Brownsword, Roger, ‘Contract, Consent, and Civil Society: Private Governance and Public Imposition’ in Odell, Peter and Willett, Chris (eds.), Global Governance and the Quest for Justice, vol. 3: Civil Society, Oxford and Portland, Oregon, Hart Publishing, 2008, pp. 5-37 (presenting the concept ‘Originating consent’. It means the agreement parties give to the application of a rule-set to govern the deal they are making. Brownsword’s paper was brought to my attention in a seminar held at the European University Institute. At that point, discussions about autonomy and regulation had become mainstream.

562 See Barnett, Randy E., ‘A Consent Theory of Contract’, Columbia Law Review, vol. 86, 2, pp. 269-321 (Barnett is committed to explain the nature and sources of legal rights and the way they can be transferred. His arguments, as he himself recognizes, lay on a definition of contractual obligation which resembles Ronald Dworkin’s distinction between rules and principles. The concepts of will, reliance, efficiency, fairness, or bargain all these are considered principles that must be ordered by a framework showing where each is in relation to another. Barnett explains that that framework is provided by the theory of consent which is, as he presents it, an entitlements-based theory. In other words, a contract is the same as a transfer of entitlements or rights).


4. Conclusions

By methodologically connecting law, economics, and biology I suggest that the uncertainty of contractual relations is not always negative. In fact, it gives legislators, regulators, and courts the opportunity to establish new legal policies that put aside inefficient legal solutions. This opportunity follows from the uncertainty of contractual relations because contracts are naturally incomplete. I suggest that legislators can try to aim at establishing new legal policies through a three-level model policy that informs the legal system in an integrated manner. This model embodies at the first level the society. It includes at the second level the legislators, regulators (politicians) and courts. It establishes at the third level the market. Law should be the result of the interaction of these three levels at a point that comes all the way from the bottom-up. The method legislators can use to create law is illustrated by the design of default rules establishing restrictions on transfer of property rights in shares which is, I aver, equivalent to the taming of the silver fox. Legislators act like the researcher who artificially selects the desirable characteristics of legal rules that should be reproduced. This task should involve a meticulous observation of reality, which cannot be undertaken by simply mimicking the market. It also cannot be achieved by only creating mechanisms that determine the periodic review of rules. I propose that it be achieved through a system of legal policy by which legislators look at the reality of things in order to avoid a sort of ‘blackboard law’. In other words, legal policy should merit form and substance. Yet, reality keeps providing examples showing this is a challenging task. Thus, perhaps the

565 This was discussed, in particular, apropos the Portuguese and Spanish cases in Part 1, Chapter 2, where the respective legislators clearly decided to mimic the market and create default rules foreseeing restrictions on transfers. However, problems resulting from the relative unenforceability of un-consented transfers disclosed by contentious disputes challenged the merit of market-mimicked rules. See, Black, Bernard S, ‘Is Corporate Law Trivial?: A Political and Economic Analysis, Northwestern. University Law Review, vol. 84, 2, 1990, pp. 542-597 (arguing that the four situations in which rules may be trivial are when they are market mimicking, avoidable, changeable, or unimportant).


567 This is an allusion to a term used by Coase. He uses this expression to describe systems that live in the minds of economists, but not on earth. ‘Blackboard economics’, as the term is used by Coase, means that ‘the firm and the market appear by name but they lack any substance’. See Coase, R. H., ‘The Institutional Structure of Production’, The American Economic Review, vol. 82, 4, 1992, pp. 713-719 (714).

568 See Stephen Bainbridge’s comments to Roberta Romano’s proposal in the article ‘Regulating in the Dark’ of two key procedural requirements to overcome the stickiness of the status quo in the US political system: ‘(1) a requirement of automatic subsequent review and consideration of the legislative and regulatory decisions at some point in time; and (2) and regulatory exemptive or waiver powers, that encourage, where feasible, small scale experimentation, as well as flexibility in implementation’. In his blog, Bainbridge manifests his concurrence‘with both the diagnosis and the proposed cure’. But he seems to ‘have zero confidence in the wisdom of Congress or the SEC, and hence no confidence that this sensible proposal will be adopted’. See
construction of a network of gatekeepers that binds legislators, lawyers, notaries, market agents and civil society throughout the three levels of the model policy will facilitate a debate about legal policy held on three levels instead of a debate held on one level only.

Normatively, restrictions are mechanisms of governance which have the effect of adapting property rights in shares to the purpose of the business organization. Yet, legislators can select any other elements and shape the market environment differently.\textsuperscript{569} Depending on this selective pressure, there may be a status quo that members and other corporate constituencies will want to keep. Moreover, the stickiness of the relational element (level 3 of the model) is liable to trigger a stable equilibrium that is difficult to curtail. In a scenario like this, default rules establishing restrictions on transfer are, for the most part, irrelevant if market agents adopt behaviors which can be perceived as in a stable equilibrium. However, even a slight change in the environment, that is, even a small change to the types of rules provided to market agents has the potential to alter the state of things. This is how I see the promise of corporate and contractual evolution – through an equivalent principle of artificial selection that is able to create a line through which contractual practices can truly evolve.

The property rights-silver fox analogy highlights a fundamental change in the conception of property rights. This change may even be compared to the revolution in ownership Berle and Means refer to in the \textit{Modern Corporation and Private Property} apropos the development of big businesses and the corporation as of the first half of the twentieth century onwards.\textsuperscript{570} Chapter 2 below explores the effects that the taming process can have on property rights, just like the size of the members, skull, color of the fur, and behavior have changed in the silver fox. It explains how the establishment of restrictions in the contract of the company can alter the physiology and morphology of property rights in shares. It extends the analogy to describe a manifestation of \textit{pleiotropy} in law. Additionally, it establishes the ground wherein I scrutinize to what extent freedom of contract enhances the power of


\textsuperscript{570} See Berle, Adolf A. and Means, Gardiner C., \textit{The Modern Corporation and Private Property}, revised ed., New York, 1967, p. 65 (saying in respect to the dispersion of ownership that: ‘Wealth is less and less in a form which can be employed directly by its owner. When wealth is in the form of land, for instance, it is capable of being used by the owner even though the value of land in the market is negligible. The physical quality of such wealth makes possible a subjective value to the owner quite apart from any market value it may have. The newer form of wealth is quite incapable of this direct use. Only through sale in the market as never before’). Finally, in the corporate system, the “owner” of industrial wealth is left with a mere symbol of ownership while the power, the responsibility and the substance which have been an integral part of ownership in the past are being transferred to a separate group in whose hands lies control’.
corporate constituencies and their control over the company to the point that the ownership veil has to be lifted to shed light on who effectively controls the company. To this I now turn.

571 See Demsetz, Harold, ‘Toward a Theory of Property Rights’, *The American Economic Review*, vol. 57, No 2, Papers and Proceedings of the Seventy-ninth Annual Meeting of the American Economic Association, 1967, pp. 347-359 (358) (referring to the management group in publicly held companies as de facto owners, and affirming that effective ownership, i.e., effective control of property is concentrated in the management’s hands. This is so due to transaction costs which would result if each member had to participate in each decision that needs to be made by the company).
CHAPTER II


‘Much of the difficulty, as regards legal terminology, arises from the fact that many of our words were originally applicable only to physical things; so that their use in connection with legal relations is, strictly speaking, figurative or fictional. The term, “transfer”, is a good example’.


Introduction

This chapter draws upon the question: How does the legislator’s taming process of imposing restrictions on transfers affect the physiology and morphology of property rights in shares? The purpose of this chapter is to scrutinize the effects restrictions have on the definition of shareholders’ property rights in shares. As I have stated before, I use the un-consented transfer as my laboratory. The unenforceability of un-consented transfers towards the company is an effect common to all jurisdictions. As a consequence, it is crucial to understand the legal basis for the unenforceability of the un-consented transfer towards the company and how the share sale and purchase agreement is affected. This will clarify effects that restrictions have on the definition of shareholders’ property rights in their shares.

This begs a careful study of the nature of the shares in the selected jurisdictions (are they composed of management rights, economic rights or other types of rights?). Answering this question is a crucial task which will enable a later definition of property rights in shares and clarify which rights can be lawfully transferred. It will open the floor to revisiting and rethinking old principles of property law, such as the principle of numerus clausus. It will establish the ground for a new conceptualization of property rights, which does not rely so much on an individualistic perception of the institution. Finally, it will provide room to explore whether it is possible to create an alternative system of transfer of property rights in
shares through the adoption of a principle of abstraction and a principle of separation, which is dominant in German contract law and other German-speaking countries.572

This chapter is structured in the following manner. Section 1 dwells on a definition of consent stricto and lato sensu. The purpose of these definitions is to distinguish between those situations in which an overall authorization is required by the law for the execution of a transaction from those situations in which compliance with specific requirements such as the consent of the company, pre-emption rights and other types of restrictions are demanded by the law or the company’s articles. On one hand, this section tries to understand if consent lato and stricto sensu are part of the share sale and purchase agreement. On the other hand, it tries to explain how these two forms of consent are liable to affect the validity of the share sale and purchase agreement. Section 2 focuses on the characteristics of the shares. It argues that, physiologically, rights in shares are similar to property rights. This section also pays attention to the morphology of shares and tries to describe their structure in all six jurisdictions. Section 3 suggests a reconceptualization of property rights based on a new reading of classical principles of property and contract law such as the principles of numerus clausus, consensualism, abstraction and separation. Section 4 concludes.

1. The dual complexity of consent and the validity of the share sale and purchase agreement

I have made in Chapter 1 the distinction between, consent lato sensu and consent stricto sensu. At this point, a more comprehensive definition is in order. Consent lato sensu comes from the idea that some kind of approval or authorization of a third party to the transfer is needed. So, the reverse side of consent lato sensu is a general restriction in the law which can be opted out by the parties. It is reflective of the policy adopted by the legislator in the sense it could have selected other types of rules to attain the governance purposes of the company. Consent stricto sensu is the idea that there is an intention of the parties to create legally enforceable obligations. The need to obtain consent in these circumstances is determined by the imposition of specific restrictions (which may be established by the law or by the parties) such as the requirement to obtain the consent of the company, shareholders or directors, pre-

emption rights or rights of first refusal, buy-sell agreements, and other types of restrictions. The difference lies in the fact that a specific party has to agree on the transfer. Therefore, consent *stricto sensu* is the reverse side of a specific restriction included by the parties in the articles of association. The concept also summons up a variety of restrictions which, as I explain in Chapter 1, are very different and may be recombined in an unexpected fashion in the companies’ articles.

Because I am concerned with governance of relationships between corporate constituencies and third parties, this construction is based on the distinction between the internal and external relations of the parties to the share sale and purchase agreement (SSPA). In other words, I am interested in the effects the SSPA has toward the company and other third parties and the effects it has on the parties to the SSPA themselves. I then try to discover if and to what extent consent, generally speaking, is part of the SSPA, and what the consequences arising from its breach are, considering the legal scheme of transfer of property in each jurisdiction. This is a different approach from that taken by Perdices Huetos, who, dealing with similar issues in Spanish law, submits a solution for the un-consented transfer that does not differentiate between effects toward the company and effects between the parties. He argues that, due to the configuration of Spanish contract law which is influenced by German and Roman laws, restrictions do not affect the SSPA, but absolutely impede the execution of the transfer toward the parties, the company and any other third party. The transfer, but not the SSPA, is absolutely void. On one hand, he distinguishes between the effects restrictions have on the act of transmission, and on the other hand he distinguishes between the effects they have on the contract which causes the contractual obligations. Hence, for him, the key to study the restrictive phenomenon rests on the analysis of the technique used in each restrictive clause of the company’s articles to grasp in which way it affects the

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573 Refer to Chapter 1 for a list of the types of restrictions inserted in the articles of association of companies in all six jurisdictions.

574 My work deals not so much with defining each type of restriction and treating it individually as in understanding the effects that restrictions in general have on the delineation of property rights of shareholders and on the governance of the company. This is of interest to me because I think that stronger property rights are likely to enable more efficient bargaining. See Perdices Huetos, Antonio B, *Clausulas Restricitivas de la Transmision de Acciones y Participaciones* Madrid, Civitas Ediciones, 1997 (describing each restrictive technique such as clauses determining the requirement of consent, pre-emption rights, and rescate). He understands that these different forms of restrictions despite having a corporate nature affect the supposed act of transmission (*el supuesto de hecho de la transmission*), and, consequently, affect the capacity of disposition of the transferor). Hence, for him the key for the study of restrictions is the analysis of each type of restriction used in each clause.

575 This exercise will help to understand the validity of the contract between the parties, even though it has no effects towards the company. It will also help define property rights in shares and discover how ‘tamed’ they actually are.
supposed act of transmission.\(^{576}\) For me, the key lies in understanding how restrictions mold property rights and influence their transmission pursuant to different principles of contract and property law in each jurisdiction.\(^{577}\)

I have made the point that members frequently ignore the rule-set they have selected to govern their company’s articles. Therefore, these actions do not stand for the operation of consent *lato sensu*.\(^{578}\) Instead, in practical terms, they represent a rejection of the body of law shareholders have selected.\(^{579}\) In other words, consent *lato sensu* and consent *stricto sensu*, that is to say, the requirement to obtain approval for a transaction in general, and the concretion of such requirement through the inclusion of particular restrictions, are not always in tune because shareholders fail to obtain the relevant consent. Between executing a SSPA, or waiting until consent is obtained, the transferor opts to execute it, especially if they are driven by opportunistic behavior, and the applicable rules cannot be strongly enforced. This begs the question: does the SSPA necessarily rest upon consent, after all?\(^{580}\) In my view, the answer is ‘no’. I do not think that the contractual obligations deriving therefrom necessarily need consent to be generated. However, it is difficult to generalize across different jurisdictions a statement that neither consent *lato sensu* nor consent *stricto sensu* are part of the sales contract. The answer to the question may depend on the purpose of a legal prohibition or limitation. The answer to the question will depend on whether or not to fulfill its purpose the prohibition or limitation would need to void the SSPA. It also depends on the content of the contract itself and upon what the parties agreed. For instance, the transferor

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\(^{577}\) Chapter 4 deals with the questions that are: how can property rights, as they are molded by restrictions, affect the governance of the company, and who actually controls the company?

\(^{578}\) I am approaching corporate law from a contractual perspective due to the default nature of the rules at stake. But this approach is not taken unwarrantedly. These defaults are introduced in the company’s articles, which is a contract. This contract has a *sui generis* nature. It lacks the bilateral features of a standard sales contract, for example. The contract of the company is drafted to regulate the internal affairs of the company.


\(^{580}\) I am referring to consent *lato* and *stricto sensu*. I am not referring to consent as the manifestation of intention to create legally enforceable obligations. See Smith, Stephen A., *Contract Theory*, Clarendon Law Series, Oxford, Oxford University Press, 2004, pp. 212-215 at 214 (referring to domestic agreements and explaining that these agreements are not intended to be legally binding. In his words ‘Domestic agreements are different from ordinary commercial agreements. Specifically they are not bargains in the ordinary sense of the term; the parties do not enter them to gain personal advantages. Rather, domestic agreements are made in order to promote the parties’ shared interests. This share interest lies both in the subject matter of the agreement … and in the goal of strengthening the relationship itself. Domestic agreements are therefore both expressive of, and a constitutive feature of the parties’ relationship. Making (and performing) such agreements is an integral part of what it means to be in a relationship, and part of the reason they are valuable’).
may want to include a clause in the agreement with a prohibition or limitation in order to avoid liability for *culpa in contrahendo*.

This can be better illustrated by zooming in on the picture of the internal relationship of the parties to the SSPA. This is where it becomes tricky. Let us imagine that the SSPA does not need consent to produce effects between the parties. Then, the un-consented transfer is liable to be valid between them. This has been the understanding of some Portuguese, Italian, and Spanish jurisprudence. Perhaps, this has been the case in Portugal and Italy due to the fact that the consensual principle, by which property is transferred by mere consent of the parties, prevails in these jurisdictions. The case of Spain is more complicated, as it does not adopt the consensual principle, but some confusion has reigned in the academia and jurisprudence as to the effects of the un-consented transfer. For the most part, this was due to the wording of the law which first determined the absolute voidness of transfers in breach of restrictions, and later, after it was changed, foresaw that transfer in those circumstances would have no effects toward the company. It deliberately left the parties aside of the negative effects of the un-consented transfer.581 In France, where the consensual principle equally prevails,582 legal doctrine and courts have held that the un-consented transfer is void.583 Case law shows that parties to the sales contract often dispute this understanding and argue that the contract is perfect and executed once they have agreed on the terms and conditions of such contract, including the price.584 Nevertheless, courts have sustained that rules on the transfer of shares such as Article L 223-14 have a mandatory nature. Therefore, their breach, courts have spelled out, determines that the SSPA be absolutely void. Acts which are absolutely void are damaged at the root, as if they had never been entered into and between the parties. Yet, the fact that voidness may prescribe in three years585 suggests that legal doctrine when referring to voidness actually implies a relative voidness that can only be claimed by the interested

581 See Article 20 of Law of 17 July 1953 and Article 112 of the Royal Legislative Decree 1/2010, 2 July, which is currently in force and keeps the previous wording of the law when it was altered.
582 The consensual principle in French law derives from Article 1583 of the Civil Code. It sets that ‘Elle est parfaite entre les parties, et la propriété est acquise de droit à l'acheteur à l'égard du vendeur, dès qu'on est convenu de la chose et du prix, quoique la chose n’ait pas encore été livrée ni le prix payé’ ([The contract] is perfect, and the property is legally acquired by the buyer from the vendor provided the thing and the price are agreed, even if the thing has not yet been delivered and the price payed”).
583 It is not always clear whether jurisprudence refers to relative or absolute voidness of the sales contract.
584 Disputes over the terms in which the price is settled are abundant in France.
585 See Merle, Philippe, and Fauchon, Anne, *Droit Commercial: Société Commerciales*, 13th ed., Dalloz, 2009, p. 248 (affirming that ‘Si la cession était réalisée sans que le projet ait été notifié à la société et aux associés, elle serait nulle. La nullité pour violation de l’article L. 223-14 se prescrit par trois ans’) (If the transfer is executed without the proposal be notified to the company and the shareholders, it will be void. Voidness for breach of Article L. 223-14 prescribes after three years).
parties until a certain point in time.\textsuperscript{586} It follows that if the un-consented transfer is relatively void, it can still be confirmed because the essential element of the sales contract, that is, the capacity of the transferor to dispose of her property rights in the shares, has not been wholly uprooted.

As to the American LLC, there are some LLC agreements which, under the wing of the default rule, specifically regulate the effects of the un-consented transfer.\textsuperscript{587} These transfers are also termed by the respective LLC agreements as improper or prohibited transfers. There is a first type of clauses establishing that any attempted transfer not strictly in accordance with the provisions of the LLC agreements will be void \textit{ab initio} and of no force or effect whatsoever, provided that any such attempted transfer might be a breach of the agreement, notwithstanding that such attempted transfer is void. LLC agreements go on establishing a second type of clauses where other negative consequences are delineated such as the transferee not having managing rights or the rights to participate in the business or affairs of the company, to receive any reports or obtain information concerning the company, to inspect or copy the company’s books records, to receive economic interests in the company, to receive upon dissolution and liquidation of the company the net amount otherwise distributable to transferor. A third type of clause provides that, except as otherwise required by the law, the company and the manager shall treat an un-consented transfer as void and shall recognize the transferor as continuing to be the owner of the membership interest purported to be transferred. However, LLC agreements also state that if the company is required by law to recognize an un-consented transfer the transferee shall be treated as an assignee with respect to the membership interest transferred and may not be treated as a member with respect to the membership interest transferred unless it is admitted as a member. For the most part, in these cases the transferee is often entitled to receive economic interests. A fourth type of case is that in which transferees are entitled to receive only economic interests to which the transferor of such units would have otherwise been entitled. The transferee has no right to vote or participate in the management of the business and affairs of the company.\textsuperscript{588} In these circumstances, the transferor remains a member of the company with

\textsuperscript{586} I adopt a broad sense of interested parties to include not only the parties to the sales contract, but also the company and other third parties such as creditors.

\textsuperscript{587} I am referring to the LLC agreements in my sample of American companies. They were all incorporated in Delaware. This state, like the state of New York, provides for default rules regarding the transfer of shares, which the parties are free to contract around.

\textsuperscript{588} This is an extention of what is provided by the law. See, for example, the Delaware Limited Liability Company Act § 18-702 (‘Assignment of limited liability company interest’). Sometimes, despite the fact that transferees are only entitled to obtain economic rights, they may be included in the term ‘member’ according to the terms of the contract.
all rights to vote and manage until non-transferring members (often owning a majority of the outstanding units of the companies) consent to make the transferee a member. A fifth type of clause conditions the validity and effectiveness of the transfer to a written instrument, payment to the company of its reasonable expenses, the compliance of requirements of relevant state and federal securities and tax laws, or any other kind of requirements for that matter. In these cases consent *lato* and *stricto sensu* have the ability to deprive the parties to the SSPA of their capacity to execute it.\(^{589}\) The costs of execution would be prohibitive.

In the United Kingdom directors may decline to sanction or recognize any instrument of transfer or refuse to register an un-consented transfer.\(^{590}\) Moreover, the transferor is deemed to remain the holder of the share until the transferee is entered in the register of members in respect thereof. Setting aside a discussion about the nature of the register (is it constitutive or merely declarative?), the power directors have to register or not the transfer determines the sales contract be valid only between the parties, and not towards the company and other non-transferring shareholders. (No transferee can be a shareholder of a company only within the internal relationship she has with the transferor). United States and United Kingdom courts alike tend to adopt an objective approach to contracts. They refuse to provide final and concluded opinions about a particular provision in the articles or LLC agreements. They evaluate the articles, and judge parties’ rights, duties, obligations and further responsibilities in light of the articles’ contractual framework. Courts in the United Kingdom reckon the transfer of shares operates in a complex fashion. For instance, according to *Re Copal Varnish Co. Ltd*,\(^{591}\) first, parties enter into the contract of sale which is followed by the execution of an instrument of transfer containing an agreement by the buyer to accept the shares subject to the restrictions imposed by the articles of association. In *Re Copal Varnish Co. Ltd* the buyer or transferee was given an equitable interest in shares. However, there was no acceptance of that transfer by the board of directors, neither was registration. The court submitted that even when the share is passed, it is necessary that the name of the transferee be effectively registered for the completion of the transfer.

As to the Spanish case there is a first type of clause in the articles of association that provides that transfers in breach of the restrictions have no effects toward the company and

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\(^{589}\) Following what I have submitted in Chapter 1 and the analogy established therein with the process of domestication of the silver fox, the fact that consent *lato sensu* and *stricto sensu* deprive the parties to the SSPA of the ability to execute it is an effect of the taming process, which does not result from the way property is transferred in the United States, but rather from the way shares are designed.

\(^{590}\) Previously, directors could decline or refuse to register discretionarily. The law has changed in this regard, and now they have to justify it.

\(^{591}\) *Re Copal Varnish Co. Ltd.* [1917] 2 Ch. 349.
are not registered in the members' register. Additionally, the exercise of the political rights in
the share is automatically suspended. A second type of restriction stresses that if procedures
especially related to the exercise of pre-emption rights are not complied with, the company
may ignore all transfers and, consequently, the buyer may not exercise any shareholder rights
in the company. There is a third type of clause that determines the unenforceability of the un-
consented transfer until the moment the company be informed about the transfer. A fourth
type of clause, besides determining the no-effects toward the company rule, adds that the
company will refuse to register the transfer in the members register. A fifth type of clauses
establishes transfers are void (ab initio) if executed in breach of the provisions of the law or
the articles. In some cases the articles of the company were altered to become reflective of the
law. They started by determining the voidness of the transfer because this was what the law
first provided, just to change the effects of the un-consented transfer, once the law changed.
The un-consented transfer, then, after the law changed became unenforceable only toward the
company. Spanish courts have adopted different approaches to the un-consented transfer, in
particular as a result of the doctrinal debate around the changes in the law.\textsuperscript{592} In general,
courts considered that the un-consented transfer was valid between the parties and was likely
to be avoided. They dwell, however, on the issue of the lack of consent when it should have
been obtained, as required by the law or the articles when they adopt the default rule. Courts
try to clear up whether the lack of consent determines the innate incapacity of the transferor to
sell the property rights she owned in the shares.\textsuperscript{593} Advocates of this theory argue that the
causal contract, however, should be considered valid and enforceable.\textsuperscript{594} For the most part,
this is in line with the particular Spanish regime of transmission of property. In Spain property
is not transferred by mere consent of the parties. It takes an additional element for property to
be transferred. Spanish laws, within the tradition of roman laws, differentiate the title from the
mode of acquisition. This is called the theory of title and mode (teoría del título y el modo). It
provides that title only creates contractual obligations, but that property is only transferred
after the delivery or possession of the thing. This is valid for all contracts liable to transfer
ownership such as a sales contract. Furthermore, it applies both to immoveable and moveable

\textsuperscript{592} See the Spanish case discussed in Part 1, Chapter 2.

\textsuperscript{593} This is another effect of the taming process of property rights in shares I refer to in Chapter 1. In fact, it seems
that Spanish courts have been discussing whether consent has a constitutive effect of property rights. Putting it
differently, they have been dwelling on the effects that consent has on the physiological and morphological
structure of property rights.

\textsuperscript{594} I discuss this apropos the nature of the rights transferred with the shares.
Thus, the Spanish regime of transfer of property puts the French law based consensual principle aside and adopts a legal model closer to German and German-speaking countries’ laws of contracts. Also deviant from the consensual principle are US and UK laws. In the United States, under UCC §2-401 (passing title), the parties can generally decide when title passes. By default, it passes upon performance. In the United Kingdom, ownership in movables passes when parties agree on the moment it should pass. Delivery, payment, or register play no role on the transfer of ownership. Therefore, the consensual principle in force in Portugal, Italy and France does not apply.

The taming process undertaken by legislators to which I refer in Chapter 1 affects the exercise of the rights shareholders hold under the sales contract and the fashion in which property rights are transferred. In the cases where the SSPA is deemed valid between the parties, but the transferee cannot exercise any rights toward the company, the transferor has, in fact, transferred empty rights in the share. This has much to do with the sort of rights shareholders intend to transfer and are actually transferring with the execution of the SSPA. For example, their ownership derives from the articles of association of the company to which the transferor is a party. Restrictions are set forth, or saying it the other way around, the requirement to obtain consent to a transfer is included in the articles pursuant to the nature and purpose of the company. What could possibly justify that the transferee becomes a party to the articles of association? The default in civil law is that everyone can choose with whom to be in a contract. Corporate law is an exception because it permits transfers without unanimous consent.

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596 I use the word ‘deviant’ in the text. Nevertheless, it is interesting that for a commentator who has been educated in a country that adopts the separation of title and modus, the perception may be that the French system that adopts the consensual principal is unusual, which is moreover limited to specific obligations.


598 Not only the United States and the United Kingdom, but also even some civil law jurisdictions do not follow the consensual principle. The same result provided by US law can generally be achieved with a constitutum possessorium. For example, Austrian law, § 428 ABGB, which also foresees tradition brevi manu, foresees the establishment of the constitutum possessorium unless there is a specific prohibition such as in the case of the creation of a security interest. Portugal (Article 1264 of the Civil Code) and Italy (Article 2:105 of the Civil Code) also foresee this legal institution.
2. The physiology and morphology of property rights in shares

In respect to the definition of shares of PLLCs, Portuguese, Italian, and Spanish laws as well as legal scholarship have been greatly influenced by German law. Thus, I will use German law as a helpful analytical springboard. German law does not present a definition of share Aktien (AG) or Geschäftsanteile (GmbH). This concept has been especially developed by legal doctrine. Commentators in general have been defining share as a membership right (Mitgliedschaftsrecht) which comprises a bundle of rights and duties. However, the authors of the main comments to the AktG and to the GmbHG have not been too concerned about the definition in abstract.\(^{599}\) Still, under German law, shares have been defined as complex rights (Mitgliedschaftsrecht). In this concept of share, property, administrative and personal rights are included. This definition may be illustrated with the rights shareholders hold to share in the profits of the company, to participate and vote in the general meetings, to ask for corporate information, to be elected members of the governing bodies of the company and so on. Additionally, all these rights enable the emancipation of shareholders within the company. Not only rights, however, are part of this concept of ‘complex right’, but also duties are attached to it. The Mitgliedschaftsrecht has very sui generis features since it cannot be straightforwardly directed to the dyadic relation between property rights and credit rights. That is to say, this concept surmounts the dichotomy between property rights (absolute, i.e., ‘good against the world’)\(^{600}\) and credit rights (relative, i.e., ‘good only against a handful of


\(^{600}\) For example, Article 544 of the French Civil Code of 1803 (Décreté le 14 14 vetôse an XII, promulgué le 24 (5-15 Mars 1803) provided that ‘La propriété est le droit de jouir et disposer des choses de la manière la plus absolue, pourvu qu’on n’en fasse pas un usage prohibé par les lois ou par les règlements’ (‘Property is the right to enjoy and dispose of things in the most absolute manner, provided their used is not prohibited by the laws or regulations’). In the literature see Hart, Oliver, ‘An Economist Perspective on the Theory of the Firm’, Columbia Law Review, 89, 1989, 1757-74 (1765) (affirming that … ownership of an asset goes together with the
people’). Despite this concept of Mitgliedschaftsrecht, the trend in German legal doctrine is to define shares of a GmbH (Mitgliedschaft) as subjective rights (subjektive Rechte). I reckon that defining them as such does not add much to the understanding of their physiology and morphology. Attending to the broad definition of subjective rights, it is obvious they can be included into the concept.

In the Portuguese case, the concept of subjective right was insufficient to define what share is. I think the problem has less to do with the concept of share than with the definition of subjective rights (it is a concept liable to include all sorts of entitlements). Consequently, other alternatives have been proposed. For instance, Raúl Ventura dogmatically circumscribed the share by using the regime of the assignment of rights established in Articles 424 and following of the Portuguese Civil Code. Pais de Vasconcelos adopted a different approach. He argues that the share can and should be perceived as a plural form. That is to say, the share represents a legal relationship, but can also be understood as a subjective right or as the position members have in the company (status socii). In his opinion, all these qualifications can be accommodated. This is trivial because it gives no hint as to the components, the function, and structure of a share in a Portuguese company.

In Italy, the concept of subjective right also was not bold enough to provide a clear definition of share, even though, like in the German case, part of legal doctrine still defines shares as a subjective right. Shares have been referred to as ‘subjective legal positions’ or as a ‘complex of subjective positions’. This is particularly true when the articles of association grant special rights to members of the company (diritti particolari dei soci) and adopt elements of the partnership to enhance these companies’ intuitus personae nature. Shares have also been considered by commentators as standing for a mere contractual position of the member summing up the rights and duties attributed to her by the articles of the company. The share as partecipazione is often seen as the measurement of the participation of possession of residual rights of control over that asset; the owner has the right to use the asset in any way not inconsistent with a prior contract, custom or any law”.

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601 See Koppensteiner, Hans-Georg, Rüffler, Friedrich, GmbH Gesetz Kommentar, 3 aktualisierte und erweiterte Auflage, LexisNexis, Wien, 2007, p. 776 (stating that ‘Die Mitgliedschaft (der Geschäftsanteil) ist freilich auch als subjektives Recht aufzufassen, das gegen den Willen des Inhabers nur im Rahmen des Gesetzes und der Satzung verändert werden kann und das deliktischen Schutz gegen Eingriffe durch Dritte genießt (...) (Membership is certainly regarded as a personal right, which can be changed against the will of the owner only according with the law and the statutes, and it enjoys the tort protection from interference by third parties).


603 See Rivolta, Gian Carlo M., La Partecipazione Sociale, Milano, Giuffrè, 1965 (debating the concept of share. He also discusses the structure and incidents of shares).


605 See Article 2468(3) and (4) of the Italian Civil Code.
the member in the company. Some commentators, however, have tried to refine the concept, and have submitted that shareholders hold a *diritto corporativo*. The nature of this right is *sui generis* since, in the same vein as the *Mitgliedschaftsrecht*, tries to surpass the twofold reality of property rights and credit rights. In other instances, in an attempt to objectify the concept, commentators and jurisprudence alike have defined shares as moveable property (*bene mobile*).  

In the United Kingdom private limited companies as well as public limited companies consist of issued shares. They are classified by English law as intangibles (*choses in action*). Ownership of the share is evidenced by a share certificate, which is different from the Portuguese, Italian and Spanish cases where certificates of shares of PLLCs are not issued. Section 541 of the Companies Act 2006 defines shares or other interest of a member in the company as ‘…personal property (or, in Scotland, moveable property) and are not in the nature of real estate (or heritage)’. However, in the United Kingdom the share has been traditionally defined as ‘…the interest of a shareholder in the company, measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders *inter se* in accordance with [the Companies Act]. The contract contained in the articles of association is

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607 See See Gagnasso, Oreste, *Trattato di Diritto Commerciale*, cit., p. 126 (arguing that ‘Il legislatore, nell’articolata disciplina della partecipazione, pare accentuare la prospettiva, già delineate dalla dottrina ed accolta dalla giurisprudenza nel sistema anterior, volta ad oggettivarla, equiparandola ad un bene’) (*The legislator in the articulated rules about the share seems to accentuate the view already outlined by legal doctrine and upheld by jurisprudence in the former legal regime, objectifies it [the share] again and equates it with an asset*). In jurisprudence see Cass. 12.12.1986, No. 7409 (the court held that the share of the società a responsabilità limitata is ‘…un bene immateriale equiparato ex. Art. 812 c.c. a bene mobile materiale non iscritto in pubblico registro…’) (*…an intangible asset comparable to movable tangible property not registered in the public registry*), and Cass. 26.05.2003 (the court considered that ‘…la quota di partecipazione in una società a responsabilità limitata esprime una posizione contrattuale obiettiva che va considerate come bene immateriale equiparabile al bene mobile non iscritto in public registro ai sensi dell’ art. 812 c.c. onde a essa possoni applicarsi, a norma dell’art. 813 c.c., le disposizioni concernenti I beni mobile…’) (*the share in a società a responsabilità limitata expresses an objective contractual position which must be regarded as an intangible asset comparable to moveable property not registered in the public registry within the meaning of art. 812 c.c., and to which rules on moveable property may be applied pursuant to art. 813 c.c.*).
608 See Micheler, Eva, *Property in Securities: A Comparative Study*, Cambridge, United Kingdom; New York, Cambridge University Press, 2007, p. 21 (saying that securities are intangibles under English law). Also see Pretto, Arianna, *Boundaries of Personal Property Law: Shares and Sub-Shares*, Oxford, Hart Publishing 2005, p. 41 (saying that ‘There are securities which are unique and for which a satisfactory substitute cannot be bought on the market, and there are securities for which a substitute is readily available. There is typically no market for shares in private companies, which is why a contract for the sale of shares in a private company is, ordinarily, enforceable by specific performance (jobson v jobson [1989] 1 wrl 1026; Grant v. Cigman [1996] 2 BCLC 24; Wood Preservations Ltd v Prior [1969] 1 WLR 1077 (CA); Sahota v Bains [2006] EWHC 131 (Ch)).
609 See Section 768 of the Companies Act 2006.
one of the original incidents of the share’. Paul Davies provides a critical analysis of this definition. In his words

...this definition, though it lays considerable and perhaps disproportionate stress on the contractual nature of the shareholder’s rights, also emphasises the fact that he has an interest in the company. The theory seems to be that the contract constituted by the articles of association defines the nature of the rights, which, however, are not purely personal rights but instead confer some sort of proprietary interest in the company though not in its property.

Commentators such as Luxton have stressed that ‘...the various contractual obligations incurred by a member, upon the acquisition and the disposal of his shares, are capable of creating rights of a proprietary nature’. Luxton submits the example of the pre-emption clause as a restriction upon the free transferability of shares. He argues that a shareholder who sells her share to a third party without first notifying the company’s secretary breaches the contract in the articles. In these circumstances, specific performance to compel the vendor to execute the transfer of the share will not be ordered because that would necessarily imply the seller breach the articles of association. Luxton, however, thinks that the unavailability of specific performance does not prevent the purchaser from acquiring an equitable interest under a trust. This is the case of un-consented transfers of shares in which the pre-emption clause was breached by the member transferring her shares. In this situation, the purchaser acquires equitable interests in the share. This is so because no conveyance of the share is needed for equitable interests to pass to the purchaser considering the trusteeship binding her to the vendor. But, then, the issue becomes one of priority between equitable interests in the share of non-transferring members and the purchaser. According to Luxton, ‘This is possible because of the nature of property in English law: it is the relationship between

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610 See Borland’s Trustee v Steel Brothers & Co Ltd [1901] 1 Ch 279 at 288.
613 As he puts it: ‘during the period between contract and registration, the vendor holds the legal title to the shares in trust for the purchaser. This imposes a variety of duties upon the vendor, including the obligation to account to the purchaser for dividends received by him which were declared after the date of the contract’.
614 See Borrowdale, A., ‘The effect of Breach of Share Transfer Restrictions’, Journal of Business Law, 1988, pp. 307-319 (advocating an opposite opinion. Borrowdale construes the right of pre-emption as an option upon the sale of the share by the transferor to a third party in breach of the articles. He argues the following: ‘To construe a right of pre-emption as an option upon the right becoming exercisable resolves the anomaly of a right of pre-emption being entirely defeated or breached. The right assumes the character of an option, i.e. an irrevocable offer, because the grantor should in first instance have offered the property to him’).
615 See Davies, Paul L., cit., pp. 947-948 (dealing with priorities between competing transferees).
persons in regard to things’. Yet, it appears that the real test would seem to be whether it has effects towards third parties. They not only include the other members of the company, but also creditors of the seller who may want to seize her assets. Property rights both in common law and in equity are relative, and the priority between equitable interests is determined pursuant to established principles. This, his argument goes, is consistent with developments in land law. Consequently, in some circumstances, equitable interests may indeed pass to the purchaser upon breach of the articles. Interestingly, Luxton’s reference to Tett v Phoenix Property and Assurance Co Ltd illustrates the idea that restrictions on transfers such as pre-emption rights or rights of first refusal generate equitable interests (or property rights) upon the breach of the articles by one of the members. Evidence of such equitable interests is not provided by the register of members. Apropos this issue, the United Kingdom Government is planning on introducing a public register of company beneficial ownership. Besides being public, the application of sanctions is foreseen if beneficial owners are not disclosed. In the meantime, while the new legislation is not passed, the fact that evidence of equitable interests is not given by the register of members grants, as Luxton acknowledges, restrictions on transfers (pre-emption rights in this case) ‘a force they would otherwise lack’. Moreover, it calls attention to the fact that shares are perceived as

See Chapter 4 where I provide a concrete example of this kind, and explore the consequences of the unconsented transfer to third parties under several settings including asymmetries of information and strategic behavior.

This is in opposition to the definition of property rights in Portuguese, Italian, Spanish, and French law. In these jurisdictions the perception that property rights are absolute is yet enduring. This idea is linked to an extremely individualistic view of these rights in these jurisdictions.

Also see Davies, Paul L., cit., pp. 945-946 (referring to the transfer of beneficial interests in the shares notwithstanding registration of shares in the register of members has not occurred).


See Davies, Paul L., cit., p. 958 (stating that ‘...although the register provides prima facie evidence of who its members are and what their shareholdings are, it provides no evidence at all, either to the company or anyone else, of who the beneficial owners of the shares are’).

Herein lays the economic value of such restrictions. The author says: ‘…Outside courts, it has been increasingly appreciated that corporate investment in unquoted companies can be positively encouraged by the imposition of reasonable restrictions upon the transferability of their shares…’). Also see Re Fry, Chase National Executors and Trustees Corporation Ltd. v Fry and Others [1946] Ch. 312. It does not deal with a sales contract but with an incomplete gift. It is interesting because it shows the court rationale in respect to the transfer of equitable interests in the context of an incomplete gift. In this dispute, the transferee, who was residing in the United States, wanted to make a gift to his son of shares that he held in an English company. The transfer was executed and sent to the company for registration. However, pursuant to the Defence (Finance) Regulations, 1939, reg 3A (as amended) the transfer of any securities or any interest in securities in which a person resident outside the sterling area had, immediately before the transfer, any interest, was prohibited unless permission from the Treasury had been obtained; and registration of any such transfer was prohibited without permission from the Treasury. Consequently, the company replied to the transferee that certain forms would have to be filled out by the transferee and that a license from the Treasury would have to be obtained for the transfer. The necessary forms were filled out by the transferee and the son, but the transferee died before the license from the Treasury was obtained. Facing the question as to whether the son was entitled to require the transferee’s personal representatives to obtain for him legal and beneficial possession of the shares, the court held that since the requisite of consent of the Treasury had not been obtained, and the company was for that
‘things’ (*chooses*) subject to property rights.\textsuperscript{622} This idea is supported by Davies, who claims shares are in law and in fact ‘items of property’.\textsuperscript{623}

The Spanish legal doctrine has defined share as a membership right or a legal relationship which stands for the position of the member in the articles of the company.\textsuperscript{624} Additionally, Spanish authors, for the most part influenced by German doctrine, have qualified the share as a complex legal relationship or a relationship of cooperation. Others qualify it as a patrimonial subjective right (i.e., ownership right) because, in their opinion, subjective rights are not more than legal relationships even if they are complex legal relationships or represent a bundle of rights and duties. Defining shares as patrimonial subjective rights implies that, in principle, individuals who own these shares are free to negotiate them in the market unless the law or the company’s contract establish differently.

Shares in the French SARL (*parts sociales*), like in the Portuguese, Spanish, and Italian cases are not represented by certificates. They are not securities. The SARL, however, may issue bonds.\textsuperscript{625} Historically, the French Civil Code classified shares of commercial companies as moveable property.\textsuperscript{626} Legal doctrine has understood that this definition does not suffice,
nor does it suffice to say that shares are mere credit rights that members hold against the company. Commentators submit the share is first and foremost representative of the quality of member (status socii). Additionally, it is regarded as an ensemble of political rights (e.g., the right to information, the right to participate in the shareholders’ general meetings and to vote therein) and ownership rights in the corporate assets (l’actif social).

In the United States, LLC agreements in my sample generally define shares (units) as interests in the company as provided in the agreement and the respective LLC Act. They entitle their holders to participate in the management. They give title and interests in the profits, losses, deductions and credits of the company, and any and all other benefits to which a holder thereof may be entitled as a member, together with the obligations of such members to comply with all terms and provisions of the agreement. In sum, units represent an ownership interest in the company and rights and obligations as described in the LLC agreement and the law. Additionally, shares have been defined as membership interests. As to the nature of units or membership interests, they are conceptualized as personal property and this has been pacifically included in the LLC agreements. Most statutes establish through default rules that the transfer or assignment of ownership interests in a LLC only conveys economic rights. The transferee can additionally acquire management rights if the non-transferring shareholders have given their consent to it. It being a default rule, members can contract around it, as they frequently do. As to the form, some agreements also provide that units of the company may be evidenced by certificates if this is approved by the board of directors, but there should be no requirements that the companies issue certificates to evidence the units. The agreements clarify that if the board determines to issue any certificates they shall on the face thereof bear a legend reflecting the restrictions on those securities.

Perpetual or life annuities, either from the State or private individuals, are also movables by prescription of law). (Translated by Georges Rouhette, Professor of Law, with the assistance of Dr. Anne Rouhette-Berton, Assistant Professor of English).


629 Such legend often goes like this: “Transfer is subject to restrictive legend on the back hereof”. The certificate should also bear a legend on the reverse side thereof substantially in the following form: “The limited liability company units have not been registered under the Securities Act of 1933, as amended (the “Securities Act”), or under the laws of any state or foreign jurisdiction, and may not be offered or sold, unless they have been registered under the securities act or unless an exemption from registration is available (and, in such case, an opinion of counsel reasonably satisfactory to the company shall have been delivered to the company to the effect that such offer or sale is not required to be registered under the securities act). The limited liability company units are subject to certain restrictions on transfer and other terms and conditions set forth in the amended and restated limited liability company agreement of the company, dated as of [ ], 2013, as amended from time to time, copies of which may be obtained from the company at its principal executive offices. Each limited liability company unit shall constitute a “security” within the meaning of, and shall be governed by, (i) Article 8 of the
The preceding paragraphs describe various theories about shares on a country-by-country basis. It appears that there is an effort to categorize, but the reason this effort is done is not always clear. The United Kingdom and the United States are exceptions. Shares or units have a dual structure. In the United Kingdom shares are perceived as ‘things’ in the sense of the French word *chose* which are objects of property rights pursuant to common-law and equity. This shows how the articles of association are liable to create proprietary interests. The effort to categorize clarifies how corporate law, contract law, property law, and equity law are interconnected, especially if there is an un-consented transfer. In the United States, the implications of the clear distinction between economic rights and management rights is that if non-transferring members do not approve the transfer or assignment of membership interests, the transfer or assignment does not convey any governance or management rights, but, generally, all other rights and obligations of the member are transferred, including allocations of income, gain, loss, deductions and credits. This distinction provides a straightforward look at what is included in a membership interest. Arguably, in the Portuguese, French, Italian and Spanish cases these theories are, for the most part, inductively generated from the various elements of the share. The nuances in the theories are different because the rights and obligations such as, for example, duties of loyalty (*Nachschusspflicht*) differ between countries. It appears that in these countries, the concept of share has first been inductively derived and, then, further consequences have been deductively developed from it, where the law was not explicit.

Physiologically, rights in shares function like property rights even though in most cases, with the exception of the United Kingdom and the United States where they can be represented by certificates, shares are incorporeal. Morphologically, however, their

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630 Most of the LLCs in the sample adopt a corporate-type and centralized management. See Ribstein, Larry E., ‘Form and Substance in the Definition of a “Security”: The Case of Limited Liability Companies’, *Washington and Lee Law Review*, vol. 51, 3, 1994, pp. 807-841 (arguing that there is a presumption that LLC’s units are not securities).

631 See, for example, Frank R. Zokaites, Appellant v Pittsburgh Irish Pubs, LLC and Colm McWilliams, Appellees, 2008 PA Super 281; 962 A.2d 1220; 2008 Pa. Super. LEXIS 4287.

structure is different. Restrictions on shares combined with the specific regime of transfer of property rights in the selected jurisdictions cause empty property rights to be transferred out of an un-consented transfer of shares. In other words, in the case where the share sale and purchase agreement is valid or has not been avoided, the transferee cannot exercise shareholder’s rights in the company because she is not a shareholder. At most, she can exercise economic rights, or is entitled to equitable or beneficial interests under a trust (UK), but that does not turn her into a member of the company. Hence, empty property rights transferred with the execution of the un-consented transfer are, in fact, credit rights. The transferee, if in good faith, holds a claim against the transferor. Good faith, however, has been interpreted narrowly in the United Kingdom and the United States. In the United Kingdom there has been an old tendency of courts not to compromise the certainty of the contract. In the United States, the principle has been acknowledged through the Uniform Commercial Code and the Restatement (2nd) of Contracts. Still, it is rather perceived has a minor requirement.

I submit that the share in Hohfeldian terms is a legal configuration of a complex right. The Hohfeldian conception of ‘property’ or ‘legal interest’ is that of a complex aggregate of rights (or claims), privileges, powers, and immunities. In other words, property rights are a

be the object of ownership or other property rights?’. In the jurisprudence see, for example, Judgment of the Court of Appeal of Porto, process No 0051450, as of 28 March 2001 (providing that a share in a Portuguese PLLC (sociedades por quotas) is susceptible of ownership or any other right in rem. Moreover, the transfer of shares may be undertaken through a sale and purchase agreement, which in Portuguese law is defined as a contract to transfer corporeal things.

The United Kingdom is a special case because the dual foundation of property law, which is based in common law and equity law, is unique and cannot be traced in the other jurisdictions.


See, for example, CPC Group Limited v Qatari Diar Real Estate Investment Company [2010] [2010] EWHC 1535 (Ch); [2010] All ER (D) 222 (Jun). This relatively recent case applies the principle of good faith. However, such principle is read within the contractual obligations entered into and between the parties. The court held that ‘It seems to me, therefore, that the obligation to use “all reasonable endeavours” does not always require the obligor to sacrifice his commercial interests. In this case, the matter is, however, clearer, because the contract itself, as I have already said, contains other indications that […] was not to be required to sacrifice its commercial interests.

See § 1-201 (19) providing that good faith ‘except as otherwise provided in Article 5, means honesty in fact and the observance of reasonable commercial standards of fair dealing’. Also relevant are §2-103(1)(b) and §1-203.

See § 205 (duty of good faith and fair dealing).


I resort to Hohfeld’s basic legal terms once more in Part II, Chapter 4 to define the broad concept of legal entitlement.
‘complex aggregate of jural relations’. The aggregate can be composed of multital or in rem ‘right-duty’ relations, multital or in rem ‘privilege – no-right’ relations, multital or in rem ‘power-liability’ relations, and multital or in rem ‘immunity-disability’ relations. Hohfeld calls attention to the fact that besides keeping in mind that all these elements are part of the aggregate, it is also important not to confuse the different classes of jural relations with one another. Making this distinction, he says, is of utmost practical and economic significance. The conception of the share in Hohfeldian terms provides an image of the components and structure of the share. Additionally, it points in the direction of the number of possibilities in which these elements may be connected in different and unexpected ways. This calls for a re-conceptualization of property rights.

3. A new conceptualization of property rights: To what extent can the fox be tamed?

I have tried to define the content and essence of shares in all six jurisdictions. It turns out that property rights in shares are hybrid property rights. This is so because they have a mixed origin or composition for the most part due to the different contractual structures of the articles of association where shares are defined, and due to their doctrinal and legal

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641 See Hohfeld, Wesley Newcomb, ‘Some Fundamental Legal Conceptions as Applied in Judicial Reasoning’, The Yale Law Journal, vol. 23, No. 1, 1913, pp. 16-59 (presenting a scheme of what he called ‘jural relations’ by which he analyses these jural relations and provides eight individual jural conceptions). In addition, see Hohfeld, Wesley Newcomb, ‘Fundamental Legal Conceptions as Applied in Judicial Reasoning’, The Yale Law Journal, vol. 26, No.8, 1917, pp. 710-770 (discussing certain important classifications which are applicable to each of the eight individual jural conceptions. He mainly discusses in this article relations in personam (‘paucital’ relations) and relations in rem (‘multital’ relations).


conceptualization. They have a mixed composition because, on one hand, their holder owns a fundamental right or claim against persons in general (right in rem). However, on the other hand, especially when the transfer of shares is subject to restrictions, their holder seems to rather own a fundamental right or claim against a single or group of persons (right in personam). This definition challenges the Roman law concept of ownership (dominium) because it appears that the share is not absolutely owned by the member if restrictions are foreseen in the company’s articles. Moreover, the requirement of consent lato sensu established in the default rules provided by the legislator demonstrates that restrictions on transfers of property rights are not at all subject to a numerus clausus.

The idea of hybrid property rights in shares bends the extraordinarily individualistic view of property rights, in particular in the jurisdictions that are part of the French legal family. There is this view in comparative law that the civil law is inherently against ‘divided’, or as I say mixed property rights because of the antagonism toward feudalism embodied in the civil code following the French revolution. This is an experience common law did not go through. In this respect, the legal solutions in United Kingdom and United States are different, and less categorically corseted. The UK law either through equity, a dual system of courts, and the use of trusts, or the US law through the partition of property rights in shares into management rights and

645 Italian legislators adopted a principle of free transferability of shares. §603 (a) of the NY Limited Liability Company Law and § 18-702 of the Delaware Limited Liability Company Act determine that, except as provided in the operating agreement, a membership interest is assignable in whole or in part. Nevertheless, management rights are not transferred, and their exercise by the transferee depends upon the consent of all the members of the limited liability company.
646 See Fusaro, Andrea, ‘The Numerus Clausus of Property Rights’, in Cooke, Elizabeth (ed.), Modern Studies in Property Law, vol. 1: Property 2000, Oxford - Portland and Oregon, Hart Publishing, 2001, pp. 309-317 (arguing that a convergence of common and civil law systems toward the notion of numerus clausus is apparent. Furthermore, the author claims that adopting a more flexible concept of ownership is better than creating new property rights). Also see Hansmann, Henry, and Kraakman, Reinier, ‘Property, Contract, and Verification, cit., pp. 399-400 (explaining that the numeros clausus doctrine operates in common law at the category level. It appears the same is true of civil law countries. In their words, ‘The civil law’s numeros clausus, after all, limits only the categories of property rights that can be created and not the content of specific rights within those categories’. However, they point out that this doctrine is perceived in a less formalistic way in common law where the creation of other types of property rights is not prohibited. ‘Rather, property rights that fall outside the standard categories are simply governed by highly unaccommodating verification rules that place a heavy burden on the holder of the right to provide notice to third parties’.
647 See Hansmann, Henry, and Mattei, Ugo, ‘The Functions of Trust Law: a Comparative Legal and Economic Analysis, New York University Law Review , vol. 5, 1, 1998, pp. 434-479 (explaining that ‘During the French revolution, divided property rights came to be considered characteristic of feudalism. As a consequence, it was thought that the number of restricted property rights had to be strictly controlled and limited. The numeros clausus theory was developed, stating that divided interests in property must be strictly confined to a small number of well-defined types, such as servitudes on real property, mortgages, and usufructs. Although this theory was largely the product of the folklore and ideology of the French revolution and lacked a well articulated general rationale, it enjoyed tremendous success and continues to have a strong influence on the civil law’). This is not true of the Austrian civil code, for example. It used to have provisions for feudalist tenancy that were in use until 1848.
economic rights, are more likely to accommodate new forms of transacting property rights. Furthermore, defining property rights in shares as hybrid property rights fundamentally changes the conception of contract law as requiring an object (a corporeal ‘thing’) so that the contract can be typified.\textsuperscript{648}

In Portugal, Pires de Lima and Antunes Varela have argued that the transfer of copyright and intellectual property rights raises problems similar to those involving the assignment of credits. They, however, do not go as far as making any reference to shares in their argument.\textsuperscript{649} The comparison of shares of the Spanish SRL to credits is boldly made by Perdices Huetos. He says that the requirement of consent of the company (\textit{clausula de autorizacion}) affects the capacity members have to dispose of their shares. He defines shares as a patrimonial subjective right which, by its nature, is liable to be transacted in the market. He understands, however, that restrictions such as the consent of the company change the configuration of property rights. There are two ways of doing this, in his view. It can be done either by considering that members, when they included restrictions into the company’s articles, they entered into a \textit{pactum de non cedendo} with \textit{erga omnes} effects, or they established prohibitions to transfers of property rights. Perdices Huetos, additionally, defines share as a contractual position. For him, transfers of shares are transfers of contractual positions. The fact that this contractual position (in the company) represented by the share encapsulates rights and duties in the company turns it into a subjective right which can be transacted. This is how he reconciles the two definitions of share. Hence, the consent of the company, as it is construed by this author, is a technical expression of the consent of the party to the company’s articles of association that are to be assigned. This consent is external to the sales contract, but it hinders the transfer. The consent complements the transferor’s right to dispose of her share.\textsuperscript{650} Perdices Huetos justifies his argument with Article 1526 of the

\textsuperscript{648} See Cassazione Civile, 26 May 2000, N.º 5957 Dir. E Prat. Soc., 2000, 23, 95 (where the Italian Court of Cassation held that shares an Italian PLLC (\textit{società a responsabilita limitata}) even though they are intangible, they have an objective economic value and can, therefore, be object of property rights).

\textsuperscript{649} See Lima, Pires de e Varela, Antunes, \textit{Código Civil Anotado}, vol. I, 4.º ed., Coimbra, Coimbra Editora, 1987, p. 603 (commenting Article 588 of the Portuguese Civil Code, which regulates the application of the rules of assignment of credits to other to other institutes), There is a similar rule in German law, which for the most part has served as an inspiration to Portuguese legal doctrine. § 413 do BGB provides that “Die Vorschriften über die Übertragung von Forderungen finden auf die Übertragung anderer Rechte entsprechende Anwendung, soweit nicht das Gesetz ein anderes vorschreibt” (“The rules of assignment of credits shall apply to other transfer of rights, unless the law provides it differently”). The same can be said of the French law, which in Articles 1689 and ff of the French Civil Code equates incorporeal rights with credit rights.

\textsuperscript{650} See Perdices Huetos, Antonio B., \textit{Cláusulas restrictivas de la transmisión de acciones y participaciones}, Madrid, Civitas, 1997, pp. 50-51 ( saying about the consent clause that ‘dicha cláusula configura el supuesto de hecho transmisivo del derecho, y por tanto, toda transmisión negocial queda afectada por el defecto de capacidad de disposición que determina en el transmitente la falta de consentimiento del beneficiario de la cláusula de autorización’) (This clause constitutes the condition of the factual transmission of the right and, therefore, the
Spanish Civil Code and Article 120(1) of the Ley de Sociedades de Capital, which compares the transfer of credit rights to the transfer of shares and other intangible rights. His doctrinal construction owes much to the influence of the Roman law tradition in Spanish contract and property laws. He also is clearly inspired by the separation principle (Trennungsprinzip), which Roman law also had (the distinction between titulus and modus), and by the abstraction principle (Abstraktionsprinzip), which is widely accepted by German legal doctrine, but did not exist in Roman law. Still, he finds that when everything else has been taken into consideration it is irrelevant to label restrictions on transfers as pacta de non cedendo or prohibitions to transfer of property rights. This is so because both techniques ‘…create a diaphragm between the right and its owner that prevents or grants to another person the faculty of disposition which otherwise would be his’.

Shares as object of hybrid property rights fit into a broad concept of thing as more than just the representation of a contractual position. I submit that the share is a legal configuration of a complex aggregate of rights (claims), which encompasses a bundle of management and economic rights involving the position their owner holds in the company according to its articles of association, and which includes a number of rights, privileges, powers, and immunities as well as their correlative duties, no-rights, liabilities, and disabilities. Unlike assets subject to ‘standard’ property rights which provide their entire sales contract is affected by the incapacity of the transferor to dispose as a result of the lack of consent of the beneficiary of the authorization clause). Moreover, this construction provided by Perdices Huetos brings to mind some forms of factoring wherein credits are not conveyed.

651 Article 1526 of the Spanish Civil Code provides that ‘La cesión de un crédito, derecho o acción no surtirá efecto contra tercero sino desde que su fecha deba tenerse por cierta en conformidad a los artículos 1218 y 1227. Si se refiriere a un inmueble, desde la fecha de su inscripción en el Registro’ (The assignment of a credit, right or claim has no effect on a third party but from the moment it is publicized according to articles 1218 and 1227. If it refers to real estate, it has an effect on third parties from the date of its registration in the Registry). Article 120(1) of the Ley de Sociedades de Capital establishes that ‘Mientras no se hayan impreso y entregado los títulos, la transmisión de acciones procederá de acuerdo con las normas sobre la cesión de créditos y demás derechos incorporales’. (‘Pending the print and delivery of the titles, the transfer of shares will proceed in accordance with the rules on the assignment of credits and other intangible rights’).

652 Savigny apparently claimed to have derived the abstraction principle from Roman law.

653 See Perdices Huetos, Antonio B, Clausulas Restrictivas de las Transmision de Acciones y Participaciones, cit., p. 41 (‘…un diafragma entre el derecho y su titular que impide o somete a otro la facultad de disposición que de otro modo le correspondería’).

654 For example, see Article 1128 of French Civil Code provides that ‘Il n'y a que les choses qui sont dans le commerce qui puissent être l'objet des conventions’. (‘Only things which may be the subject matter of legal transactions between private individuals may be the object of agreements’) (Translated by Georges Rouhette, Professor of Law, with the assistance of Dr. Anne Rouhette-Berton, Assistant Professor of English).


656 Normatively, I am treating contractual rights arising from the company’s articles as property rights, especially if harm is done to non-transferring shareholders and to the company as a result of the execution of the un-consented transfer of shares. This echoes the discussion on the enforcement of contractual rights against third parties. See Smith, Stephen A., Atiyah’s Introduction to the Law of Contract, Oxford, Oxford University Press, 2006, p. 369, explaining that ‘…an act that makes it impossible or more costly for a contracting party to perform
owners with rights to take certain actions and prevent ‘the rest of the world’ from taking actions involving those assets *(rights of exclusion)*, the share is subject to hybrid or ‘divided’ property rights due to its complex nature. Three implications derive from this statement. First, shares are object to property rights because they can be owned. Second, restrictions on their transfers deviate from a principle of *numerus clausus* in property law because they imprint a new configuration of property rights in their physiognomy and morphology. This challenges the closed catalog of forms of property rights in their physiognomy and morphology. This challenges the closed catalog of forms of property rights, which includes interests in personal property like shares. (The whole idea of hybrid property rights, which is directly linked to the molecular structure of the share, is not subject to a principle of *numerus clausus*). Third, shares are morphologically positioned between property and credit rights, and this is evidenced by the effects of the un-consented transfer and the perception legislators have on transfer of shares. Case law analyzed in Part I suggests that the Portuguese, Spanish, Italian, French, United Kingdom and United States legislatures as well

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657 See Hansmann, Henry, and Kraakman, Reinier, ‘Property, Contract, and Verification’, cit, pp. S373-S420 (defining property rights as claims on assets that can be enforceable against subsequent transferees of rights in the asset. For them, property rights run with the asset. They focus on voluntary transfers and, therefore, dissociate themselves from the ‘good against all world’ criteria. Unlike their take on property rights, this criterion focuses on tortuous interference). See Campbell, Kenneth, ‘On the General Nature of Property Rights’, vol. 3, *Kings College Law Journal*, 1992, pp. 79-97 (presenting a theory of the nature of ownership. Campbell rejects the ‘bundle theory’ to explain the concept of ownership. He advances his own understanding of the concept. Campbell presents an account of ownership which says nothing about the content of the rights in question. In his words at p. 94, ‘Provided it is a property right and that it is not dominated by any greater right of the same content, it is a right of ownership). Additionally, see Black’s Law Dictionary, 8th ed., St. Paul, MN; Thomson,West, 2004, pp. 1252-1253 (providing a definition of property. It is ‘The right to possess, use, and enjoy a determine thing (either a tract of land or a chattel); the right of ownership <the institution of private property is protected from undue governmental interference>. – Also termed *bundle of rights*).  

658 An interesting example is provided by Article 12 of the articles of association of the company Maximat Propre Service, Sarl that I analysed while creating a sample of French companies to support this study. This company ended up not being included in the final sample of 50 French companies, but I highlight the clause in the company’s articles entitled ‘Droits et obligations attachés aux parts sociales’ (Rights and Duties Attached to Shares). It said that ‘Chaque part sociale confère à son proprietaire un droit égal dans les benefices de la Société, dans la propriété de l’actif social et dans le boni de liquidation. Elle donne également droit à une voix dans tous les votes et deliberations. Les associés ne sont tenus à l’égard des tiers qu’à concurrence du montant de leur apport. Toutefois ils sont solidairement responsables, à l’égard des tiers, pendant cinq ans, de la valeur attribuée aux apports en nature lors de la constitution de la Société, lorsqu’il n’y a pas eu de commissaire aux apports ou lorsque la valeur retenue est différente de celle propose par le commissaire aux apports (…’). (‘Each share entitles its owner to equal rights in the profits and assets of the company and the liquidation. It also attributes the right to one vote in all resolutions and deliberations. Shareholders are only liable toward third parties in respect to their contributions. Nonetheless, for five years they may be jointly and severally liable toward third parties for the value assigned to in-kind contributions upon the incorporation of the company provided that there was not an auditor or the value assigned to the shares is different from the one proposed by the auditor (…’). This is an example that shows how rights, benefits and liabilities can comprise the structure of a share.
as courts perceive rules about transfer of shares – legal and conventional defaults - as some sort of property rules. In other words, not only property rights in shares cannot be sold without the shareholder abide by the restrictions established in the contract, but also, in principle, propriety rights of the shareholder in the share cannot be taken without his or her consent. In relation to the case-law, actions are mostly taken by the company, managers and other members to invalidate the transfer or to prevent it. On the other hand, the transferor takes actions to be able to transfer. Damages and other sort of compensations may be asked for, but they are not the essence of the disputes. Shareholders’ entitlements are not, therefore, especially protected by liability rules or inalienability rules. I do not think that the legal perception of transfer of shares adopted by legislators and courts in the selected jurisdictions makes shares inalienable, as it would if parties to the company’s contract had entered into a pactum de non cedendo by including a clause prohibiting the transfer tout court. The transfer of property rights in shares is restricted by contractual limitations included in the contract of the company, i.e., a pactum de non alienando. As a result of this contractual limitation, transferees are likely to acquire empty property rights because they are not entitled to exercise the rights the transferor can exercise in the company vis-a-vis the company itself, other members and other corporate constituencies.

The effects of property rules adopted by legislators to protect the entitlements of shareholders in the company combined with the hybridity of rights shareholders hold in the share (which stands for their own position and no one else’s in that company), the consensual principle reigning in Portugal, France, and Italy, the rules of equity applicable to un-consented transfer in the United Kingdom, and the not-so-clear-cut definition of property rights in units of American LLCs and Spanish SrLs, demonstrate the complexity of the system of property rights and transfer of ownership in PLLCs. Besides, all the above-mentioned suggests that further research is needed to understand whether property rules are the best form to protect shareholders’ rights and how they can do so in the most efficient way.

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659 I refer to ‘some sort of property rules’ in the text because entitlements allocated in the PLLC may be protected by property rules and by reverse property rules when pre-emption rights are given to non-transferring shareholders and the company. This would correspond to the mysterious rule 4 discussed by Calabresi and Melamed. Furthermore, this does not prevent property rules be combined with liability rules. I treat this in Part II, Chapter 4. Also see Calabresi, Guido and Melamed, Douglas A., ‘Property Rules, Liability Rules, and Inalienability: One View of the Cathedral’, vol. 85, No. 6, 1972, pp. 1089-1128 (1093) (presenting their entitlements model).


661 See Chapter 4.
certain corporate constituencies (not necessarily the shareholders) for the transfer. In addition, the idea of introducing qualifying elements to these rules which are able to mitigate the problems arising from the un-consented transfer should be contemplated. These elements could be the introduction of a time limit for the validity of restrictions on transfers introduced in the company’s articles. After that time limit, the decision to maintain those restrictions should be revisited by the shareholders. The merits of dissolution at will to overcome problems of combining action, asymmetries of information and a prevailing status quo in the company can be explored. I view this as a possible way of tipping balance in companies: indeed, as a way to champion a new kind of collectivity. A third possibility with somewhat broader policy implications is to investigate the benefits of promoting jurisdictional competition for the creation of a law market based on the offer and demand of new and better rules. These rules should be capable of protecting shareholders’ property rights and of nudging shareholders and potential investors to invest in the company.

Finally, the conceptualization of property rights I present here hints at the possibility of an alternative system of transfer of property rights in shares. For instance, the execution of such transfer by an abstract act can be sketched, following the consecration of a principle of separation of contracts in jurisdictions where the consensual principle prevails. Consent of the company would be as necessary for the effectiveness of the transfer as the performance with reference to (physical) delivery is in Spanish, Austrian, German, UK and US laws. The comparative bottom line is the following. In consensualism countries (e.g., France) third parties can claim the lack of consent voids the contract as a whole, whilst in separation countries (e.g., Germany and Austria) the lack of consent would only void the transfer.

662 Liability rules allowing the transfer against compensation, or even inalienability rules may be also perceived as better choices on this regard. It will all depend on the policy choices made by legislators. I explore this in chapter 4.
663 Easterbrook, Frank H. and Fischel, Daniel R., ‘Close Corporations and Agency Costs, Stanford Law Review, vol. 38, N.º 2, 1986, pp. 271-301 (288-289) (saying that ‘some commentators, sympathetic to the potential plight of minority shareholders, have advocated relaxing the standards for involuntary dissolution and allowing a minority shareholder to obtain dissolution whenever his “reasonable expectations” have been frustrated’. They, however, argue that this assumption as well as the creation of an automatic buy-out defended by some was inaccurate. For them there are other alternatives such as suits for the breach of fiduciary duties, the appointment of a custodian or provisional director, and in case the latter remedies did not work, there was still the possibility of bargaining for more protection).
664 See Mauss, Marcel, The Gift: The Form and Reason for Exchange in Archaic Societies, London and New York, Routledge, 2002 (arguing that there are no gifts. Gifts create a social bond that forces the receiver to reciprocate). By referring to a new kind of collectivity, I am thinking of a social environment in the company where corporate constituencies feel compelled to reciprocate.
666 See Reichert and Weller in MüKo GmbHG § 15 Rz 362.
Defining the best solution will depend on which one causes a Pareto improvement. In other words, it will depend on the solution that constitutes the best response to any feasible contractual choices. In fact, the comparative analysis of the relevant legal provisions in all six jurisdictions shows that the consensual principle is more residual than often pictured. There still is space for new configurations of classic institutions of civil law in light of corporate law. This is how tamed the fox can be.

4. Conclusions

After an in-depth analysis of the case law selected in Part I, I could sense the existence of problems of interpretation of the articles of association, of combining action, asymmetries of information, strategic behavior and, generally speaking, bargaining failures in PLLCs. This is another situation that can be aligned with others stressed in the literature in which the mere assumption of zero transaction costs of the recurrently labeled Coase Theorem does not apply. This premise, or ‘parable’ as some have called it, holds that if there are no transaction costs, parties are able to bargain in order to satisfactorily accommodate their interests. In these circumstances, legal entitlements end up being, in fact, irrelevant to the achievement of efficient solutions. Reality, however, has been recounting a different story. There are transaction costs that impede Coasean bargaining. Because of these transaction costs, parties are unable to reach efficiency-improving solutions that help them maximize their benefits with the least costs. My case shows that shareholders’ property rights in these companies are often weak in the sense that they are frequently put in doubt as a result of the transfer system. Moreover, it is apparent that there is an imbalance between the allocation of property rights in shares and the way that they are protected. Several cases show that restrictions on transfer of shares were not conceived to be part of the share sale and purchase.

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667 I reckon this statement is somewhat tautological because there would be no bargaining failures if there was no case law. I am trying to stress, however, that this phenomenon is rather curious considering the freedom parties enjoy to get the best contractual outcome for themselves.


670 See Nicita, Antonio and Rizzolli, Matteo, ‘Hold-up and externality: The firm as a nexus of incomplete rights?’, International Review of Economics, vol. 59, 2012, pp. 157-174 (noting that the reference to incomplete property rights is missing in the Coasean theorem. In their words, when costs of defining ex-ante a system of complete property rights are prohibitive, then externalities do emerge as reciprocal claims over rival uses. When property rights are well defined, but ex-post transaction costs over the exchange of those rights are prohibitive, then the externality is depicted as the social waste of having a sub-optimal Paretian allocation. In this respect, they say, the notion of externality would coincide with that of an inefficient market configuration).
agreement. However, the un-consented transfer determines that rights that are assigned, if
the sales contract is not invalid, are empty property rights. (They will continue to be empty as
long as consent *stricto sensu* is not obtained or the transferee does not hold priority rights
against the members of the company, in whose benefit the requirement to obtain consent *lato*
and *stricto sensu* was established).

Given the above, I submit that, in general, restrictions on transfers, when introduced in
the articles of association, assume the nature of contractual limitations on the transfer of
property rights (*pacta de non alienando*). This type of agreement does not have an *erga omnes*
effect as commentators attribute it to a *pactum de non cedendo*. A different understanding
has been conveyed in respect to the restrictions on transfer of shares of the Spanish Srl.
Commentators have described the clause providing for such restriction as a *pactum de non
cedendo*. The transferability of shares is one of the most important features of the company.
Thus, I do not construe transfer restrictions as total bans or prohibitions on transfer of
property rights in shares. Sometimes, however, articles of association are drafted to include
‘prohibitions’ on transfers. Even when they are not drafted in that manner, the terms in
which the transfer clause is supposed to operate renders any attempt to transfer shares
extremely cumbersome and almost equivalent to a prohibition. Still, by including a transfer
clause in the company’s articles providing restrictions on transfers, shareholders agree not to
transfer their property rights in the shares. This agreement, however, is frequently ineffective
not only because it does not deter shareholders from selling, but also because it does not
prevent property rights or beneficial interests in the share from being transferred to a third

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671 This will obviously depend on the purpose legislators and shareholders wanted to accomplish when they
established those restrictions. It will also depend on the structure of the articles of association and any other side
agreements shareholders might have entered into.

vol. 64, 1989, pp 171-199 (referring to the pactum de non alienando as a ‘contractual prohibition of sale and
cencumbrance’, or a ‘contractual prohibition of alienation’. I think this is the case because he compares pactum
de non cedendo to a pactum de non alienando. Furthermore, he considers that both types of agreements may be
read in light of Article 364 of the General Civil Code of Austria. This provision establishes a contractual or
testamentary prohibition to sell or encumber a thing or a real right. The idea I offered in the text about the *erga
omnes* effects of the *pactum de non cedendo* makes sense in Austria given that there is this understanding that
property law is supposed to provide some type of signaling for third parties. Furthermore, following the
Zessionsrechtsänderungs-Gesetz of 2005, in Austria a *pactum de non cedendo* only has relative effects.

673 Hansmann, Henry and Kraakman, Reinier, ‘What is Corporate Law?’ in Kraakman et al., *The Anatomy of
and in particular pp. 10-11 (considering transferable shares together with legal personality, limited liability,
delegate management under a broad structure, and investor ownership basic legal characteristics of the business
corporation).

674 For instance, see *Holt and Others v Inland Revenue Commissioners*, [1953] 2 All ER 1499, [1953] 1 WLR
1488, [1953] 2 Lloyd's Rep 506, 32 ATC 402, [1953] TR 373, 46 R&IT 801 (the court referring to the
restrictions established by the articles of the company explained that according to those articles unfettered
transfer to non-members was prohibited as long as a member or a person approved by the directors was willing
to purchase the shares at the fair value to be certified).
party.\textsuperscript{675} If and when this happens, the share is not transferred in full. In the United States, the transferee is assigned economic rights that are basically the right to receive dividends and the liquidation value. In the United Kingdom, the transferee is entitled to beneficial ownership. In the other selected jurisdictions shares are not designed to have a dual structure. However, freedom of contract allows parties to draft contracts by which the transferee may be granted the economic rights that the transferor is entitled to because she still is a member of the company. The contract associating the purchaser with the company’s shares (\textit{convention de croupier} or \textit{Unterbeteiligung}) is a case in point.\textsuperscript{676}

The complex nature of the share and the hybridity of the property rights in it call for a reformulation of the consensual principle. More, on one hand, the taming process of property rights through restrictions on transfers puts at stake the classical understanding of principles of property law such as the principle of \textit{numerus clausus} because elements of contract law, corporate law, and civil law in general are connected in surprising ways. On the other hand, it also calls for new theoretical constructions which, all things considered, are likely to break with any manifestations of doctrinal path-dependence in respect to the potential (re)configuration of property rights and their function. Given the configuration of property rights in shares presented herein, chapter 3 below attempts to unveil the functionality of members’ property rights in their shares within the governance structure of the company.

\textsuperscript{675} See Davies, Paul L., cit., pp. 945-946 (arguing that ‘Notwithstanding that the transfer is not lodged for registration or registration is refused, the beneficial interest in the shares will, it seems, pass from the seller to the buyer (...). The seller then becomes a trustee for the buyer and must account to him for any dividends he receives and vote in accordance with his instructions (or appoint him as his proxy’).

CHAPTER III
THE EFFECTS OF THE REQUIREMENT OF THE COMPANY’S CONSENT: PIERCING THE OWNERSHIP VEIL

‘The wisest of you men is he who has realized, like Socrates, that in respect of wisdom he is really worthless’.


‘Often managers must act now and learn later; delay for more study may be the worst decision; the market will decide whether the decision was good’.


Introduction

In this chapter, we arrive at a fundamental question: Given the nature of property rights of members described in Chapter 2, who actually controls the company? Ultimately, this will help clarify how the taming process developed by the legislator by providing restrictions on transfers affects the physiology and morphology of the governance structure (decision-making) of PLLCs in the selected jurisdictions (can managers or directors in these business organizations afford to think they do not know it better or cannot do it better?). I define the effective powers shareholders have in the company as a result of their ownership rights, as opposed to the powers held by managers and directors as a result of their management duties. It is often the case that shareholders have residual control of the company, whilst managers have actual control of it.\textsuperscript{677} Thus, in reality, the scope of the rights held by shareholders is more limited. They are even more limited, perhaps, than what articles of association foresee.

\textsuperscript{677} For an illustration, see the United Kingdom case in Part 1, Chapter 3.
It is in this context that I refer to the 'piercing of the ownership veil'. I use this expression to stress that in my view, some circumstances demand that courts ignore restrictions. The expression is also used here to suggest court intervention to clarify ownership of property rights in the shares. Here, I shall attempt to show under what circumstances this should be done. The idea that there may be situations in which the ownership veil must be pierced rests on the principle ‘substance over form’, which maintains that the economic substance of transactions rather than just their legal form be disclosed.

Managers add value to the company. They are independent in the way they operate, in spite of the fact that in PLLCs shareholders typically can give legally binding instructions to managers. But at the end of the day, these managers are also employees. They must take a common-sense approach to their work, including the meeting of shareholders' demands. For instance, in order to make the business more attractive, they must ensure that information flows quickly. Innovation and the pursuit of new technology must be foremost in the managers’ mind, and this is true whether the business is small or big. Shareholders want the company to grow. Essentially, managers should have the will to take responsibility, the ability to take initiative, and the capacity to add value to the company. The company is an ecosystem wherein path-dependent legal solutions, as illustrated by the metaphor of the fox, lead to a fuzzy definition of property rights. Piercing the ownership veil entails investigating the reality of the company’s governance and tracing the real ownership profile of the company. It means asking: who controls the company (i.e., managers or shareholders?) and how 'tamed' are shareholders’ property rights according to the consensual agreements into which members and other stakeholders have entered?

Toward this goal, I examine the extent to which freedom of contract is likely to enhance the power held by managers or directors in the PLLCs, and how this can be reconciled with  

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678 See Fama, Eugene F., and Jensen, Michael C., ‘Separation of Ownership and Control’, Journal of Law and Economics, vol. 26, 2, Corporations and Private Property: A Conference Sponsored by the Hoover Institution, 1983, pp. 301-325 (304-305) (noting that that ‘The interesting problem is to determine when separation of decision management, decision control, and residual risk bearing is more efficient than combining these three functions in the same agents’). My understanding is that in most PLLCs, the separation of ownership and control is blurred. Hence, considering that members hold property rights in shares, I try to understand the scope of these rights, and if members in general are in a position to control de facto the company.

679 See for example Alchian, Armen A. and Demsetz, ‘Production, Information Costs, and Economic Organization’, American Economic Review, vol. 62, 5, pp. 772-795 (referring within the team production theory to the figure of the monitor of the members of the team. The monitor is a specialist with enough knowledge and motivation to reduce shirking in a team). American corporate history, however, is littered with managers who play on both sides of the deal).

680 See Gelter, Martin, ‘Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debates in a Comparative Light’, NYU Journal of Law & Business, vol. 7, 2, 2011, pp. 641-730 (providing a comparative historic account of the debate about the role of managers in running publicly held companies and whether they should be run exclusively in the interests of shareholders or whether the interests of other stakeholders should also be taken into account).
the ownership or property rights of the shareholders. Interestingly, we shall see that freedom of contract is used in different ways. For instance, corporate law is much more prescriptive in the United States than in the United Kingdom. Comparison can also be made with other countries. For example, in the United Kingdom it seems that freedom of contract has been used to enhance the power of directors. In Italy, where the principle of free transferability of shares prevails, this has not happened to the same extent. Members who are often managers hold the major stake in the company. Below, I look at how the taming process established by legislators affects the governance structure of the PLLC.

The structure of this chapter is the following. Section 1 analyses the relationship between concentration of ownership and control, which is different in the PLLC and the publicly held company. In the PLLC, there is a high concentration of ownership and often no separation of ownership and control, at least to the extent there is in the publicly held company. The implication of this is the emergence of clashes of interests not only between managers and shareholders, but also between shareholders themselves. Section 2 explores the definition of fiduciary duties in the selected jurisdictions, in particular the duties of loyalty and care, and the different ways they are materialized. This section also dwells on the concept of business judgment rule (BJR) and links it to the piercing of the ownership veil, and the process of decision-making in the company. Additionally, it suggests the application of the BJR to civil law countries, considering that this is a mechanism rooted in US law. The idea is that whenever the advantages of the business judgment are hindered by the actual exercise of control and its manipulation, courts should be able to pierce the ownership veil, and read beyond the contractual terms. Finally, this section typifies the situations in which the


682 This affirmation is backed up by the analysis in Part I, chapter 3 of the sample of articles and memoranda of association collected for this dissertation. The design of their clauses is telling. Furthermore, this idea seems to be shared by Naomi Lamoreaux, whose research interests include the study of contractual freedom in Europe and the United States in the late nineteenth and twentieth centuries. Her research, however, is mostly based on quantitative methodology.
ownership veil could be pierced. Section 3 concludes by pointing in the direction of a general theory of fiduciary duties in Europe that does not neglect hybrid property rights.

1. Hybrid property rights and piercing of the ownership veil

An article of the Wall Street Journal dated as of 1917 (a time when there were no LLCs in the United States yet) noted that

Theoretically, and even in practice, if directors direct and stockholders exercise their voting privilege, the limited liability corporation is almost an ideal democracy. It is clear that if the stockholder does not receive fair play from the management, he has largely himself to thank. He is protected, if in no other way, by the courts and the channels of publicity.  

American corporate law has come a long way since 1917. It is filled with cases in which directors play on both sides of the deal as a result of the effective control they have over the company. Therefore, today, in light of recent developments in corporate law not only in the United States, but also in Europe, the above-noted statement may sound somehow unwarranted. The case of the United Kingdom treated in Part I suggests strong control of directors over the company even though Bureau van Dijk Database (BvD) indicators show a high dependence level of companies on their shareholders. This is in line with the approach taken by that database. When referring to the category of employees, managers and directors it could have considered them as part of a collectively designated category, unable to jointly exert a power of control (like the category ‘public’ in the publicly held companies). Alternatively, it could have considered them as syndicated and jointly exerting their voting power. The BvD database follows the second alternative. Most importantly, this means that these three categories can be viewed as the ‘ultimate owners’ of a given company. In a

685 The basic information contained in this database is processed and analyzed in order to, among other things, qualify companies pursuant to their degree of independence with regard to their shareholders; list the shareholders of a given company with their percentage of ownership; indicate, if any, the ‘Global Ultimate Owner’ and the ‘Domestic Ultimate Owner’ of a given company; and provide the evolution of the ownership of the shareholders in a company. I use this database because it is more concerned with tracking control relationships than with patrimonial relationships.
686 Other categories of shareholders are disregarded for the purpose of establishing the BvD Independence Indicator. These categories are: (i) the ‘public’ that is used for ‘public quoted companies’; (ii) ‘unnamed private shareholders’, aggregated (more than one unnamed individual or family labeled such as ‘Private Shareholders’;
similar fashion, when I refer to control, I mean control over the decision-making process of the company.  

In many instances, the case law in Part I showcases the influence and control that managers wield in the PLLC. They decide whether or not to register the transfer, whether to consent to it or not, and the terms in which the process to calculate the fair value of the share must be undertaken. In most cases, it is up to them to determine the fair value of the share or hire an accountant to do so within a certain period. Indeed, often directors engage into dilatory schemes that hurt the intentions of the transferor to dispose of her shares. In this scenario, shareholders’ property rights are weak. They are not in control, but directors are. Thus, I deal with the relationship between shareholders’ influence, which translates into the degree to which the company is dependent on them, and managerial control. The level of independence of the company vis-à-vis shareholders’ influence is indicated by the number of shareholders in a company and, most importantly, by the type of ownership they have. The ownership structure in LLC is naturally concentrated in few(er) members. Here, however, its analysis has as a backdrop the structure of the board of directors or management board, since they as well as employees are liable to be the ‘ultimate owners’ of the company. The case of

*Individual Investors*, ‘Other Individuals’, etc; (iii) other ‘unnamed shareholders’, aggregated (more than one unnamed shareholder containing a mixture of companies or of companies and individuals and families).

687 See Berle, Adolf A. and Means, Gardiner C., *The Modern Corporation and Private Property*, revised ed., New York, 1967, pp. 66-116 and 207-218. Also see Stigler, George J., and Friedland, Claire, ‘The Literature of Economics: The Case of Berle and Means, *Journal of Law and Economics*, vol. 26, 2 (Corporations and Private Property: A Conference Sponsored by the Hoover Institution), 1983, pp. 237-268 (following Berle and Means who defined control of a corporation as the power to select a majority of the board of directors, suggest a test of de facto control. Their explanation runs as follows: ‘if the membership of the board of directors changes substantially, normal retirement aside, but the senior officer remains in office, again normal retirement aside, then the management is in control. With the reverse pattern, the stock ownership is in control.’ They stress that this test, which they have not made, is most likely applicable in times of serious crisis).

688 This happens mostly in the United Kingdom, but I have registered this in respect to the PLLCs of other selected jurisdictions such as France regarding the *gerants*. It depends on the applicable clauses of the articles of association. It is important to note that in Portugal, France, Italy and Spain there are several issues that are decided by shareholders in the general meeting of the company. By default, the articles of association may provide otherwise. In US LLC agreements, there are clauses that foresee that some management decisions are taken by the majority members. Some LLC agreements also foresee that managers shall not take actions such as sell, finance, convey, assign, transfer or otherwise dispose of or refinance all or a substantial portion of the assets of the company; enter into any merger or consolidation of the company with or into any other business entity; change the name of the company, or the location of its principal office; admit a new member; incur any leases conveyance, mortgage or other indebtedness not included in the company’s budget, etc.

689 See Gay Jenson Farms Co. v Cargill, Inc. 309 N.W 2d 285 (Minn 1981). (This is a case of application of the law of agency. It raises very important questions as to who exercises de facto control over the company. Furthermore, the court discusses if a creditor who assumes control of its debtor’s business becomes liable as a principal for the acts of the debtor in connection with the business. This case brings to mind other questions: For instance, can creditors become the owners of the business without the accompanying legal indicia? This is relevant for the purpose of this dissertation because the inference in the company’s business of banks and firms who provided loans to it may explain why restrictions on transfers and restrictions on changes of ownership structure are imposed. Also see Martin v Peyton 246 N.Y. 213; 158 N.E. 77; 1927 N.Y. LEXIS 863; and Minute Maid Corp v United Foods, Inc. 291 F.2d 577; 1961 U.S. App. LEXIS 4364.
the United Kingdom, as I refer to it above, is interesting because I realized that, although the sampled companies are highly dependent upon their shareholders (which could indicate strong shareholder influence, especially in private companies), in practice, control is exercised by directors. This is different from what formally happens in Portugal, Italy, Spain, and France where shareholders in the PLLC still have a considerable influence in the company. In the case of the United States, due to the business object of the companies in the sample, some of which are equity funds, directors are granted a great deal of control. Maybe ownership rights are stronger in the United Kingdom and the United States than in the other jurisdictions, and shareholders feel at ease to delegate managerial tasks. Or perhaps ownership is less concentrated in UK and US companies, which would naturally result in a lower level of shareholder influence and which would then determine that the effective control of the company was in the hands of directors. I explore this keeping in mind, as follows from Chapters 1 and 2, that members have statutory control rights which derive from their ownership of property rights in shares. In most situations, members delegate their control to managers. However, as Ribstein puts it when referring to the indirect effects of restrictions on the company’s ownership structure

 restricted transferability effectively limits the passivity of even the most remote owners. As long as transferability is restricted either legally by share transfer restrictions or practically by the lack of an efficient market for the firm’s shares, the members cannot respond to problems in the firm simply by selling their shares. Accordingly, the members have incentives to gather information and to take an active role in management. This reduces the need for mandatory disclosure rules that ensure centralized disclosure by the firm.

Ribstein’s words are in line with Alchian’s overall understanding that wealth concentration determines greater bargaining power and control. It is surprising,

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690 This hints that private companies in the United Kingdom have a different purpose than private companies in the other selected countries of Continental Europe.
691 See Ribstein, Larry E., ‘Form and Substance in the Definition of a “Security”: The Case of Limited Liability Companies’, Washington and Lee Law Review, vol. 51, 3, 1994, pp. 807-841 (830) (claiming that ‘Applying a clear rule is desirable because establishing clear property rights allows people to make contracts based on the known rule’). Also see Holderness, Clifford G., ‘Legal Foundation for Exchange’, The Journal of Legal Studies, vol. 14, No.º 2, 1985, pp. 321-344 (326) (dwelling on how certain assignments of rights provide a foundation for exchange while others frustrate it. In his opinion ‘The larger is the closed class assigned rights, the greater will transaction costs of arranging an exchange be because a prospective buyer must negotiate with each individual who has been assigned rights’).
nevertheless, how this may not be true of the PLLC. Data suggest that restrictions tend not to empower shareholders in several circumstances. They tend to empower directors. In other words, freedom of contract tends to enhance the directors’ control over the company. Therefore, inherent to the idea of piercing the ownership veil is the understanding that property rights in shares are hybrid and tamed. 693 This means that not only their structure is adapted to the purpose of the PLLC, but also that their definition may be indefinite, given the combination of corporate, contract and civil law elements. Piercing the veil over property rights serves to sharpen their definition, and sets the foundation for efficient bargaining.

i. Why is the Berle-Means corporation not true of the PLLC?

Berle and Means introduced in 1932 their idea of separation of ownership and control. This notion remains the paradigm of US corporations today. 694 (Their findings are now considered almost intuitive. But this shows how pathbreaking ideas are often simple). There are, however, circumstances which are not favorable to the development of a Berle-Means corporation, that is, there are situations in which control of the company is used to choke minority members or those who can only exert weak property rights. The circumstances include (i) the opportunistic conduct of shareholders and managers; (ii) high transaction costs to transfer a share in a PLLC; (iii) and the inexistence of a market for the shares. It is true that members can strive to create a private market by including mechanisms such as buy-sell agreements to that end in the articles of association, 695 but this does not fundamentally change the lack of liquidity of these companies’ shares. Other circumstances are the weak enforcement of law, which renders cumbersome the task of creating sophisticated legal systems. Pre-emption rights, rights of first refusal and clauses establishing the terms in which the value of the share should be calculated are meant to protect minority shareholders from oppression when they want to call themselves. If rules are not enforceable, their purpose is empty. Additionally, managerial self-dealing, agency problems, asymmetries of information,

693 Refer to Chapters 1 and 2 above.
694 See Berle, Adolf A. and Means, Gardiner C, The Modern Corporation and Private Property; and Fama, Eugene F., and Jensen, Michael C., ‘Separation of Ownership and Control’, Journal of Law and Economics, vol. 26, 2, Corporations and Private Property: A Conference Sponsored by the Hoover Institution, 1983, pp. 301-325 (323) (defining separation of ownership and control as ‘…the separation of residual risk bearing from decision management.’. They say this equates with the notion of separation of ownership and control that has long bothered students of ‘open corporations’).
and lack of mandatory rules for disclosure are all likely to challenge the paradigm of separation of ownership and control. This paradigm is definitely challenged in the PLLC.  

Another element to take into consideration is the correlation between ownership concentration and control. In this context, it is also important to differentiate member-managed companies, in which all shareholders are managers, from manager-managed companies, in which only designated members or non-members or a combination of the two are managers. There were some Portuguese companies as of the beginning of the twentieth century that, despite being private, had a large number of shareholders (over twenty). The management controlled the transfer of shares and any changes in the structure of ownership of the company. These companies were more similar to joint stock companies than to partnerships. In most companies, however, ownership was concentrated in fewer shareholders and it was up to the company and its shareholders in the company’s general meeting to decide about giving the consent or not to transfer of shares and consequent alterations in the ownership structure.

In the United Kingdom, in respect to the companies in the sample for which data are available, ownership is concentrated in a small number of shareholders. Directors, however, decide if and how the ownership structure can be altered. The management of the company is centralized and composed of directors who are individuals and generally do not hold any kind of membership interests in the company. This is outstanding, since PLLCs are normally associated with control exerted by shareholders over the company, namely by taking part of its management. UK companies also have a notable dimension. They are distinctive in the number of employees and level of internationalization. They easily surpass Portuguese, Italian, Spanish, French and most of the US companies in the samples. UK private companies are very large businesses and benefit from all the flexibility provided by the law that was historically granted to small private companies.

On average, ownership in the Italian companies of the sample is concentrated on two shareholders, who also can be managers. It is often the case that there is a sole director, who may or may not be a member of the company. In several fifty-fifty companies, members outsource the management to an outsider. Some articles of association foresee a collegio sindicale which main purpose is to supervise and control the administration (consiglio di amministrazione). In some situations it is up to the sole director, who is also a shareholder (normally the majority shareholder), to convene the general meetings. The company, in these

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696 One can fairly ask: when is there even a separation of roles in the PLLC? Often the managers and shareholders are the same people.
circumstances, is more likely to be in the hands of this shareholder-director. Additionally, there are cases in which sole directors are appointed for a long period of time. Their mandate can go up to a decade, more than a decade or even indefinitely.

Spanish companies in my sample are frequently manager-managed, but managers may or may not be members of the company. The company is not only managed by the managers, but also by the shareholders gathered at the company’s general meeting. Often, the management is composed of a sole manager who, with few exceptions, also is the majority shareholder. Shareholders, however, are entitled to terminate directors’ mandates through resolutions taken at the general meeting. Directors are paid an amount of money from the profits of the company. They also receive additional benefits. So, presumably they are interested parties in the profitability of the company. Some clauses provide that managers must not develop the same business as the company. There are several cases where articles have been altered to extend the mandate of the managers for an unlimited period of time. This is recurrent in the sample, especially when the management turns out to be composed of a sole manager. The sole manager may be in charge of distributing dividends. Some management boards also include the figure of the CEO (consejero delegado) to whom managers delegate some of their tasks. In a company whose members were spouses it was possible to learn that the articles of association were changed to include the wives in the management board. There was one case in which the manager was simultaneously the president of the general meetings. Still, in these situations, shareholders are liable to hold power in the company. For example, by exercising their voting rights or including clauses in the company’s articles forbidding any agreements from being entered into without the consent of the general meeting.

In France, SARLs may be member-managed or alternatively manager-managed. Management is undertaken by one or more individuals, who may or may not be shareholders. Generally, managers (gérants) are appointed by shareholders in the articles of association or by collective decision at the general meeting of shareholders. Their mandate may be for a limited or unlimited period of time. Frequently, the manager is the majority shareholder. In the internal relations with shareholders, managers must act in compliance with duties of care, diligence and, sometimes, are expected to devote their entire time to the companies’ affairs. The payment of a salary, in these situations, is not always certain. Shareholders decide on whether or not to pay a salary. These duties can be expressly foreseen in the company’s articles. In the external relations with third parties, managers enjoy full powers to represent and act on behalf of the company, without the need to justify special powers. Their mandate can be revoked by the shareholders through a collective decision at the general meeting. In the
internal relations with shareholders, managers may undertake all management actions in the interest of the company. The line separating internal and external relations of the managers is very thin, especially when managers also are shareholders.

The operating agreements of the American LLC often provide definitions of 'member'. A member may be defined as any person holding units and who has been admitted to the company as a member with the approval of the manager and the management. It may also be provided that, except as otherwise expressly established in the agreement, ‘…no member acting alone shall have any authority to act for, undertake or assume any obligations or responsibility on behalf of any other member of the company’. In general, the business, affairs and management of the company is vested in the board of directors (board of managers, board of representatives, etc.), but it can also be the responsibility of a managing member. In some circumstances, the board may delegate its authority to the officers or to others to act on behalf of the company. Except as set forth in the respective agreement, it may be provided that managers serving on the board have the sole and exclusive power to do any and all acts necessary or convenient to or for the furtherance of the purposes of the agreement. Additionally, some clauses clothe members with the power to appoint one or more individuals to act on their behalf at the meetings of the board of managers. In these circumstances, the constitution of quorum in the board of managers heavily depends on its composition. In some agreements, it is possible to learn how the managing tasks are shared between members and managers. In these circumstances, there exist cases in which members retain all authority and control over the assets of the company but delegate certain authority to the board of managers or, eventually to a board of trustees. Notwithstanding any other provision of the relevant agreement, the members (in particular if it is a sole member) may retain the power to unilaterally take any and all actions required to, among other things, effectuate the capitalization, merger, acquisition, consolidation, liquidation, or dissolution of the company or any amendment, change, modification, and admit new members to the company on such terms as may be established by the members. When this happens, it is common practice to amend any schedules to the LLC agreement to reflect the name, address and capital contributions (if any) of the additional member and changes in membership percentage of the members in connection with the admission of the additional member. The terms in which equity funds should work are, additionally, related to the figure of the sponsor or financial sponsor (which can be a corporation or a partnership), its relationship with members and the negotiations between them as to the management and operation of the company and determination of its policies. From an economic perspective, this provides members with
managing and control powers over the return of their investment. In some cases, managing and operating powers are vested exclusively in the sponsor, who may act in its absolute discretion, unless otherwise expressly provided in the agreement. Strategically, sponsors are more concerned about developing the business and preparing it for a sale or initial public offering (IPO). The fact that some of these LLCs work as exit vehicles explains the corporation features most of them display in the sample. The screening of these LLC agreements suggests concentrated ownership, monitoring by members alongside strong management.

Most of the companies in the samples for each selected jurisdiction have concentrated ownership, show no diversification of membership and a low level of separation of ownership and control (it is certainly lower than in publicly held companies), except in the cases of the United Kingdom and the United States where privately held companies are as nearly as likely as publicly held companies to have a similar governance structure; that is, they are likely to be manager- or director-managed. This is why the Berle-Means corporation model is unlikely to be true of the average PLLC.

ii. The implications of the Berle-Means corporation not being true of the PLLC

Most PLLCs in the samples are manager-managed, but there also are cases in which companies are member-managed. Reportedly, there are clashes of interests in both cases. In a scenario of un-consented transfer of shares, there are clashes of interests between majority and minority shareholders and between shareholders and management, in particular when the transferor must seek the consent of the managing board / board of directors.

In most cases, the relevant clauses of the articles of association allow members to be managers, and, in fact, they are. When that is so, members prefer to assign the managing tasks

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697 This is intuitive. Since the shares in these companies are not typically publicly traded there could not be anything but concentrated ownership.

698 See Sheen, Albert, ‘Do Public and Private Firms Behave Differently? An Examination of Investment in the Chemical Industry’, Job Market Paper, January 9th, 2009, pp. 1-35 (18) (claiming that private equity-run firms tend to invest more efficiently than public companies. He argues that ‘Because of Private Equity’s explicit focus on aligning incentives, private firms that are the product of leveraged buyouts may thus be different from private firms which have simply never gone public’).

699 That I do not discuss whether there is more of a clash between majority and minority shareholders, or between shareholders and management has to do with the fact that in most cases shareholders are also managers. The case law collected does not show a trend. Perhaps, this trend can be more easily seen in the UK companies where directors have a very strong role. See, for example, Re Inverdeck Ltd [1998] 2 BCLC 242, [1998] BCC 256. The interesting point in this case is that, despite the dispute revolving around the refusal of registration, the court pointed out the need for the director, who was also a member, to clarify his roles in the conflict.
to one or more activist members, who generally are the majority shareholders. Additionally, even when the company is managed by all members, there are situations in which minority shareholders are not able to come out and take their share of control over the company. This phenomenon is not new. It has been thoroughly explored by the literature on separation of ownership and control (in the context of the Berle-Means corporation), agency costs and fiduciary duties. ⁷⁰⁰ The intriguing aspect of this is that normally these situations are associated with dispersed ownership in large public corporations. However, the prevalence of the relational element, the lack of a market for the shares (which dissipates the fears of IPOs and does not push the managers to run the extra mile for the company, for the members, or for any other residual claimant), ⁷⁰¹ and the lower levels of separation of ownership and control make the internal governance of LLCs appear elective.

For example, the fact that members in American LLCs are allowed to waive fiduciary duties toward each other, which they do by including the respective clause in the LLC agreement, strengthens the individualist aspects of the LLC, which do not favor weaker members. However, manager-managed companies are susceptible to agency problems


especially if managers hold no membership interests. Further, if the company is manager-managed, the position of the manager may become encrusted due to her long mandate. Here we see not only agency-related problems but also those related to abusive behavior on the part of the management, which ultimately leads to the expropriation of the members’ membership interests. Moreover, samples of case law in the selected jurisdictions disclosed shareholders’ opportunistic behavior; bargaining failures; difficulties in combining action among shareholders, and among shareholders and other non-shareholder constituencies such as creditors; shareholders holding-up others; and, finally, situations of deadlock for which articles of association do not provide efficient responses. These problems are accentuated by majority rules, the power of controlling or activist shareholders, and the benefit of hindsight of the knowledgeable manager acting in an opportunistic way. Such bargaining failures create disincentives for members to engage in the management of the company. Members expect managers do their job without much supervision. Thus, they grant the managers autonomy, but in the process become dependent on them to the point that unclear property rights in shares are not sufficient to overcome dilatory maneuvers undertaken in the shadow of restrictions on transfers.

It is often said that the separation of ownership and control leads to agency problems between members and managers in publicly held corporations. Agency problems, however, also are likely to happen in PLLCs, where the separation between ownership and control is

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702 See Allen, William T. et al., *Commentaries and Cases on The Law of Business Organizations*, 2nd ed., 2007, pp. 83-109 (100-101), where they observe regarding the publicly held company that unlike officers, directors are not ordinarily subject to the will of the majority of shareholders and thus are not ‘agents’ of the shareholders, strictly speaking.

703 For example, I reported cases in Part I in which directors of UK companies have been in their position for over twenty years. Articles of association of Spanish companies were frequently changed to allow mandates of managers for an indefinite period of time.

704 This is rather surprising, in as much as it is a common understanding in the literature that in PLLCs, or broadly speaking closely held corporations, members are usually part of the management. Those who own shares or units in these business organizations have part of their wealth linked to the business and, therefore, considering that these are not liquid investments, participating in the management of the company should constitute an incentive for the members to protect their investments. See Cheffins, Brian R., *Company Law: Theory, Structure, and Operation*, Oxford, Clarendon Press, 1997, p. 63 (stating that ‘Those who own equity in a closely held company typically have a substantial portion of their wealth invested in the firm and thus do not benefit greatly from diversification. Also... an ownership stake in a closely held company is ordinarily not a liquid investment. Consequently, participating in corporate decision-making will often be the only way for a shareholder to protect his interests’).

705 See Bruner, Christopher M., ‘The Enduring Ambivalence of Corporate Law’, *Alabama Law Review*, vol. 59, pp. 1385 – 1449 (1410) (referring to shareholders’ moral disengagement in public corporations. However, this is not exclusive to this sort of corporation).

frequently indistinct. Commentators have not always understood it this way.707 The fact of the matter is that agency problems, albeit of a different type, do crop up in the PLLC. Instead of agency problems between managers and dispersed shareholders, the PLLC experiences agency problems between the members in control of the firm and those that are not. And there are shareholder-creditor agency problems. These agency problems are not evident to the regulator (e.g., the Securities Exchange Commission, the London Stock Exchange or any other agencies).708709 This is so because these business organizations are not subject to the demands of a global market for securities, nor are they or their members bound to mandatory disclosure rules or whistleblower practices. Furthermore, PLLCs as well as closely held corporations are mostly financed by debt and retained earnings. External equity financing plays a small role in these companies. Therefore, without self-motivated investors minding the business of the company, the effective constraints on managers are small. In those situations where shareholders are in a weak(er) bargaining position, for example minority shareholders, or where the complexity of the contractual relations is such that creditors of one shareholder are led to think she will be in a position to capitalize on her assets when, in fact, she is not, due to agency problems, bargaining failures, and hold-ups in the company, there should be a mechanism to pierce the ownership veil in favor of those shareholders. Likewise, the piercing mechanism should be used in situations in which shareholders sell their shares without respecting requirements of consent *stricto sensu* established in the articles of association such as those of obtaining the consent of the company or of the board of managers. The previous chapter showed that the effects of the un-consented transfer of shares

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707 See Fama, Eugene F., and Jensen, Michael C., ‘Separation of Ownership and Control’, cit., p. 322 (saying that the combination of decision management and control in a few agents in closely held corporations, small partnerships, and proprietorships avoids agency problems between ‘residual claimants’ and decision makers).

708 See Easterbrook, Frank H., and Fischel, Daniel R. ‘Close Corporations and Agency Costs’ (noting that even though closely held corporations avoid agency costs of the same dimension of publicly held corporations by rolling managers and investors into one, the fact is that this does not impede opportunism and deadlocks from happening. These authors adopt an objective approach to contract (for them the company is a nexus of contracts). Therefore, problems as those just mentioned must find an answer in the contractual framework of the company to which lawyers greatly contribute by providing mechanisms to overcome the costs of closely held corporations).

709 It comes to mind an anecdotal report it was given to me by a manager of a closely held corporation while I was developing my research in New York City. This corporation has its registered office in the suburbs of New York City. It was composed of three members. Some of its shares were transferred to a third party without the consent of the company neither of the non-transferring shareholders. The third party was the brother of the transferor, who was also the manager. The transferee was un-documented and originally from the Dominican Republic. Notwithstanding this was an un-consented transfer, the transferee was tacitly accepted into the corporation. As time went by, conflicts between the majority shareholder and the transferee surfaced. The transferee threatened to take the majority shareholder to court for breach of his duty of loyalty due to problems related with the distribution of dividends, and the interference with employees’ strategy in the corporation. In his turn the majority shareholder accused the transferee of keeping information away from the management. At the end of it, they agreed the company would pay the transferee $100,000 for him to withdraw.
are not always clear. To circumvent the invalidity of the share sale and purchase agreement, the transferor may associate the transferee to her shares so that the latter receives economic rights. Parties to the share sale and purchase agreement may also agree that the transferor be a trustee of the transferee. In these circumstances, where clarification as to the ownership of shares is required, the ownership veil should be pierced. Respecting requirements of consent *stricto sensu* is crucial, especially if the transferor has pending corporate contributions to make, tax and environmental obligations to meet, or enjoys corporate benefits she was given as a result of her ownership of membership interests.

This means two things: it should be possible to clarify if and how the management board controls the company to the point that decisions taken by it directly or indirectly affect the shareholder’s ability to exercise her property rights in the shares;710 and it should be possible for courts to pierce the veil, and in this way interfere with the arrangements in respect to which there is a perception of unequal bargaining power advanced by one of the parties to the dispute.

Piercing the ownership veil, by directly interfering in a consensual agreement, runs counter to the objective approach that in particular common-law judges tend to adopt towards contracts. They are often said to consider that parties are able to look after themselves and, thus, interpret contracts narrowly. Often, the result in respect to un-consented transfer of shares is the enforcement of the prohibition against the transferee or the minority shareholder who is viewed as the cause of a deadlock in the company. In the other selected jurisdictions there are other instruments that judges can use, such as the general duty to act in good faith,711

710 In order to create a link to the publicly held company, see Dodd, E. Merrick, Jr., ‘For whom are Corporate Managers Trustees?’; *Harvard Law Review*, vol. 45, 7, pp. 1145-1163 (1146 and 1153), 1931-1932 (who by presenting arguments close to a ‘centric shareholder approach’ to the governance of corporations, says that ‘The directors and other agents are fiduciaries carrying on the business in the sole interest of the stockholders. These latter have indeed lost much of their *de jure* and, if the enterprise is large one, perhaps nearly all of their *de facto* control so that they may appear to be more like *cestuis que trust* than like partners. Nevertheless, they are not strictly *cestuis que trust*, for it is the association of which they are members and not an individual acting as a trustee for them that comes into contract relations with customers and creditors’. But most importantly in his contribution he refers to ‘absentee owners’. He means investors who take no part in carrying their business enterprises. As he puts it, in many cases these absentee owners ‘...have not even seen the property from which they derive their profits...’. Also see *The Curse of Bigness: Miscellaneous Papers of Justice Brandeis*, Fraenkel, Osmond K. (ed.) as projected by Lewis, Clarence M., New York, The Viking Press, 1935, p. 75 (referring to ‘absentee owners’ who are detached from the corporation and do not do much to improve wages and other conditions existing in the corporation in which they are financially interested. It is also noted that owners are responsible for the enterprise, and should behave accordingly. There is no such thing as ‘innocent stockholders’. This understanding derives from the idea, presented in the book, that the large corporation enables so-called ‘industrial absolutism’. This is not the case in small businesses and the PLLC where, in principle, labor, for instance, shares the responsibility for the business. This is, it is argued, in line with American aspirations for democracy, which should be not only political, but also industrial).

711 The duty to act in good faith is not as developed in the jurisdictions of common-law (United States and the United Kingdom) as it is in countries with a civil-law system. For instance, in the United Kingdom there is an
the principle of unjust enrichment (which also exists in common-law countries), and the principle of the abuse of law (abus de droit), to judge situations of alleged inequality of bargaining power or in which one of the parties takes dilatory or abusive actions against the other. An interesting consequence of piercing ownership is that judges would be in a position to evaluate the un-consented transfer and understand, for example, whether the transferor is acting like a trustee for the transferee while exercising property rights in shares towards the company. In other words, judges should be able to plumb the contract insofar there is evidence that the transferee is benefiting not only from the exercise of economic rights, but also from the exercise of management rights in the company, when this runs counter to the law and/or the articles of the company. Furthermore, judges should be able to probe the un-consented transfer to determine that extent to which managers were indirectly hindering the exercise of property rights in shares and, if necessary and under certain circumstances, order them to consent. Elapsed time limits on establishing restrictions in the articles of association is an example. By piercing the veil in such circumstances, it would be possible to determine if control over the company, in respect to its decision-making process, is in the hands of the management board when, according to the articles of the company, it should be in the hands of the members, or that such control is being abusively held. It is true that these issues may fall within the rubric of business policy for which courts may not be sufficiently knowledgable. However, the piercing is also designed to penetrate situations in which managers' acts are abusive, fraudulent or destructive of shareholders’ rights.

2. Fiduciary duties in PLLCs, the business judgment rule, and piercing the ownership veil

i. Fiduciary duties

Let us imagine shareholder A, who, wishing to sell her share, obtained the relevant consent stricto sensu as required by the company’s articles. However, the board of directors subsequently decides to change the articles of association to impose restrictions on transfers. Consequently, the share sale and purchase agreement (SSPA) is challenged by the management board which, on behalf of the company, does not authorize or approve the understanding that the commercial features in which contract law lies make it generally fit for commercial transactions. The idea that parties should take care of each other and not exploit one another never gained much ground there, as it did in civil law.
execution of the SSPA. Other non-transferring shareholders do not support it either. In her turn, shareholder A challenges this decision in a suit by asking the court to order the transfer. Let us now suppose that the transferor still challenges the decision of the management board, but this time to recover damages from the directors as a result of their decision not to authorize the transfer. Shareholder A accuses the board of not complying with its fiduciary duties toward shareholders. Additionally, she accuses other (majority) shareholders of not complying with the fiduciary duties with which they are bound toward minority shareholders. The first riddle is: have directors adequately performed their duties? The second riddle is: is this an issue of business judgment? The third riddle is: are shareholders bound to fiduciary duties toward each other, in particular when contracts are incomplete and the law does not establish procedural mechanisms to evaluate the merits of directors/managers and shareholders’ decisions? This scenario evokes the discussion on the relevance of fiduciary duties in corporate law. It also brings to the fore the debate over the business judgment rule (BJR).

Relationships between shareholders and directors or managers configure a fiduciary relationship. In corporate law the economic analysis of agency costs and the doctrine of incomplete contracts have created the ground for discussion of fiduciary duties owed by managers and directors to shareholders. Fiduciary law imposes on fiduciaries, in this case directors and managers, fiduciary duties which are traditionally divided into two major categories: the duty of loyalty and duty of care. Then there is the duty of good faith, which

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712 See, for example, W & A. M’Arthur Limited v The Gulf Line Ltd 1909 1 S.L.T. 279. In this case, there was a transfer of shares of a member to a third party. The company through a resolution of the board of directors, decided to alter the companies articles to prevent the registration of the transfer of shares. The court held this unacceptable because, among other things, the petitioner obtained a transfer of shares in the respondent company, and in due course and in due form presented that transfer for registration.


Delaware courts recently said is an aspect of the duty of loyalty (at least with respect to corporations).\footnote{715} Notwithstanding the views of some corporate law commentators who treat fiduciary law as part of contract law pretty much based upon an economic analysis of corporate law, which views consensual agreements such as the company’s articles of association as purely contractual,\footnote{716} American courts have put out a solid amount of case law on fiduciary duties as part of a separate field of law.\footnote{717} This situation is to a certain extent similar in the United Kingdom. Differently, in European civil law countries, particularly Portugal, France, Italy and Spain, contract law is overall designed to encompass fiduciary relationships. In these jurisdictions, fiduciary law is not an autonomous field. With some exceptions such as the mandate, the contract for the benefit of a third party, \textit{la fiducie} in France, and long-term contracts such as employment contracts or distribution contracts, which are liable to trigger fiduciary duties, the concept of beneficial ownership in the Anglo-American systems is not accepted in the same terms in the selected European jurisdictions. Furthermore, courts in civil law systems are more likely to interfere with the consensual agreement and interpret the relevant contractual duties as opposed to the contractual objective approach adopted by courts in common-law systems, especially the United Kingdom and the United States.\footnote{718}

In the United Kingdom there is a general notion that directors do not directly owe duties to shareholders.\footnote{719} This rule bends whenever there is ‘a special factual relationship between the directors and the shareholders in the particular case’.\footnote{720} This is certainly the case when

\footnote{715} This principle is consecrated in the civil codes of Portugal Spain, Italy and France. Traditionally, it has not gained much ground in United Kingdom law, but it is possible to find recent court decisions that make reference to this principle. In the United States, Delaware courts have long recognized good faith as one of the director’s fiduciary duties toward shareholders. See Griffith, Sean J., ‘Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence’, \textit{Duke Law Journal}, vol. 55, No. 1, 2005, pp. 1-73.


\footnote{718} See Piscitelloo, Paolo, ‘La Responsabilità degli Amministratori di Società di Capitali tra Discrezionalità del Giudice e Business Judgment Rule’, \textit{Rivista delle Società}, vol. 57, 6, 2012, pp. 1167-1183 (calling attention to the discretionary powers of Italian courts and saying that Italian jurisprudence is venturing new paths which allow a fair compensation for damages, but without an automatic overturn of the debts of the company on the managers).

\footnote{719} Section 170 of the Companies Act 2006 provides that ‘The general duties specified in sections 171 to 177 are owed by a director of a company to the company’.

\footnote{720} See Peskin v Anderson [2001] 1 B.C.L.C. 372 where the court held that ‘Fiduciary duties owed by directors to shareholders only arise if there is a special factual relationship between the directors and the shareholders in the particular case capable of generating fiduciary obligations, such as a duty of disclosure of material facts, or an obligation to use confidential information and valuable commercial opportunities for the benefit of
there is an agency relationship between directors and members. But it can also be true beyond these cases wherein agency law determines directors’ fiduciary duties toward shareholders. It has been understood that a fiduciary duty of disclosure arises when there is blatant asymmetry of information between directors and shareholders, and shareholders have entrusted directors to inform them and give them the necessary advice. This, as pointed out by Paul Davies, particularly favors small family companies, given their nature and the relationships between corporate constituencies therein, in particular between managers and shareholders. Statutorily speaking, UK law provides a list of general duties of directors that form ‘a code of conduct, which sets out how directors are expected to behave’. These duties cover those situations in which ‘a director may put his own or other interests ahead of those of the company’ and those situations in which ‘he may be negligent’.

The general duties listed in Articles 170 to 177 (Chapter 2, Part 10 of the Act) are based upon equitable and common-law rules. They can be divided into the duty to exercise reasonable care, skill and diligence, which is formulated pursuant to the objective standard of the reasonable director, and all other duties with a fiduciary nature such as the duties to act within powers, to promote the success of the company, to exercise independent judgment, to avoid conflicts of interest, not to accept benefits from third parties, and to declare interest in proposed transaction or arrangement. UK law follows the paradigm of shareholder primacy. Even if directors have the duty to take into consideration first and foremost the interests of the company, authors like Paul Davies, who was a member of the Company Law Review Steering Group that led to the Companies Act 2006, equate the interests of the company with the interests of shareholders. So, ultimately, directors are the guardians of shareholders' interests. They should only take account of other shareholders and not to prefer and promote the directors own interest at the expense of shareholders’. This is also referred to by Davies, Paul L., Gower and Davies Principles of Modern Company Law, cit., pp. 480-482. Also interesting is Salomon v Salomon & Co. Ltd.; Salomon & Co. Ltd. v Salomon [1895-1899] All ER Rep 33; [1895-99] All ER Rep 33 (where in the words of Lord Herschell ‘In a popular sense a company may in every case be said to carry on business for and on behalf of its shareholders, but this certainly does not in point of law constitute the relation of principal and agent between them or render the shareholders liable to indemnify the company against the debts which it incurs’).

See Coleman v Myers [1977] 2 N.Z.L.R. 225, NZCA. Also see Davies, Paul L. (referring to and explaining this case).

See Companies Act 2006 (c.46), Explanatory Notes, p. 45.

See Companies Act 2006 (c. 46), Explanatory Notes, p. 45.

See Section 174 of the Companies Act 2006.

'(1) A director of a company must exercise reasonable care, skill and diligence.
(2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with –
   (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
   (b) the general knowledge, skill and experience that the director has'.
stakeholders’ interests if doing so would be in the interest of the company and its shareholders.\textsuperscript{725}

Portuguese law adopted as a standard the 'diligence of a careful manager', to assess the work done by managers of PLLCs (\textit{sociedades por quotas}) and directors of publicly held companies (\textit{sociedades anónimas}).\textsuperscript{726} This standard may be approached objectively or abstractly by reference to the \textit{bonus pater familias}, or to more demanding criteria. Mainly, this rule is likely to determine the civil liability of managers.\textsuperscript{727} Following the common-law structure, the legislators made the general distinction between duties of care and duties of loyalty. Additionally, the law yields a communitarian view of the firm. It foresees that managers and directors must comply with their duty of loyalty and take into account not only the long-term interests of shareholders, but also of other stakeholders (e.g., employees, clients and creditors).

French corporate law is suffused with the notion of social interest (\textit{intérêt social}). This, as in Portuguese corporate law, allows managers to consider corporate constituencies other than shareholders when setting up the company strategy.\textsuperscript{728} Managers (\textit{gérants}) are elected by shareholders in the articles of association or through a resolution of the general meeting.\textsuperscript{730} Formally, they are supposed to be under shareholders’ general control. There is a general understanding that managers should represent shareholders’ interests, even if they first and foremost legally owe their obligations to the company.\textsuperscript{731} They are like fiduciaries, in the


\textsuperscript{726} See Article 64 of the Portuguese Commercial Companies Code (fundamental duties). This Article was altered by the Decree-Law 76-A/2006, 29 March. It was one of many rules altered in the Portuguese Commercial Companies Code to adapt it to the challenges of corporate governance discussed at the time, and harmonize it with other Continental and non-Continental rules of corporate law.

\textsuperscript{727} This rule was basically copied from German law (§93/I AktG). See Cordeiro, António Menezes, \textit{Manual de Direito das Sociedades: Das Sociedades em Geral}, vol. I, 2\textsuperscript{nd} ed., Coimbra, Almedina, 2007, pp. 805-811 (discussing whether this is a rule of conduct or a standard of guilt). Despite the fact that it was taken from German law, German law clearly does not talk about a \textit{pater familiae} as the Portuguese law does. If anything, it sometimes refers to the ‘good merchant’.

\textsuperscript{728} I am not considering in respect to this particular point whether French law influenced Portuguese law or the other way around.

\textsuperscript{729} See Fanto, James A., ‘The Role of Corporate Law in French Corporate Governance’, \textit{Cornell International Law Journal}, vol. 31, 1, 1998, pp. 31-91 (47) (saying that ‘The concept of the \textit{intérêt social}, which permeates the French corporate code, permits directors to consider the interests of all constituencies in deciding upon corporate strategy’).

\textsuperscript{730} See Articles L 223-18 and L 223-29.

\textsuperscript{731} According to L 223-18 and L 221 – 4 of the Code de Commerce ‘…les pouvoirs des gérants sont déterminés pour les statuts, et dans le silence de ceux-ci, par l’article L 221-4’ (‘… the powers of the managers are determined by the articles of association and, in silence thereof, by Article L 221-4’). Additionally, see Article L 223-25 stating that the mandate of managers may be revoked by shareholders, but there should be a just cause
strict sense of the word, that are bound by the duties that bind a *bon père de famille*. This intellectual framework of French corporate law is close to UK corporate law. French corporate law allows for the construction of a duty of care and loyalty to which it submits managers’ actions in the running of the company, and by which it tries to avoid conflicts of interest and self-dealing. It also provides for the duty of managers to act in good faith.

These duties boil down to the prohibition imposed on managers to contract any form of loans with the company, to be granted an overdraft in a current account or otherwise, or to guarantee or endorse third parties’ commitments. Managers are responsible, individually or jointly, as appropriate, vis-à-vis the company or vis-à-vis third parties, for violations of the laws or regulations applicable to the *société à responsabilité limitée*, or for negligence in their management. In addition to the action for damages for personal injury, the shareholders may, either individually or as a group under the conditions laid down by decree of the Council of State, bring an action for damages against social managers (*action en responsabilité*). The plaintiffs are entitled to pursue compensation for the entire loss suffered by the company to which, if any, damages are awarded.

The management of the Italian *società a responsabilità limitata* is entrusted to one or more shareholders elected by other shareholders in the articles of association or in the shareholders’ general meeting. If the management is composed of more than one element, the law foresees the constitution of a management board. According to the law, shareholders are expected to hold a clear control over the managers / management board. Managers are liable toward the company, but ultimately they must act in the interests of shareholders. The Italian

*(juste motif)* for the revocation under penalty that managers be entitled to receive a compensation for damages to which interests are accrued.

Managers have broad powers to represent and bind the company. See Article L 223-18 stating that ‘Dans les rapports avec les tiers, le gérant est investi des pouvoirs les plus étendus pour agir en toute circonstance au nom de la société, sous réserve des pouvoirs que la loi attribue expressément aux associés. La société est engagée même par les actes du gérant qui ne relèvent pas de l'objet social, à moins qu'elle ne prouve que le tiers savait que l'acte dépassait cet objet ou qu'il ne pouvait l'ignorer compte tenu des circonstances, étant exclu que la seule publication des statuts suffise à constituer cette preuve’. (*'In dealing with third parties, the manager is vested with the broadest powers to act in all circumstances on behalf of the company, subject to the powers expressly granted by law to the shareholders. The company is bound by the acts of the manager, even if they do not fall within the corporate purpose, unless it can prove that the third party knew that the act was ultra vires or that, given the circumstances, it could not ignore it, not being the publication of the articles of association sufficient evidence for that purpose'.*)

Additionally, see Loi n.º 2007-211 of 19 February 2007 adopting la fiducie in the French Legal System and Article L 233-10 1.º and 5.º.

As for the duty of loyalty see the decision of the *Cour de Cassation* on 27 February 1996, No 94-11241 (where the court held that within the process of reclassification of shares in which the director of the company was an intermediary, the director breached his duty of loyalty towards the member of the company who wanted to transfer his shares).

See Article L 241-3 of the Code de Commerce. I am deriving a duty of good faith from the sanctioning of the abuse of the company’s assets (*abus de biens sociaux*).

See Article L 233-22.
legal system also requires managers to comply with the fiduciary duty of loyalty (which the Italian Civil Code treats under the provision on conflict of interests)\textsuperscript{736} and duty of care.\textsuperscript{737}

Any shareholder may bring a law suit against managers (azione di responsabilità) if there are serious irregularities in the management of the company. Italian law also establishes a general clause of responsibility for the direction and coordination of the company. It basically states that the companies or entities that, by exercising the management or coordination of the company, act in their own interest or in the interest of others in breach of the principle of correct corporate and business management of the company, are directly accountable to the shareholders of those companies for the damage caused to the profitability and value of the shares, as well as to the creditors for the injury inflicted to the integrity of the company’s assets.\textsuperscript{738}

The management structure of the Spanish sociedad de responsabilidad limitada is reflective of the principle of private autonomy that strongly pervades its legal framework and of the closed nature of these business organizations.\textsuperscript{739} The relevant legal regime shows how formally shareholders are in control of the company. Managers are elected by shareholders in the general meeting. Shareholders may also resolve to ask managers for guarantees that assure their competence and quality of their management. The law provides shareholders with the option of discretionarily adopting different forms of management. Managers, in principle, exercise their mandate for an indefinite period of time, but they can be removed from office if shareholders resolve accordingly in the general meeting. As to their duties, Spanish law sets forth for managers a duty of diligent management and a duty of loyalty.\textsuperscript{740} Additionally, it determines the prohibition to use the name of the company or to use the title of manager to undertake operations in their interests or in the interests of persons connected to them (e.g., spouses, ascendants, descendants, brothers and sisters, and the spouses of ascendants and descendants); it prohibits taking advantage of business opportunities regarding the company’s assets and of which they have only known as a result of their mandate as managers; it regulates conflicts of interests, and it establishes a prohibition of competition that prevents managers from developing the same or similar business object as the company. Finally, the law imposes a duty of confidentiality to which managers are bound even after their office has

\textsuperscript{736} See Article 2495 – ter. of the Italian Civil Code (regulating conflicts of interests).
\textsuperscript{738} See Article 2497, first paragraph of the Italian Civil Code.
\textsuperscript{740} See Articles 225 and 226 of the Real Decreto Legislativo 1/2010, July 2nd, approving the consolidated text of the Ley de Sociiedades de Capital.
come to an end. Managers are liable vis-a-vis the company, its shareholders and creditors. Any shareholder may bring an action on behalf of the company against managers if the latter breach their duties according to the law and the articles of association (acción social de responsabilidad). Both the resolution to bring this action and its withdrawal are subject to the vote of shareholders and to the majorities established in the law and the articles of association.

ii. The Business Judgment Rule

Fiduciary duties are the reason the BJR exists. The BJR works as the obverse of fiduciary duties to protect directors or managers against personal liability while in office. The BJR is an old common-law principle of corporate governance that was created in late nineteenth and early twenty-first century. The American Law Institute defined the BJR in the following terms.

A director or officer who makes a business judgment in good faith fulfils the duty under this section if the director or officer (1) is not interested in the subject of the business judgment; (2) is informed with respect to the subject of the business judgment to the extent to which the director or officer reasonably believes to be appropriate under the circumstances; and (3) rationally believes that the business judgment is in the best interests of the corporation.
This principle has traditionally been construed by US jurisprudence and doctrine as appropriate for handling situations in which conflicts between directors or managers and shareholders demand careful review because the cases are not clear-cut. The typical rationales for the BJR are the following. Courts should be competent to decide. Courts should not substitute the decisions taken by experienced business executives whose knowledge makes them more equipped to decide on business matters for the courts’ inexperienced judgments. Moreover, courts should adopt a standard of judicial review that enables them to avoid the impact of hindsight bias on their judgments regarding the risks taken by directors in respect to the company’s business. It is in this context that I link the BJR with the piercing of the ownership veil by courts, and the process of decision-making in the company. The link lies in the idea that when directors are not able to make an adequate business judgement, courts should be able to interfere with the consensual agreement from which directors’ duties derive. The presumption of the BJR can (leaving aside bad faith and knowing violations of the law) be rebutted by proving that directors did not act on an informed basis (in which case there is a violation of the duty of care) or that directors have a self-interest in the transaction (in which case there is a breach of the duty of loyalty). Piercing should take place when it is shown that directors acted in a self-interested way in blocking the transfer of shares. One could object by saying that this would apply in almost all cases. Nevertheless, the burden of proof to show that the ‘blocking’ decision did not breach the duties of care and loyalty would rest entirely on the directors (who can also be majority shareholders), as it happens in self-dealing cases in the United States when the plaintiff has succeeded in rebutting the

“business judgment rule generally operates to relieve the directors of liability in such cases. The business judgment rule involves the specification of a set of procedural steps, which, if followed, will give the directors the benefit of a presumption that they were not negligent”).

See Blair, Margaret M., and Stout, Lynn A., ‘A Team Production Theory of Corporate Law’, Virginia Law Review, vol. 85, No. 2, 1999, pp 247-328 (260) (criticizing the principal-agent model by saying that ‘...the principal-agent model assumes that it is clear who the principal is, and who the agent is in the particular relationship or transaction under study. Yet many of the most important relationships inside corporations may be more ambiguous, in the sense that both parties may be contributing productive inputs and neither may have authority over the other. In fact ... this fundamental ambiguity underlies the basic structure of corporate law and provides the foundation for a more useful theory of public corporations’. I would say the same applies to the PLLC in particular due to its contractual nature. I suggest the pierce of the ownership veil is this theory applied to the PLLC in order to overcome the ambiguity of the relationships between corporate constituencies in particular managers and shareholders).

See Rachlinski, Jeffrey, J., ‘A Positive Psychological Theory of Judging in Hindsight’, University of Chicago Law Review, 65, 1998, pp. 571 – 625 (suggesting that the business judgment rule is an example of a situation in which courts do not apply a liability rule when a particular course of action could have been in hindsight considered negligent).

This contractual setting is composed of the articles of association, but may also include other contracts of which the articles of association are part of as an exhibit, for instance.
presumption of the BJR. Being a principle which is rooted in US corporate law, the application of the BJR to civil-law countries may be difficult, but it is not impossible.\textsuperscript{748}

The business judgment rule has been understood and designed in legal doctrine in different ways, in particular in respect to publicly held corporations. For example, Stephen Bainbridge generally points out the role of the board of directors. Most US corporate law scholars do not go this way. For him, though, the BJR is meant to establish a compromise between two competing values: authority and accountability.\textsuperscript{749} These values, as Bainbridge explains, correspond to the need to guarantee that the board of directors holds a discretionary power over the decisions it takes and the need to hold the board accountable for these decisions. He advocates for a ‘directors’ supremacy theory’. This paradigm is meant to answer two essential questions of corporate governance: Which constituency’s interests will prevail when the ultimate decision maker is presented with a zero sum game?; and, in which organ of the corporation is the ultimate power of decision vested?\textsuperscript{750} US corporate law scholars who plead for the shareholder primacy model in public corporations argue that directors must exert their corporate decision-making power to maximize shareholders’ wealth.\textsuperscript{751} They also yield that shareholders hold the residual power in the corporation despite the separation of ownership and control.\textsuperscript{752} This is, in fact, a view followed by the Italian legislator in respect to the Italian counterpart – \textit{società per azioni}\textsuperscript{753} - as well as by the Portuguese legislator with the \textit{sociedade anônima}\textsuperscript{754}, by the French legislator with the \textit{société}

\textsuperscript{748} In Germany, it was largely adopted by the \textit{Bundesgerichtshof} (BGH) in the II ZR 175/95 ‘ARAG/Garmenbeck’ case. It was also established in Section 93 of the Aktiengesetz (AktG).


\textsuperscript{751} Unlike some European countries, in the United States shareholders of publicly held companies cannot give orders to the board of directors. See §141(a) of the Delaware Geral Corporation Law (DGCL).

\textsuperscript{752} Article 2364 of the Italian Civil Code lists a number of competences that exclusively belong to the general meeting of shareholders such as resolve on those issues brought to it by the directors of the corporation or by the \textit{collegio sindicale}. This rule is also applicable to the società a responsabilità limitata.

\textsuperscript{753} Article 376 (1), c of the Commercial Companies Code provides that the general meeting of shareholders makes the general evaluation of the management board and supervision board of the corporation and resolve about the dismissal or manifest its distrust regarding administrators. This rule is subsidiary applicable to the Portuguese form of PLLC – the \textit{sociedade por quotas}. 285
anonyme, and the Spanish legislator with the sociedad de responsabilidad limitada. In all these jurisdictions shareholders are provided with tools that enable them to formally have their hands on the work directors are doing through the resolutions taken at the general meetings, in particular to approve the accounts of the corporation, or through the exercise of rights to obtain information directly from the board of directors. This is not only true of the publicly company in these countries, but also of the PLLC in the selected jurisdictions of Continental Europe. It is not the same in the United States. The picture is also different in the United Kingdom. In the case of the United States, the empirical work I have developed so far hints at a tendency for directors’ powers to be contractually enhanced compared to the power of shareholders. This happens in the United States in respect to the LLC because there is enormous flexibility of the governance mechanisms. In the United Kingdom this occurs in respect to the private company as the law does not foresee general meetings of shareholders, and thus gives quite a lot of leeway to directors. Legally, however, shareholders are granted a substantial control over the company. Shareholders’ control is translated into their power to decide who sits on the board, and to resolve on issues such as increase and reduction of capital, mergers and acquisitions, divisions, dissolutions, among others. Furthermore, provisions requiring the approval of members for certain transactions can be found in the Companies Act 2006. As the analysis of data provided by the BvD database suggests, despite the strong dependence of United Kingdom private companies on their members, members seem not to be as involved in the affairs of the companies as their legal status allows.

755 For example, Article 225 – 108 establishes that ‘Le conseil d'administration ou le directoire, selon le cas, doit adresser ou mettre à la disposition des actionnaires les documents nécessaires pour permettre à ceux-ci de se prononcer en connaissance de cause et de porter un jugement informé sur la gestion et la marche des affaires de la société’. (‘The board of directors or management, as the case may be, must send or make available to the shareholders the necessary documents to enable them to make decisions based on a knowledge of the facts and arrive at an informed judgment on the management and progress of the company and its business’) (Translated by Louis Vogel, Professor at the University of Paris II, at URL: file:///C:/Users/Lecia%20Vicente/Downloads/Code_32.pdf, last accessed on 27 April 2014).

756 For instance, Article 5 16 of the Real Decreto Legislativo 1/2010, July 2nd foresees that ‘En las sociedades anónimas cotizadas el consejo de administración, con informe a la junta general, aprobará un reglamento de normas de régimen interno y funcionamiento del propio consejo, de acuerdo con la ley y los estatutos, que contendrá las medidas concretas tendentes a garantizar la mejor administración de la sociedad’. (‘In listed companies, the board of directors approves, upon report to the general meeting, a regulation of internal rules and operation of the board itself, according to the law and the statutes which contain the specific measures aimed at ensuring the best management of the company’).

757 However, the articles of association of the private company Clipper Windpower Ltd included in my sample of UK companies foresee general meetings. Still, it is not a meeting exclusive to shareholders, for directors can also participate irrespective of not being shareholders.

758 See Chapter 4 of the Companies Act 2006 regulating transactions with directors requiring approval of members.
them to be.\footnote{See Cheffins, Brian R., \textit{Company Law: Theory, Structure, and Operation}, Oxford, Claredon Press, 1997, pp. 61-62 (apropos control over corporations he explains that ‘Almost invariably, the power to manage the company is delegated to the board of directors. Nevertheless, the members will in most circumstances retain the authority to select who sits on the board. Consequently, in legal terms, shareholders have substantial control over corporate affairs. Still, an observation which has often been made about shareholders is that the extent of their actual involvement does not correspond with the important legal role which they have’).} This role seems to be increasingly played by directors, and freedom of contract has been used to increase directors’ powers of control.

In US corporate law literature, Bainbridge is one of the few voices saying that ‘...shareholder primacy is neither normatively persuasive nor descriptively accurate.’\footnote{Bainbridge, Stephen M., cit., p. 86.} He puts forward a director primacy model as an alternative to the shareholder primacy model, and endorses the ‘nexus of contracts’ doctrine as he submits that ‘the director primacy model describes the corporation as a vehicle by which the board of directors hires various factors of production’. In this sense, the board is not an agent of the shareholders but it rather is a corporate principal serving as a nexus of contracts making up the corporation.\footnote{Bainbridge, Stephen M., cit., p. 86.} He understands that director primacy is able to identify the tension between authority and accountability, which for him is the central problem of corporate law. He suggests that this impasse is solved by the BJR. Nevertheless, he yields a very particular conception of it. He perceives the BJR not as a standard of liability, but rather as a doctrine of abstention by which courts excuse reviewing decisions of the board unless strict preconditions for review are met.\footnote{See Fischel, Daniel R., ‘The Business Judgment Rule and the Trans Union Case’, \textit{The Business Lawyer}, vol. 40, 4, 1985, pp. 1437-1455 (1454) (stressing that giving shareholders as well as their attorneys more leeway to sue directors for damages and, thus, to interrupt transactions is not in the best interests of shareholders. In his words ‘One of the major problems in the principal agent relationship between managers and shareholders … is … that managers already have incentives to avoid risk because of their inability to diversify the value of their human capital. Liability rules that reinforce this incentive will operate to shareholders’ detriment’).} The problem seems to be the identification of appropriate intervention situations for courts.\footnote{Bainbridge refers to Omnicare, Inc V NCS Healthcare, Inc, 818 A2d 914, 927 (Del 2003) and, most importantly, Cede & Co. v Technicolor, Inc. 25 634 A.2d 345 (Del. 1993) as emblematic decisions treating the business judgment rule as a standard of liability. Following the rationale established in these decisions, some courts and scholars have claimed that the BJR enables directors to avoid liability provided they have acted in good faith. Others argue that the BJR only affects the degree to which directors would be considered liable (e.g., mere negligence, gross negligence or recklessness). Alternatively, the author quotes Shlensky v Wringley 237 NE 2d 776 (III. App. CT 1968), which applies Delaware law, to back up his understanding of the BJR as a standard of abstention. In this case, the principle of good faith does not establish a standard of liability, but rather a standard of abstention that prevents courts from reviewing claims of duty of care, unless the plaintiff can prove that there was a breach of the principle of good faith.} Regardless, Bainbridge's view is that the courts should not even ask whether or not the board breached its duty of care.\footnote{See Bainbridge, Stephen M., cit., p. 128 (saying that ‘The business judgment rule builds a prophylactic barrier by which courts pre-commit to resisting the temptation to review the merits of the board’s decision’. He goes on to say that ‘The question is not whether the directors violated some brightline precept, but whether their conduct satisfied some standard of judicial abstention’).} This is, for him, the whole point of the BJR. By
imagining directors who are moved by a public interest and by quoting Plato, this author puts forth the idea that directors are a sort of ‘Platonic masters’ or ‘Platonic guardians’ of the corporation. Additionally, the directors’ obligation to maximize shareholders’ wealth, his argument runs, is an implied contractual obligation in American business law. The key point is that corporate constituencies such as shareholders – the human factors of production – have no say in the decision-making process of the company. Referring to the publicly held company, he says that its chief distinctive feature is the separation of ownership and control. In many circumstances, shareholders who are said to be residual claimants according to the supporters of the shareholder primacy model have, in fact, no control over the company and no decision-making power. Their only choice is to react.

This is not quite the case for the PLLC, where shareholders are much more involved in the day-to-day business of the company and in its decision-making process because they are, frequently, shareholders as well as managers. Plus, they are fewer in number than in publicly held companies, which on a theoretical basis, at least, reduces the number of problems related to collective action. Bainbridge construes the BJR in this setting of separation of ownership and control, and stresses that the difficulty of the matter lies in the fact that authority and accountability are antithetical: ‘one cannot have more of one without having less of the other’, he says. His position is that by holding boards accountable, the decision-making authority is shifted to shareholders or judges. This claim is understandable, but not totally convincing. It is a commonplace that with great(er) authority comes great(er) responsibility. Following this reasoning, there should be no problem in delegating to shareholders or other gatekeepers such as courts the power to question the merits of the decisions of the board. Board members should be ready for it. This is particularly so when it is proven that shareholders delegated a great deal of power to directors, and the fate of the company as well as of businesses worth millions is on the line. Of course, it all depends on how much shareholders and courts know about the business, and how well educated they are in issues of corporate law. It may be true that allowing shareholders and courts to interfere with the business judgment of the board will prevent directors from taking riskier and more ambitious business decisions. That directors’ actions are highly constrained by markets and that these constraints are not imposed on faulty judges is indisputable. It is a fact, however, that directors’ decisions are affected by ‘bounded rationality’ and asymmetries of information, and that this alone should be enough to turn the task into a spiky one.

765 See Bainbridge, Stephen M., cit., p. 104.
The corporation is more than just a ‘nexus of contracts’, and the role of directors is typically not limited to the ‘hiring factors of production'. Directors also safeguard shareholders’ property rights. Attributing this function to directors would enhance the value of human capital in the company as a factor of production and work as a refinement of Bainbridge’s thesis. The company’s contract regulates each corporate constituency’s part in the organization of the company and in the decision-making process. If not, because the company’s contract is incomplete, normally the respective default rule applies. Whilst directors contribute with their expertise to the corporate production (to use the term used by Bainbridge), shareholders, whether they are managers or not, still hold the power to review directors’ business judgments through their votes in the general meetings. (The problem in the PLLC is that they do not always do so: They are passive. This situation provides leeway to directors, who are often shareholders, to take advantage of the ambiguity of the corporate relations.)

Can the BJR also be applied to managers of LLCs and to managers of PLLCs of the other selected jurisdictions? In general, I think that it can be applied to managers of LLCs, not to managers of PLLCs.  

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767 See Blair, Margaret M., and Stout, Lynn A., ‘A Team Production Theory of Corporate Law’, Virginia Law Review, vol. 85, No. 2, 1999, pp. 247-328 (presenting another vision of the economic function of the board of directors. Their mediating hierarchy approach suggests that directors should be under direct control of neither shareholders nor other stakeholders. This model, which is an internal governance structure, is intended to surpass team production problems such as shirking and rent-seeking. It entails the surrender of important rights by team members such as shareholders (including property rights over the teams’ joint output and over team’s inputs such as financial capital and firm-specific human capital) to a legal entity created by the act of incorporation. The corporate assets would then belong to the corporation itself and not to the shareholders. In the corporation, control over those assets is exercised by an internal hierarchy which is supposed to coordinate the activities of the team members, allocate the results of production, and mediate disputes among team members over that allocation. At the top of the hierarchy is the board of directors, whose authority over the corporate assets is absolute and whose independence from individual team members is protected by law. In my view, in this case the construction of the BJR disfavors the shareholder primacy view which underscores many other constructions of the BJR. Blair and Stout say that their proposed model highlights the important function that the BJR can serve. They affirm that the rule can prevent coalition members (in particular, shareholders) from using lawsuits as strategic devises to extract rents from the coalition. This is so because the BJR works to ensure that directors can only be found liable for breach of the duty of care in situations wherein a finding of liability serves the collective interests of all firm members. (see p. 300). Their view of the firm translates into what they call ‘corporate coalition’ and the BJR is designed accordingly. It is important to note that the mediating hierarchy approach makes greater sense when applied to publicly held corporations than to closely held corporations, as indeed the authors stress. In their words ‘… in a closely held firm, stock ownership is usually concentrated in the hands of a small number of investors who not only select and exercise tight control over the board, but also are themselves involved in managing the firm as officers and directors’ – p. 281. This paper, however, converges with my own work in the sense that views the role of directors as not exclusively linked to the representation of shareholders, but rather to the representation of the interests of the corporate constituencies as a whole).

768 See Painter, Richard W., and Kirchner, Christian, ‘European Takeover Law: Towards a European Modified Business Judgment Rule for Takeover Law, European Business Organization Law Review, vol. 1, 2, 2000, pp. 353 – 400 (putting forward an internal mechanism of governance that consists of shareholders’ review of defensive measures based upon the veto of those measures or directors business judgments in the context of a takeover bid. They explain that the principle of neutrality in Europe binds directors and, for that reason, the directors do not have the discretionary power that is wielded by their American counterparts under Revlon and Unocal).
which eliminates judicial review of management decisions. The problem, however, is that the LLC has a peculiar contractual setting in which rules of governance are not always easy to interpret. Additionally, it is also difficult to control abuses, especially when one of the parties does not have strong bargaining power in a context where the relational element is pervasive. This calls for a reflection at the contractual level. The standards of loyalty and care in these companies may call for a different standard of judicial review.\(^\text{769}\)

In respect to the LLC, most case law regarding breach of fiduciary duties centers on the duty of loyalty. Members of LLCs make every effort to eliminate fiduciary duties, and the Delaware LLC Act allows them to eliminate even the duty of loyalty.\(^\text{770}\) LLC operating agreements in my sample illustrate this. Additionally, relevant cases on this matter are Fisk v. Segal,\(^\text{771}\) Lerner v. Westreich,\(^\text{772}\) and Tzolis v. Wolf.\(^\text{773}\) These cases raise important questions as to the applicability of fiduciary duties in LLCs (which are not creatures of state but rather of contract)\(^\text{774}\) as opposed to the conventional applicability of fiduciary duties in the corporation. They also show the dominance of contract under Delaware law. Only the principle of good faith seems to limit a posteriori this contractual supremacy. Courts adhere to an objective theory of contract and, thus, they decide whose business judgment is more in keeping with the plain meaning of the contract. Members, managers and officers may act selfishly insofar as the behavior does not jeopardize the reasonable expectations of the other party. If according to the contract a certain course of action is expected and is not expressly or implicitly limited by the agreement of the parties to the contract, courts tend to be reluctant to condemn a particular conduct. Tzolis v. Wolff shows that derivative suits can be filed by LLC members against managers who do not comply with their fiduciary duties, in particular the

\(^{769}\) See Miller, Elizabeth S., and Rutledge, Thomas E., ‘The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations?’, \textit{The Delaware Journal of Corporate Law}, vol. 30, N.º 2, 2005, pp. 343-388 (discussing the role played by the BJR in the context of unincorporated companies. These authors question the feasibility of the BJR in the contractual framework of unincorporated companies such as the partnership, the limited partnership and the LLC).

\(^{770}\) See Del. C. § 18-1101(c) allowing the elimination of all fiduciary duties as part of the LLC Agreement. Only the implied contractual covenant of good faith and fair dealing must be preserved. Regarding the Delaware corporation, only the duty of care can be eliminated. On this topic, also see Ribstein, Larry E., ‘Pre-formation Fiduciary Duties in LLCs: another NY Problem’, 21 June 2010 at \texttt{http://truthonthemarket.com/2010/06/21/pre-formation-fiduciary-duties-in-llcs-another-ny-problem/} (accessed on 21 April 2013).


\(^{774}\) Still, LLCs must be registered to gain legal personality.
duty of loyalty, or enroll in self-dealing.\textsuperscript{775} Derivative suits, however, are not the only remedy. Besides, there are impending collective action problems when shareholders resolve to bring an action on behalf of the company against a third party as well as high litigation costs to handle for a LLC.\textsuperscript{776}

In respect to the PLLCs of the other selected jurisdictions, I do not see a problem in applying the BJR. However, much of its implementation will have to do with the scope of fiduciary duties in each jurisdiction. Unlike the United States, where an objective standard for the evaluation of the board of directors has long been established and where the BJR is supported by a backbone of case law that perceives it as a palliative to avoid directors’ liability, in the United Kingdom the BJR did not break through in the same way.\textsuperscript{777} UK courts, like their US counterparts, adhere to an objective theory of contract,\textsuperscript{778} but they are often reluctant to apply the BJR, especially because of the strong power exerted by company directors. However, this reluctance of UK courts is offset by the cautiousness they must have when interpreting the contractual terms of the articles of association and other side agreements as a result of the objective standard set by the law of a reasonable director.\textsuperscript{779} Furthermore, UK courts should be prepared to deal with situations where there is lack of clarity as to who should take responsibility for fiduciary duties in the investment chain, especially when members are simultaneously managers.


\textsuperscript{777} See Davies, Paul L., \textit{Gower and Davies’ Principles of Modern Company Law}, cit., pp. 493-494 (claiming that ‘The Law Commissions thought such a rule unnecessary in the United Kingdom; and there is certainly a risk with the business judgment rule that the courts will come to regard cases where the procedural standards have not been met as presumptively negligent. The Commissions thought that one could expect the courts to be alive to the probability that they are better at dealing with the conflicts of interest than with the assessment of business risks and to the desirability of avoiding the luxury of substituting the courts’ hindsight for the director’s foresight’). Also see Languado Giraldo, Carlos Andrés, cit. p. 147 (arguing that the United Kingdom adopts a low / implicit model of application of the BJR. He says that ‘Accordingly, a low model of application of the BJR is the one embraced by the United Kingdom where, despite the inexistence of a legal structure called the business judgment rule’, its elements, and the general understanding of its functioning have been implicitly recognized by the courts, providing, at least facially and psychologically, the lowest degree, of certainty to the directors’)

\textsuperscript{778} This is clear in the judgements included in the sample of case law adjudicated by UK courts.

\textsuperscript{779} See Davies, Paul L., \textit{Gower and Davies’ Principles of Modern Company Law}, cit. pp. 488-490 (explaining that historically common law was based on a low standard of care because it was subjectively construed by courts).
The BJR is foreseen in Portuguese law. However legal commentators, mostly influenced by the debate on the subject that has taken place in Germany, have framed the rule within the scheme of civil liability, and tend to say that it operates first and foremost as an exclusion of culpability on the side of the manager or director. This is different from the way the BJR is viewed in the United States, its native home. It is seen there as as a rule on how courts will evaluate directors’ decisions, rather than as a construction of tort law.

Courts and legal doctrine in Italy have accepted the BJR, at least regarding the publicly held company (società per azioni). Italian courts tend not to evaluate the merits of a business judgment unless decisions are taken without the care that is required from managers by the nature of their job and by their specific skills. French and Spanish Courts do not use the BJR as a standard rule of review.

In all six jurisdictions, shareholders and other stakeholders share an expectation that managers and directors will act in an informed and fair manner. Plato’s above-noted advice counts for little if managers are unable to provide convincing evidence that they have done everything possible to keep themselves, the company and shareholders informed.

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780 See Article 72 (2) of the Commercial Companies Code. This provision was also included upon the legislative reform of the Decree-Law 76-A/2006, 29 March. The Portuguese legislature sought inspiration not only in the American rule, but also in § 93/I of the AktG which was altered by UMAG as of 22 September 2005.

781 See Montalenti, Paolo, ‘Amministrazione e controllo nella società per azioni: riflessioni sistematiche e proposte di riforma?’, Rivista delle Società, vol. 58, 1, 2013, pp. 42-77 (saying that “…il merito della gestione, e cioè il contenuto delle scelte manageriali è assistito – il punto è pacific anche nel nostro ordinamento – dalla c.d. business judgment rule: le operazioni gestorio degli amministratori non sono sindacabili, né dal collegio sindacale né dal comitato audit né dai revisori né dal giudice, se non in caso di manifesta irrazionalità [underlined by the author]).

782 See Tribunale di Milano, 10 febbraio 2000, Giu. Comm. 2001, II 326 (where the court held that ‘Nell adempimento delle obbligazioni verso la società, l’amministratore deve osservare la diligenza del mandatario, che non può prescindere da un connotato di adeguata perizia consistente nella prudenza ed avvedutezza in relazione a quelle attività, negoziali e materiali, tipicamente implicate dalla gestione societaria – commerciale’) (While fulfilling the obligations toward the company, the director must observe the diligence of the agent, which cannot withdraw from a standard of adequate expertise based upon prudence and foresight in relation to that contractual and material activity, typically inherent to corporate management’). Also see Article 2392(1) of the Italian Civil Code providing that ‘Gli amministratori devono adempiere i doveri ad essi imposti dalla legge e dallo statuto con la diligenza richiesta dalla natura dell’incarico e dalle loro specifiche competenze. Essi sono solidalmente responsabili verso la società dei danni derivanti dall’inosservanza di tali doveri, a meno che si tratti di attribuzioni proprie del comitato esecutivo o di funzioni in concreto attribuite ad uno o più amministratori’. (“The directors must comply with the duties imposed upon them by law and by the articles of association with the care required by the nature of the job and their specific skills. They are jointly and severally liable vis-à-vis the company for damages deriving from the failure to comply with such duties, unless it is the case that such duties are attributions of the executive committee or functions specifically assigned to one or more directors”).

783 See Joordan, Hendrik F., ‘A Comparative Analysis of Corporate Fiduciary Law: Why Delaware Should Look Beyond the United States in Formulating a Standard of Care, The International Lawyer, vol. 31, 1, pp. 133-161 (claiming that ‘…France’s standard of care, lacking Delaware’s protective business judgment rule, ranks among the most exacting standards in Western Europe’). The BJR implies a procedural process that French judges do not apply. The same happens in Spain, even though some literature has interpreted judgments as implicitly accepting the BJR. For a comparative overview of the BJR, see ‘Study on Directors’ Duties and Liability’, prepared for the European Commission DG Markt by: Carsten Gerner-Beuerle, Philipp Paech and Edmund Philipp Schuster (Department of Law, London School of Economics), pp. 108-118.
Nonetheless, the burden of proof regarding the meeting of the elements of the BJR generally rests on the plaintiff, and not on the defendant directors. This is in line with general principles of civil procedure, which hold that the responsibility for meeting the elements of a claim lies with the claimant. If plaintiffs manage to rebut the BJR because managers or directors were acting in a self-interested manner in blocking the transfer of shares, a piercing of the ownership veil should induce a shift in the burden of proof, and managers or directors would have to show a lack of bad faith or miscarriage of duties of care and loyalty regarding the protection of the interests of the company, its shareholders and other stakeholders. If they are unable to do so, the BJR or courts’ review according to the abstract standard of the *bonus pater familiae* established in Portuguese and French laws, or to objective standards established by law and case law in the United Kingdom, Italy and the United States, will not hold in their benefit.

Nevertheless, there is a grey area wherein the nature of relationships between managers and shareholders is somewhat murky. Often, a single shareholder or a group of shareholders hold a controlling block of shares in the company. Not infrequently, these shareholders are entitled to choose the members of the board. Managers or directors appointed under these conditions are attentive to the business policy of the company and are keen to satisfy the interests of those who elected them. In these situations, it is easy for controlling shareholders to manipulate the decision-making process in the company. Other scenarios include when shareholders also function as managers, and when shareholders behave in a passive way because they rely on the relational element that binds them to the company and other shareholders. Courts should be permitted to pierce the ownership veil and read beyond the contractual terms when the manipulation of control has been shown to hinder the advantages of business judgment.

iii. Piercing the ownership veil

The notion of piercing the ownership veil yields an increased degree of court intervention precisely because law is a byproduct. The piercing would entail scrutiny of the 'genetic' composition of the law, and an assessment of the need to modify its 'DNA'. Clearly,

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784 See Re Inverdeck Ltd [1998] 2 BCLC 242, [1998] BCC 256 wherein not only the registration of the transfer was refused, but also it was apparent that the director, who was also a member, did not succeed in distinguishing his role in the conflict.

785 One might ask whether managers are obligated to follow shareholders' resolutions instructing them to do something, even when these resolutions did not follow a proper procedure. I would say that, in this case, the relevant resolutions are invalid.
this approach represents a challenge to judicial systems and to courts that would be called upon to intervene in situations in which the principle of freedom of contract has traditionally kept them at arm’s length. This is how I picture the breaking of path-dependence in the PLLC, especially if such path-dependence translates into negative externalities or market inefficiencies. In other words, in cases of dispute similar to that with which I opened this chapter, courts should be able to examine what market agents are doing empirically, including the design of fiduciary duties. Still, breach of fiduciary duties is not the only circumstance in which courts should be able to interfere with consensual agreements and practice the above-mentioned ‘substance over form’ principle. They should be free to pierce the ownership veil in the presence of any of the issues listed in the clusters of legal issues in Part I. Legal issues in these clusters derive from problems of interpretation, problems concerning the functionality of restrictions on transfer of shares, and breach of formalities. Specifically, the veil of ownership should be pierced when:

1. Managers engage in dilatory schemes that damage the ability of shareholders to transfer their shares.
2. Managers indirectly hinder the exercise of property rights in shares.
3. The decision-making process is abusively held.
4. Restrictions tend to enhance directors’ control over the company and a clear definition of shareholders’ property rights is needed to establish the foundations for efficient bargaining.\(^786\)
5. Shareholders, despite having the right to take part in the decision-making process of the company, become dependent on directors to the point that the property rights they hold in their shares are unclear, and they lose the ability to overcome dilatory maneuvers undertaken by managers in the shadow of restrictions on transfers.
6. When shareholders who want to transfer their shares are in a weak(er) bargaining position in respect to other non-transferring shareholders, managers or directors.\(^787\)

\(^786\) This would be necessary especially if the restrictions that were introduced in the company’s contract were not intended to enhance directors’ or managers’ power in the company. In these situations, the enumeration of shareholders’ rights in the law is not enough.

\(^787\) One could fairly ask why the transferor needs to be protected. Did she not voluntarily put herself into the bargaining position ex ante by buying the shares under the terms of the company’s articles? Buying shares in a PLLC does not mean that shareholders must become prisoners of their own investment, especially if the company’s contract does not efficiently accommodate the expectations of the members throughout the life of the company.
7. When there is a deadlock caused by a minority shareholder which threatens to
dissolve the company.\textsuperscript{788}

8. When shareholders are not able to comply with their obligations \textit{vis-a-vis} third
parties (e.g., creditors) due to agency problems, bargaining failures, and hold-
ups in the company.\textsuperscript{789}

9. The transferor sells her share without obtaining consent \textit{stricto sensu}, and acts as
a trustee of the transferee so that she can indirectly exercise property rights in
the shares (e.g., management rights when she only is allowed to exercise
economic rights pursuant to the law and the articles of association).\textsuperscript{790}

10. The transferor causes a reduction in the social welfare of the company by
executing an un-consented transfer.\textsuperscript{791}

11. The control over the decision-making process is manipulated by managers or
directors, who act in a self-interested manner in blocking the transfer and,
therefore, hinder the advantages of the business judgment.

This taxonomy of cases is exemplificative. Depending on the dynamics of the
company’s contract, there may be other situations in which courts may be called to pierce the
veil of ownership to understand its structure and how it affects the governance of the company
or vice-versa.

\section*{3. Conclusions}

In this chapter, I have tried to determine who actually controls the PLLC. In light of the
nature of property rights in shares discussed in Chapter 2, I submit that the answer to this
question ultimately sheds light on how the legislator’s taming process affects the physiology

\textsuperscript{788} Naturally, restrictions may have been included in the company’s contract because the minority shareholder
bargained for this power ex-ante, otherwise she would not have invested in the firm. This is certainly a bargain
courts should honor. I am, however, referring to those situations in which the petitioner who is a minority
shareholder unreasonably seeks a winding-up order instead of accepting the majority’s view regarding their
shares. See, for example, Virdi v Abbey Leisure Ltd and others; Re Abbey Leisure Ltd [1990] BCLC 342,
[1990] BCC 60.

\textsuperscript{789} I am not questioning the principle of limited liability or the idea of ‘asset partitioning’. This recalls the
situations in which members of these companies are prevented from capitalizing on their investment, which can
jeopardize the legitimate expectations of third parties.

\textsuperscript{790} In case of conflict, ‘piercing’ will allow the court to understand who exactly exerts power in the company –
the transferor or the transferee?

\textsuperscript{791} In this case, piercing will also help the court investigate who effectively is controlling the company.
and morphology of the governance structure of the PLLC.\textsuperscript{792} This is another manifestation of \textit{pleiotropy} in law that exemplifies how the contractual setting based upon restrictions on transfers is liable to affect the governance of these business organizations. Their governance is delimited by a network of interaction among corporate constituencies which are linked by the fiduciary duties managers owe to shareholders, and shareholders owe to each other. Governance is also delimited by the interaction of corporate constituencies and their environments. Courts, as external agents, are part of the ‘institutional environment’ and are liable to change the dynamics of governance. This idea enhances the importance of fiduciary duties precisely because property rights in shares are tamed like the fox which, unlike its wild forebears, lacks some of the characteristics that make it absolute (valid against everyone) and generally unrestricted. This analogy hints at the construction of a general theory of corporate fiduciary duties for Europe that takes into account hybrid property rights,\textsuperscript{793} and is capable of introducing new formulations that are not merely designed with the old molds of contract and tort laws. The leap that courts, as gatekeepers, will have to make in this regard may be different in different countries.

The idea of piercing the ownership veil in the PLLC runs up against the perception of courts and adjudication in civil-law systems where judges are expected to interpret the law, but not to make law. As my argument for legal policy is a normative one, it could be implemented either through the legislature or by the courts with the available doctrinal tools (e.g., teleological interpretation). However, I am not dogmatic as to how it would be implemented. Courts could be able to do it by themselves by employing specific doctrinal arguments based upon an explicit comparative method, for example. The idea of ‘piercing’ also challenges the understanding of courts and adjudication in common-law systems where courts tend to adopt an objective reading of the contract.

I am not oblivious to the fact that this understanding may raise questions to which problems that more positivist readings of the role of courts call attention. The ‘irrationality’ of courts, the threat to the separation of powers because courts take over prerogatives that belong to the legislature, the fear of interfering with freedom of contract, and the fear of judicial supremacy are some salient examples. However, from a normative perspective there is no fear of risk if we think of PLLC law as a byproduct of private ordering manifestations or an extended phenotype. This would require that courts observe market agents empirically before adjudicating and engaging in ownership piercing.

\textsuperscript{792} For a reference to the taming process I refer to in the text, see Part II, Chapter 1.
\textsuperscript{793} See Part II, Chapter 2.
CHAPTER IV

PROTECTING ENTITLEMENTS IN THE PLLC:
AN INQUIRY INTO THE RULES OF PROPERTY, LIABILITY AND
INALIENABLE

‘How fleeting are the wishes and efforts of man! How short his
time! And consequently how poor will be his results, compared
with those accumulated by Nature ‚. Can we wonder, then, that
Nature’s productions should be far “truer” in character than man’s
productions; that they should be infinitely better adapted to the
most complex conditions of life, and should plainly bear the stamp
of far higher workmanship?’

Darwin, Charles, The Origin of Species by means of Natural

‘…sound work in law can and must build on and borrow the direct
operational approach so well tested in the Services, or in
engineering’.

Llewellyn, K. N., ‘The Modern Approach to Counseling and
Advocacy – Especially in Commercial Transactions’, Columbia

Introduction

Starting from the premise that fiduciary duties alone are not sufficient to overcome
bargaining problems in the PLLC and to protect hybrid property rights in shares,794 this
chapter investigates whether or not there are alternatives in corporate law to well- delineated
property rules. One could ask: why would we expect fiduciary duties to accomplish this? The
legal imposition of fiduciary duties has been seen as a remedy drawn upon equity, which can

794 See Whincop, Michael J., ‘Painting the Corporate the Corporate Cathedral: The Protection of Entitlements in
confer a range of entitlements on the shareholder, which, he argues, have the object not of deterring fiduciary
duties as such, but of structuring bargaining to encourage trades who are likely to be Pareto-superior).
do no harm, not only due to its legal component, but also due to the ethical relationship established on trust that bond the parties. However, the reality of the matter is that, often, fiduciaries’ interests coincide with the interests of those who trust. Moreover, monitoring the actions of fiduciaries can be costly, especially when they are supposed to be aligned with the two fundamental duties of loyalty and care. Furthermore, the external monitoring of fiduciaries is frequently impracticable, or simply impossible. Thus, the purpose of this chapter is to determine if liability and inalienability rules can work as good alternatives to property rules to solve problems of governance in the PLLC, to surpass bargaining problems and to protect entitlements in these business organizations. To this end, I look at property, liability and inalienability rules and try to understand which of these types of rules best serve the interests of shareholders and other corporate constituencies. It is difficult to measure this without having access to disposable values and data that allows the drawing of an exact profile of the circumstances in which applying one or the other rule would be preferable. Moreover, while evaluating the efficiency of each type of rule, I stress the variable of welfare maximization. Hence, this chapter presents a theoretical model based on assumptions that involve two layers of cognition - the layer of the market and the layer of the aggregate or society. Both layers are read in accordance with Pareto efficiency. I adopt the following concept of efficiency. A transfer of shares is efficient or optimal if there is no further transfer that makes everybody better-off. Another way to view it might be that a transfer is efficient if there is no further transfer that can make someone better-off while making nobody worse-off. Because efficiency is a social concept, I look at both levels of my theoretical model and try to understand how resources can be allocated so as to maximize benefits with the least cost.

The first layer is that of the individual shareholders who, facing an offer of transfer of shares, behave pursuant to the benefits and losses each and every single one of them will incur with the transaction. This implies awareness of the objectives of shareholders regarding their holding of shares in the company. For instance, at some point, shareholders may wish to be free to sell their shares, thereby diversifying their investment. They may also wish to retain this as a personal privilege, on the basis of the notion that a widespread ability to do so might cause distortions in the company.

The second layer of the theoretical model regards the aggregate, that is, the society, as a whole. It tries to establish the welfare effects deriving from a scenario in which a shareholder

795 In this dissertation, I am not using the concept of Kaldor-Hicks efficiency.
wants to transfer her share. At this level, I consider the regulator (e.g., legislators, politicians, and courts) and the enforcement costs related to the types of rules designed by it to sanction such type of transactions. Part I has shown the economic relevance of the PLLC. Consequently, I make the case for the centrality of an appropriate regulatory framework. As mentioned above, the crux of the problem is the fact that the default rules included by shareholders in their articles of association can be avoided by the transferor and the transferee. I call this the 'problem of un-consented transfer of shares'.\textsuperscript{796} Because it leads to inefficient outcomes,\textsuperscript{797} I look at the types of rules applicable in each jurisdiction to the transfer of shares. I try to establish their positive and negative welfare effects, by taking into account the scenario of an un-consented transfer of shares. I also look at the enforceability of these rules. Different enforcement levels may impact shareholders’ incentives to hold on to their shares; they may impact on shareholders’ commitment toward their company (e.g., if the incentive structure does not favor collective action). This exercise should hint at whether or not law should be reformed, and if so, in which direction (e.g., by making it more or less difficult for a would-be seller to sell her shares).\textsuperscript{798} It also hints at the ideal role of lawyers in law reform and market design. Hence, the question underlying the investigation at this level is: what kind of rule is most welfare-enhancing?

Additionally, in light of the concept of share presented in Chapter 2, which is related to the nature of the rights shareholders hold in it, this chapter aims to disclose the paradigm adopted by legislators to allocate and protect legal entitlements (property rules, liability rules

\textsuperscript{796} Again, one could ask: Why is it a problem? Default rules are so termed precisely by dint of their avoidability. Otherwise, they would be mandatory rules. I am referring in the text to those situations in which transferor and transferee breach the articles of association to execute the sales contract, instead of contracting around the default rule by changing the articles of association.

\textsuperscript{797} Absent market failure, one would expect that parties, by contracting around default rules, do not want to achieve inefficient results. The fact is that parties seem not to care about changing the rules they did not opt out of in the first place, possibly because it is too costly, which leads them to litigation. For a possible link with this question, which basically asks why shareholders do not opt out of rules ex ante, and prefer to breach them ex post, see Whincop, Michael J., ‘Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law’, \textit{Oxford Journal of Legal Studies}, vol. 19, 1999, pp. 19-50 (32) (stating that ‘… the value of a contractual term depends in part on the extent of its use by others. Products that feature network externalities are problematic, because there is no guarantee that a free market will produce them in optimal quantities. Firms may opt for more commonly used terms of lower intrinsic value because of the positive network externalities associated with them. This, I suggest, could be true of standard-based terms like fiduciary duties. One might accept the deficiencies of fiduciary duties sufficiently to believe that parties should be able to contract out of them. However, given the diffuse risk that shareholders face, any replacement contractual term is likely to be highly open-ended and standard based, and face a significant risk of misinterpretation. Accordingly, shareholders may accept a term which they recognize as inferior because of the external effects conferred on the term because of its widespread use’).

\textsuperscript{798} In this case, a solution that could be explored to strengthen the law is to make it more costly for existing shareholders to sell, therefore creating incentives for them to invest more in the company (after all, if shareholders are stuck with their shares, they will try to maximize their value).
or inalienability rules) in the PLLC. Teasing out these paradigms will help to clarify legislators’ views on market functioning. It is often the case that property rights are not well defined, especially in jurisdictions in which business organization law has exploded in the last several decades. On the other hand, shareholders have been justly described as the bearers of the residual risk of the firm, since their claims come last after the claims of the company’s creditors have been satisfied. Their contractual position in the company’s contract is naturally incomplete and contingent. Thus, investigating the relevance of property rights in shares and the choice of this over other forms of protecting entitlements will shed light not only on the reasons legislators opt to protect some entitlements and not others, but also on the potential that rules have to shape the relationships between corporate constituencies, and to overcome the fallback of contractual incompleteness and bargaining failures in these corporations. Ultimately, this chapter attempts to clarify the need for reform of rules toward greater liberalization of the PLLC. In other words, it aims to determine if the absolute freedom to sell shares is more efficient, on balance, than a restrictive approach.

Section 1 looks at the features of the market and how entitlements are allocated within market dynamics. It also contextualizes the creation of a theory of defaults informed by an entitlements framework. Section 2, drawing upon the seminal work of Guido Calabresi and A. Douglas Melamed, presents four types of rules liable to protect entitlements in the PLLC: Property Rule 1, Liability Rule 2, Reversed Property Rule 3, and Reversed Liability or Rule 4. This section borrows the entitlements framework developed by those authors and applies

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799 See Calabresi, Guido and Melamed, Douglas A., ‘Property Rules, Liability Rules, and Inalienability: One View of the Cathedral’, vol. 85, No. 6, 1972, pp. 1089-1128 (asking ‘In what circumstances should we grant a particular entitlement? And ‘In what circumstances should we decide to protect that entitlement by using a property, liability, or inalienability rule?’). Also see Whincop, Michael J., ‘Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law’, Oxford Journal of Legal Studies, vol. 19, 1999, p. 30 (stating that ‘Any attempt to understand the structure of costly bargaining needs to be premised on a description of how the law allocates and divides entitlements between parties, and protects the entitlements so allocated. Especially in the closely held corporation context, the exchanges between actual and potential coalition partners are significantly affected by bilateral monopoly conditions. That is, the parties are substantially locked into dealing with each other’). Also see Kaplow, Louis, and Shavell, Steven, ‘Property Rules versus Liability Rules: An Economic Analysis, Harvard Law Review, vol. 109, N.° 4, pp 713-790 (providing an economic analysis to answer the question of whether or not property should be absolutely protected by property rules, or by liability rules).

800 See Scott, Kenneth E., ‘Agency Costs and Corporate Governance’, in Newman, Peter (ed), The New Palgrave Dictionary of Economics and the Law, New York, Palgrave, 2002, p. 26. Also see Posner, Richard A., Economic Analysis of Law, New York, Aspen Publishers, 2007, p. 429 (asking why the corporation has shareholders rather than just creditors, since investors are really just a type of creditor. He says the answer lays in the fact that ‘...there is an ineradicable uncertainty about the level of profits, and the shareholders are simply the investors who have agreed to be the recipients of this uncertain stream of earnings rather than negotiating for a fixed return’).

801 As is noted by Ian Ayres, before Calabresi and Melamed’s famous Rule 4, this was previously discussed by Atwood, James R., ‘An Economic Analysis of Land Use Conflicts’, Stanford Law Review, vol. 21, N.° 2, 1969, pp. 293-315. However, it appears that Calabresi and Melamed were better at marketing their views.
it to the un-consented transfer of shares. This is undertaken in the context of the two-layer model which considers at layer 1 the market, and at layer 2 the aggregate, or society. Following the principle of Pareto efficiency, this section tries to clarify which types of rules – property rules, liability rules or rules promoting inalienability – are best suited to protect the interests of the company, the shareholders and the society, in general. It also suggests mechanisms such as a second-price auction which lawyers can use to draft the relevant contractual setting. Section 3 concludes by stressing the importance of a normative construction based on property rules that gives shareholders the chance to affirm their hybrid property rights in the shares of the company.

1. The market and the production of new forms through natural selection: A promising new theory of defaults based upon a framework of entitlements

I have tried to show in Chapter 1 how rights in corporate law are bound together by a web of complex relations. Any change in legal relations, regardless of changes in the environment itself, will necessarily affect others. Besides, the crossover between different legal institutions is a general phenomenon. The complex structure of entitlements in the PLLC, their allocation and the effects of the existing legal mechanisms for their protection is illustrative in this regard. The concept of legal entitlement is very broad, for it embodies all sorts of rights. To define them, I once more resort to Hohfeld’s scheme of jural relations. I have submitted that ‘share is a legal configuration of a complex right in Hohfeldian terms. The Hohfeldian conception of ‘property’ or ‘legal interest’ is that of a complex aggregate of rights (or claims), privileges, powers, and immunities. In other words, property rights are a ‘complex aggregate of jural relations’. According to Hohfeld’s scheme of jural relations, an investigation of the concept of entitlements in the PLLC entails a consideration of who owns what in a particular context. For example, if shareholders have the right (or claim) to receive dividends, managers have a correlative duty to distribute them. If managers have the ‘power’ to refrain from registering a transfer of shares in the register of members, the transferor and transferee have a corresponding ‘disability’ to prevent them from doing so. Alternatively, if a

804 See Part II, Chapter 2 above.
particular shareholder holds a ‘privilege’ to sell her shares, other non-transferring shareholders have the opposite ‘duty’ to facilitate this transfer.\textsuperscript{805} 

Before delving into the efficiency of legal rules, I now take a step back and look at the market that forms the ‘DNA’ of legal solutions. This is genetic material that legislatures are not free to ignore.\textsuperscript{806} I highlight both the organic and inorganic features of the market to which market agents are exposed. Also here, natural selection acts through the preservation and accumulation of beneficial variations. These variations do not occur suddenly. They take time. They are effected by a slow, long-standing process of change. Ultimately, every element and condition of the market is improved. This improvement allows market agents to organize themselves into firms by hiring human capital and contracting factors of production that will contribute to the advancement of the organization.\textsuperscript{807} The question is, to which standard of advancement is natural selection likely to lead? We know that natural selection is likely to lead to the specialization of corporate constituencies inasmuch as this specialization allows them to better perform their functions. Furthermore, and considering that market agents are continuously seeking to maximize their utilities in the market economy, natural selection has the potential to prevent retrogression in the organization by fitting each constituency to its role in the firm which, if otherwise, would have been taken by useless and ill-fitting elements. Entitlements are allocated accordingly. That is to say, they are allocated to those who value them most considering the role they play in the advancement process of the firm. Nevertheless, if organic beings to which I compare the market, as well as its elements such as firms, households and even governments tend to get better or ‘rise up the ladder’, how is it that some less-developed forms still persist?\textsuperscript{808} Do not all organic beings, including the market, possess an innate tendency towards perfection? Natural selection does not necessarily imply progressive development. Change will come if it is advantageous for each market agent within her web of complex relations. It appears that lower forms have been retained because

\begin{footnotesize}
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\item See Hohfeld, Wesley Newcomb, ‘Some Fundamental Legal Conceptions as Applied in Judicial Reasoning’, cit., pp. 16-59 (clarifying several terms that are typically included in the rights-duties binomial by exploring his scheme of ‘opposites’ and ‘correlatives’).
\item The articles of association with practical solutions preserved for almost one century contain some of this genetic material.
\item I do not mean to convey the idea that some organisms are ‘higher’ or ‘better’ than others. This would be a view rejected by most contemporary evolutionary theorists. What I mean is that some organisms are more complex than others. This does not imply, however, that they are necessarily the ones best adapted to their environment.
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they have not been subject to competition or, at least, noticeable competition. It may also be that in some cases there was indeed retrogression of the organization. In any case, variation among organic beings is contingent upon a number of complex relations. What is more, their preservation depends on the environment and on each other organisms with which each being has come into competition. The preservation of variation is also related to inheritance from other beings who were themselves equally involved in an intricate web of relationships. This is another advantage of the firm. Besides surpassing transaction costs, which would be higher if market agents decided to hire factors of production through a chain of arms-length contracts, the firm potentiates the convergence of character of corporate constituencies through the business organization, even if these constituencies do not share the same genetic background. However, this does not affect the diversity in structure, constitution and corporate habits caused by the complexity of relations in the market and in the firm. Variations are accepted, and tend to be kept, if they are advantageous for the welfare of each corporate constituency. Given the principle of inheritance, certain actions, measures, decisions and sorts of behavior tend to be inherited, and create a noticeable path-dependence in the firm. Market choices obey a principle of natural selection that in the struggle for life through cooperation and competition is viewed as a source of advancement in the organization. There are, however, limitations to evolution. Not all minor variations (including the intermediary ones) are advantageous. This is a problem to which legislators are not immune, especially if manifestations of socio-economic path-dependence are on the way. This is where legal engineering, that is, a theory of corporate default rules informed by an entitlements framework fits in.

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809 One might question whether competition will necessarily lead to more complex forms. It is indisputable, however, that complexity has its cost, and it might not be the best adaptation. Complex adaptations may also be lost if their costs outweigh their benefits.
810 Refer to Part 1 Overview.
2. Property and liability rules and inalienability: engineering the protection of entitlements in the PLLC

i. Calabresi and Melamed’s entitlements framework

In their seminal paper, Property Rules, Liability Rules and Inalienability: One View of the Cathedral, Calabresi and Melamed present a framework for entitlements. They open their discussion with the general problem of entitlement. The state must decide to whom to give an entitlement, and also must make other difficult second-order decisions in respect to the transfer and trade of entitlements, which side in a dispute should win, and the kind of protection that should be granted. They consider three types of entitlements, and distinguish between them insofar as they are protected by property rules, liability rules or inalienability. They note that while this categorization is not absolute, it helps them to sort out the reasons behind legislators' choices of certain entitlements over others. The authors highlight the fact that most entitlements are mixed.

Property Rules, Liability Rules and Inalienability: One View of the Cathedral explores two primary questions. First, under which circumstances should a particular entitlement be granted? Second, in which circumstances should the legislator decide to protect that entitlement by using a property or liability rule, or by making it inalienable? The authors address the first question by considering the issues of efficiency, distribution, and justice. If there are transaction costs, entitlements are allocated to those who value them most. In addition, Calabresi and Melamed argue that distributive considerations should also be made. On one hand, economically efficient allocation of entitlements, that is to say Pareto-optimal solutions, varies with wealth distributions. On the other hand, distributions of wealth imply their own Pareto-optimal allocation of resources. This is why, they explain, distributions of wealth may affect a society's choice of entitlements. As to justice considerations, the authors seem to have some difficulty in extracting a normative statement. Perhaps, because the concept of justice itself is too broad, Calabresi and Melamed instead define efficiency and

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814 This is what Pareto optimality stands for. This has been generally accepted in the literatures of law and economics. For a different approach, see Ayres, Ian, Optional Law: The Structure of Legal Entitlements, Chicago, London, The University of Chicago Press, 2005.
distributions of wealth. They do not extend the ‘efficiency-distribution locution’, to use their own expression, to justice and equality considerations. However, justice, or better, ‘other justice reasons’, seems to be a back-seat concept that is pulled out whenever there is a need to delve into other reasons that, even though linked to efficiency, are autonomous or, if linked to distributional goals, cannot be fairly described in terms of equality.

The authors advance three types of rules liable to protect entitlements. First, they refer to property rules, which they define as rules that protect entitlements which can be voluntarily transacted provided the price of the entitlement is agreed upon by its holder. Second, liability rules protect entitlements which can be taken without the consent of the respective holder or be destroyed, provided that she who takes the entitlement or destroys it pays an objective value for it. Liability rules involve state intervention, in particular to set up the respective compensation. Such intervention is higher than state’s intervention through property rules. Third, entitlements are inalienable when their transaction is not allowed under any circumstances. The state intervenes in respect to these entitlements not only to set forth compensation if they are taken or destroyed, but also to assure they are not sold.

Calabresi and Melamed demonstrate how entitlements are allocated, and how each of these rules operates by using the classic example of a nuisance or pollution problem. The authors refer to three rules that are traditionally applied to the nuisance-pollution problem. First, polluter A may not pollute unless his neighbor, B, allows him to do so. B has the right to clean air and, therefore, A is not permitted to pollute. In this case, an entitlement is given to B, and it is protected by a property rule. Second, A may pollute, but B is entitled to be compensated for damages. In this situation, B is still granted an entitlement, which is protected by a liability rule. Third, A has the right to pollute at will and B cannot stop him or ask for damages. If B wants to stop A, B must pay off A. Here, the entitlement is awarded to A, and is protected by a property rule and a liability rule (reverse property rule). Calabresi and Melamed add a fourth rule that consists of the following. When A tries to pollute, B can stop A from polluting, but must compensate A for her loss (reverse liability rule). This last rule poses innumerable difficulties. It does not prevent freeloader and holdout problems, especially if there are several neighbors (‘B’s). It also makes it difficult for courts to determine the relevant benefits tax. The authors suggest that these difficulties have hindered scholars and courts from adequately developing a ‘Rule 4’ type of formulation. However, Rule 4 may be important vis-à-vis goals of efficiency and distribution, particularly if the choice between

\[815\] As to economic efficiency and wealth distribution preferences, one must think like this: ‘there must be good efficiency and distributional reasons for preferring an entitlement to one good over another’.
liability entitlements is based on the asymmetry of the costs of collective determination, pretty much like the choice between property entitlements can be based on asymmetry of transaction costs.\textsuperscript{816}

The analogy to the polluter is the shareholder who tries to sell her share to a third party to whom other shareholders of the PLLC object. In respect to transfer restrictions the following rules can be observed:

- Property Rule 1: the sale cannot be executed without consent.\textsuperscript{817}
- Liability Rule 2: the sale can be executed, but the shareholder must pay for damages.
- Reverse Property Rule 3: there is no transfer restriction.\textsuperscript{818}
- Finally, pre-emption rights, even if they are frequently coupled with property rules, are not property rules. They closely resemble Calabresi and Melamed’s Rule 4. A can sell, but the other shareholders may stop her by paying her the same price. Putting it differently, they pay her the same price to prevent her from giving her share to the buyer they do not want. This situation can be equated with that of the polluter who can be stopped, provided she is paid for her lost profits.

An interesting aspect of Calabresi and Melamed’s line of reasoning is that they assume costless bargaining as a means to achieving Pareto optimality. The authors maintain that individuals know what is best for them and, therefore, they bargain. This is the principle underlying their concept of efficiency. When no transaction costs exist, the choice of entitlements is irrelevant, a proposition that is an extension of the so-called Coasean Theorem. But this is rather utopian. Thus, the question that poses itself is how to bargain in order to achieve Pareto efficiency. From an economic point of view, Calabresi and Melamed would use property rules if they believed that the polluter could more cheaply avoid or reduce the costs of pollution than the pollutee.\textsuperscript{819} This hypothesis, however, relies on the idea that the transaction is cheap or even cost-free. The moment that that is no longer the case, everything changes and the bargaining is most likely to fail. This is particularly true if the number of parties increases, making extremely costly (due to holdout and freeloader problems) the buying out of the other party(ies). These difficulties would still exist even if the party trying to

\textsuperscript{816} See Calabresi, Guido and Melamed Douglas A., cit., pp. 1121.
\textsuperscript{817} This is the normal rule in Germany or Austria, for example, when a GmbH agreement stipulates a restriction on transfer (although the seller could sell if consent is unreasonably withheld). It is also the default rule under Portuguese, French and US laws such as DLLCA §18-702. In the particular case of the United States, however, economic rights can be transferred without consent.
\textsuperscript{818} This is the default rule in Italy, Germany and Austria.
\textsuperscript{819} See Calabresi, Guido and Melamed, Douglas A., cit., p. 1118.
buy the other out placed a higher value on the good in question.\textsuperscript{820} So, when transaction costs are too high, particularly on both sides, the allocation of an initial entitlement, even if incorrect from the point of view of economic efficiency, will most likely not be altered through bargaining. It is in these circumstances that liability rules can be applied as a protection.\textsuperscript{821} As Calabresi and Melamed explain, the cost of establishing the value of an initial entitlement by negotiation is frequently so great that even though a transfer of the entitlement would benefit all concerned, such transfer will not occur. If a collective determination of the value is available instead, the beneficial transfer would quickly come about. Thus, liability rules are used where markets fail.\textsuperscript{822} This is the essence of these rules. Additionally, there are other reasons for preferring liability rules to other types of rules. They can be used in the case of accidents. Damages are settled by their collective valuation. Liability rules facilitate a combination of efficiency and distributive results which would be difficult to achieve under a property rule alone. They can be employed for redistributive goals. Moreover, if transaction costs and bargaining barriers are present and relevant (e.g., high), and we are not certain who is the ‘cheapest cost avoider’, economic efficiency is not attained by property rules, but rather by liability rules.\textsuperscript{823}

Calabresi and Melamed focus mostly on property and liability rules. However, they explain in which situations inalienability should be afforded to protect entitlements. They maintain that inalienability may fulfill efficiency objectives in situations of paternalism, self-paternalism, and externalities. Paternalism is an exception to Pareto optimality in the sense that it does not take into account the individual’s valuation of what is best for her. Under the

\textsuperscript{820} See Calabresi, Guido and Melamed, Douglas A., cit., p. 1119 (explaining how in situations in which transaction costs are not symmetrical, that is, transaction costs are not high on both sides, property rules can still be used).

\textsuperscript{821} Liability rules help surpass the freeloader and holdout problems, which is something parties cannot always do through bargaining because it is too costly. See Calabresi, Guido and Melamed, Douglas A., cit., p. 1107 (saying, apropos the example they give on eminent domain, that ‘If a society can remove from the market the valuation of each tract of land, decide the value collectively, and impose it, then the holdout problem is gone. Similarly, if the society can value collectively each individual citizen’s desire to have a park and charge him a “benefits” tax based upon it, the freeloader problem is gone. If the sum of the taxes is greater than the sum of the compensation awards, the park will result’).

\textsuperscript{822} See Calabresi, Guido and Melamed, Douglas A., cit., p. 1110 (arguing that ‘… a very common reason, perhaps the most common one, for employing a liability rule rather than a property rule to protect an entitlement is that market valuation of the entitlement is deemed inefficient, that is, it is either unavailable or too expensive compared to a collective valuation’).

\textsuperscript{823} See Whincop, Michael J., ‘Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law’, \textit{Oxford Journal of Legal Studies}, 1999, vol. 19, pp. 19-50 (exploring this idea. The author assumes a relatively low bargaining cost, which is a reality he acknowledges particularly in respect to closely held corporations, and therefore considers that property rules are the best protection of entitlements in these circumstances. However, he acknowledges that whenever there are asymmetries of information, liability rules may work to facilitate the transaction by nudging the parties to disclose their valuations of the assets. I will claim later in the text that it can be created a scheme by which property rules can exert a similar nudging effect).
corset of paternalism, the individual is not able to choose what is best for herself and, therefore, the state or other individuals make that choice for her because they know what is going to make her better off. This is typically based on a judgment that the individual was not in a position to choose best for herself when she made a certain choice. This is the rationale to determine when contracts are void or inexistent rather than avoidable, for example. Self-paternalism rests on the understanding that the individual herself limits her own actions because she knows what is best for herself. This does not contradict Pareto efficiency, in as much as no one but the individual knows what is best for herself. Self-paternalism justifies cases in which the law determines the invalidity of contracts entered into by drunk parties, coercion, error, or undue influence. The third case, in which entitlements are inalienable, is that of a transaction that creates considerable externalities or costs to third parties that are not collectively measurable by an objective and non arbitrary standard. These externalities include what has been recurrently called moralisms.

Calabresi and Melamed describe lawyers’ work as solely based on an ad hoc case law approach from which they extract relevant categories. This, like model building, has its own limitations and only provides one view of the cathedral. Despite the caveats they present, the authors hold that their model may be applied in other fields of law. Michael Whincop has applied it, for example, to issues of corporate law, and tried to paint the cathedral that lawyers are said to give only one side of. I also apply it to treat the selling of shares of PLLCs for which consent stricto sensu is required. I concentrate on property and liability rules. Nevertheless, I will refer to inalienability, considering the system of transfer of property rights in the selected jurisdictions, and the definition of shares discussed in Chapter 2.

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824 See Calabresi, Guido and Melamed, Douglas A., cit., p. 1114 (affirming that ‘...the most efficient pie is no longer that which costless bargains would achieve, because a person may be better off if he is prohibited from bargaining’).
825 See Calabresi, Guido and Melamed Douglas A., cit. p. 1113 (referring to most of these examples).
828 I am investigating which types of rules are more advantageous from an entitlements’ point of view. However, other approaches could be followed, such as looking at the choice of rules from the perspective of administrative costs, risk aversion, and income distribution. See Kaplow, Louis, and Steven Shavell, cit., pp. 739-745 (making considerations of this kind whilst comparing property and liability rules in the context of externalities).
ii. The entitlements framework applied to the transfer of shares and a two-layer theoretical model

I apply the entitlements framework to the transfer of shares by a member of a PLLC for which consent *stricto sensu* is required. I have thus far highlighted property rights and, depending on the circumstances as we shall see below, the legislators of all six jurisdictions treat the transfer of shares under property rules. There may be several reasons for this. Legislators may have wanted to insulate members from risk, whilst they would not be protected under a liability rule due to the uncertainty of takings and the magnitude of damages. Furthermore, for distributive reasons, property rules favor owners over takers.\(^\text{829}\) This is indeed reconcilable with the closed nature of these business organizations. Perhaps another reason is the fact that the holder of property rights does not depend on the other party’s ability to pay (if the other party cannot pay, a liability rule cannot be enforced). However, entitlements protected by these property rules are allocated differently in the six jurisdictions. In Portugal, Spain, France and the United States, legislators have by default allocated the respective entitlements to the company.\(^\text{830}\) UK law determines that shares and interests of any shareholder are transferable in accordance with the company’s articles.\(^\text{831}\) Italy establishes by default the freedom of transfer, unless otherwise established in the articles of association. In the particular case of the United States, the laws of the states of New York and Delaware allow the transfer of economic rights but not the membership.\(^\text{832}\) This means that, in order to transfer her membership interests, the transferor needs to obtain the consent of the other non-transferring members or possibly managers or directors – a property rule.

In most cases in the samples collected, shareholders include restrictions on transfers (*consent stricto sensu*), which may be the consent of shareholders or the company, pre-emption rights or rights of first refusal (which are equivalent to Rule 4) or other more

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\(^{829}\) See Kaplow, Louis and Steven Shavell, cit., pp. 770 – 771 (considering how owners are ‘... well insulated from risk under property rule protection, whereas they are not fully shielded under a liability rule, assuming that there is uncertainty as to the magnitude of damages’. They go on saying that as for the distribution of income, they note that ‘...property rule protection favors owners over takers. Under property rule protection, when owners sell things, they tend to receive more than the value they place on them; they are generally able to extract some of buyers’ surplus. Under the liability rule, owners’ valuation is all that they are in principle awarded, and when damages are too low, they will suffer undercompensated takings or pay bribes to others to refrain from taking things’).

\(^{830}\) See Part 1, Chapters 2 and 3 to learn about Article 228(2) of the Portuguese Commercial Companies Code, Article 107 of the Spanish Law 1/2010, Article L 223-14 of the French Commercial Code, 18-702 Delaware Limited Liability Company Act and §603 New York Limited Liability Company Law.

\(^{831}\) See section 541(1) of the Companies Act 2006.

\(^{832}\) See Article 2479 of the Italian Civil Code and §18-702 Delaware Limited Liability Company Act and §603 New York Limited Liability Company Law.
sophisticated restrictions. I have stressed the hybrid nature of property rights in shares, and their 'domestication' by the legislator, which puts to the test the idea that the owner of a thing has the absolute right to prevent others from taking it. The wish shareholders have to maximize their individual utilities must be reconciled with welfare concerns, that is, with the maximization of the firm’s value and corporate wealth. I also look at the aggregate and try to perceive how the framework of transfers can affect the society as a whole. In light of the problem of un-consented transfers, the underlying question of this section is: Would the company, shareholders, and society in general be better off if transfer of shares were rather treated under liability rules or made inalienable? I start with two hypotheses. The first hypothesis is the following. If transferors make relatively ambitious offers, they decrease the likelihood that non-transferring shareholders will execute hold-ups or hold-outs. An offer is ambitious if it consists of the transfer of the share, plus market idiosyncrasies. The transferee will pay the price and promise to add human and social capital to the company. The transferor will sell the share for a value that exceeds its actual value. The offer also has the potential to prevent bargaining failures in general. This will be the case because the company and its shareholders as well as managers see the transferee as a major asset for the company. This is so because the amount received for the share will greatly exceed the reservation price. The second hypothesis is: If legislators were to incentivize shareholders to maximize the firm’s long-term value, they would need to lock them into their shareholdings for a long time.

This scenario is filled with constantly shifting coalitions among shareholders and coalitions of shareholders with managers. In this setting, shareholders have difficulties in acting collectively. They hold-up others. Oftentimes, the situations resemble bilateral monopolies. Opportunistic behavior on the part of the parties results in frequent bargaining failures. In these situations, bargaining is obviously costly. Based upon the way law allocates and protects entitlements in respect to the transfer of shares, and considering the way shareholders allocate and protect entitlements in the articles of association, I will try to understand the structure of costly bargaining inside PLLCs. So, viewing articles of association

833 See Part 1 and Part II, Chapter 1 for a definition of the types of restrictions included in the articles of association of PLLCs in each jurisdiction.
834 See Kaplow, Louis and Steven Shavell, cit., p. 774. By 'absolute right' I do not mean an unrestricted right. In countries following the French civil law tradition as well as in German Speaking countries an absolute right is perceived as right against everyone (e.g., property) as opposed to a relative right (e.g., a contractual claim). However, absolute rights are not unrestricted.
as incomplete contracts, I consider situations in which there is an un-consented transfer of shares that triggers post-contracting between shareholders and other corporate constituencies.

Let us think of the following example. Shareholder A owns a share representing 55% of the company’s share capital (share $x$). She entered into a bank loan agreement with Bank Y in order to pay the employees and suppliers of a trading company she owned. Bank Y had knowledge of the commercial activity undertaken by shareholder A, and given that she was a long-standing customer of the bank, did not place obstacles in the way of granting the loan. The loan was to be repaid in instalments by the end of the first half of 2012. By that time, shareholder dividends would have been allocated. In February 2012, shareholder A entered into a share sale and purchase agreement selling share $x$ to Mr. D without the company’s prior consent. Mr. D. was involved in several enforcement proceedings that had been brought against him for non-payment of the debts accumulated in his existing business. As a consequence of Mr. D’s purchase of share $x$, his personal creditors believed he had sufficient assets to clear his outstanding debts and expected to be paid through the execution of the relevant enforcement proceedings. This is the example that is further discussed in the following subsections.

Let us assume that the law clothes the company and its residual claimants, that is, its shareholders, with the entitlement to the shares the transferor wishes to sell. This entitlement is allocated by means of a rule foreseeing pre-emption rights (reversed liability rule corresponding to the mysterious Rule 4), and couples it with the consent of the company if it does not wish to subsidiary exercise its right to pre-empt (property rule). This entitlement, however, could have been protected by a liability rule (Liability Rule 2) included in the articles of association by which shareholder A would be allowed to sell her share without consent as long as she compensated the company and other non-transferring shareholders.

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837 It may be questioned whether or not a 55% share is enough to control the company. However, this fact in itself does not leave aside the requirement to obtain consent to the transfer. Perhaps, being a majority shareholder gives the transferor enough confidence to execute an un-consented transfer. A minority shareholder may not display the same confidence.

838 While the sale of a majority share implies the transfer of control over the company, its economic value does not necessarily correspond to the nominal value of the share that has been sold.
A. Layer 1

(i) Allocation of shares when there is bargaining under conditions of perfect information

I take efficiency as the primary goal. If there is no further transfer that makes everybody better off, then I consider the current allocation of shares in the company to be efficient or optimal. Shareholders may hold shares for two opposite reasons. After staying in the company for a while, and receiving the dividends of their membership, shareholders may want to leave the company and invest elsewhere when a business opportunity comes along. Conversely, shareholders may not want shares to be transferable or to be sold easily if this may cause distortions in the company. Let us imagine that there is a status quo that non-transferring shareholders want to keep in the company. So, this is in line with the reason shareholders do not want shares to be sold. However, this status quo is freezing the value of shares, in particular because there is not an open market for them. It will likely provoke the retrogression of the company. According to the efficiency principle, the law and the articles of association that transcribed it should facilitate the transfer of shares when shareholder A (SA) values the share more than the non-transferring members, which as opposed to SA give more value to the prevailing status quo (VS_A > VS_B). Another way to put it would be that articles of association should facilitate the transfer if the value or price SA receives from the transfer is greater than the value of her staying in the company both to herself and to other, non-transferring members. If the parties have perfect knowledge of the terms of the business and there are not asymmetries of information (such as hidden knowledge regarding the execution of the loan with Bank Y), it should be irrelevant whether they chose to protect the entitlement with a property or a liability rule. If the entitlement was protected by a property rule, and VS_A > VS_B, SA could bargain with other non-transferring shareholders and managers to sell her share provided she makes an ambitious offer to Mr. D. This would prevent passive non-

839 Often the consent to the transfer of shares is constituted by the consent of the company and not of its members. Nevertheless, the company is a legal fiction and not someone who can have incentives and interests for an economic analysis. V stands for value. S_A stands for shareholder A. S_B stands for other shareholder(s) who is (are) not transferring.

840 An ambitious offer includes the share, plus idiosyncrasies associated with the business object of the company, which is a start-up company. This is an innovative venture capital LLC. Shareholder A wants to leave the company because she has her own idea of business, has already secured venture capital, and believes that she will become a millionaire once she incorporates her own company in Silicon Valley. On this matter, see Gilson, Ronald J., ‘Locating Innovation: The Endogeneity of Technology, Organizational Structure, and Financial Contracting’, Columbia Law Review, vol. 110, 3, 2010, pp 885-918 (894-900) (establishing an interaction between technology, organizational structure, and financing that undergirds the innovative activity of start-up companies. Gilson makes an interesting point regarding the fact that a mature employer company sometimes
transferring shareholders from free-riding on more active non-transferring shareholders’ resolutions at the company’s general meeting.\footnote{313} This would make passive shareholders care about the investment in the company by any potential buyer, in particular Mr. D. So, the price paid for the share should be \( P > V S_A > V S_B \). Moreover, \( P \) must be smaller than the value of the share for Mr. D. This transaction would be Pareto-superior because both the non-transferring members and \( S_A \) would wind up better off. The question is: Why would the buyer or indeed anyone pay such a high price for a share whose value is likely to be frozen by the policies adopted by non-transferring shareholders on behalf of the company? This company is a promising start-up. The buyer will gain market idiosyncrasies that come along with the share. Therefore, because entitlements are protected by property rules and there are no asymmetries of information she could easily bargain in order to maximize her individual utility.

Let us now imagine that the entitlement of the company is protected by a liability rule. In this situation, \( S_A \) could sell her share without consent, but she would have to pay a compensation to the non-transferring shareholders that would, minimally, leave them no worse off than if the transfer had not been executed. Under conditions of perfect information, both non-transferring shareholders and the transferor would be better off (\( \text{Comp} \geq V S_B \) as long as \( \text{Comp} < V S_A \)). The crucial point here is that even though efficiency is obtained, the taking as such weakens non-transferring shareholders’ property rights in their shares because physiologically and morphologically, property rights in shares as such are not strong enough to prevent a taking from happening. Furthermore, even though non-transferring shareholders can bargain the compensation, the amount will be diffuse.\footnote{314} Again, this shows how tamed property rights in shares are. One may counter by asking: Is this not the case for all situations where entitlements are protected by liability rules? Yes, it is true that takings can happen in other scenarios. Still, the introduction of restrictions on the transfer of property rights in

\footnote{313} Passive shareholders free-ride because they do not want to be accountable for the decisions taken in the general meeting, even though such decisions bind all shareholders equally. By letting others do it, they detach themselves from the decision-making process. They do not show up in meetings, and typically send up a proxy.

\footnote{314} It is up to courts to establish compensation. When I refer to bargaining between the parties to a dispute to set up the amount of compensation, I am thinking about those situations in which they potentially can settle before going to court. Indeed, the fact that courts have to intervene to settle compensations is a crucial difference from a property rule (1 and 3) where the parties would have to bargain.
shares reduces property rights’ resistance to takings because they need consent *stricto sensu* to be executed. Courts then go from being gatekeepers to something more challenging, especially if they must analyze who benefits and who loses if efficiency is the principle they use for the adjudication. Results will depend on whether or not courts have access to costless information, and on whether courts are apt to understand the implications that restrictions have on the definition of property rights, shares and governance.\footnote{I note, however, that my comparison between property and liability rules rests upon what have been called ‘traditional liability rules’or ‘first-order liability rules’. For example, Ayres and Balkin have tried to demonstrate, from a normative point of view, that bargaining is also possible with liability rules through what they have defined as ‘second or higher order liability rules’. Their perspective is that these rules, unlike traditional liability rules, would allow bargaining by promoting reciprocal takings between the plaintiff and the defendant. Their theory is an extension of the caveats of the Coase Theorem, namely that transactions in the real world are filled with asymmetries of information and other transaction costs that prevent efficient bargaining, regardless of the allocation of entitlements. Their construction is also an extension of Calabresi and Melamed’s ideas, for it tries to go beyond property and liability rules and provide a unifying concept of the two types of rules. The problem, however, is to understand in a comparative perspective whether different legal systems allow second or higher-order liability rules. See Ayres, Ian, and Balkin, J. M., ‘Legal Entitlements as Auctions: Property Rules, Liability Rules, and Beyond, *The Yale Law Journal*, vol. 106, N.º3, 1996, pp. 703-750. Also see Ayres, Ian, *Optional Law*, cit.}

(ii) Allocation of shares when there is bargaining under conditions of unverifiable information and strategic behavior

Now, I assume that parties behave strategically. In this case, the transferor, who cannot contract around the property rule due to the number of non-transferring shareholders, ends up selling without consent of the company, other shareholders, or the managers. If the company’s entitlement is protected by a property rule, but there is strategic bargaining, $P > V_{SA} > V_{SB}$ may not happen just because the company is bargaining hard, even when it would be beneficial for the company not to do so, and let Mr. D. take the share. So, the problem of the un-consented transfer comes to the surface. In these circumstances, liability rules can be thought of as alternatives to protect the company’s entitlement. If $Comp > V_{SB}$, but $<V_{SA}$, the latter could bargain, and Mr. D. could even take the share. Bargaining under liability rule may not happen if $Comp = V_{SB}$ because of strategic bargaining which can boil down, for example, to hold-outs by shareholders or managers for a greater value than the actual value of the share (they claim that the economic value of the share is greater than its nominal value).\footnote{It would seem that under a liability rule (Rule 2), no bargaining is necessary. I am referring, however, to those cases in which parties seek a settlement.}

Shareholders would feel that all the gains of the transaction would go to $V_{SA}$, which would
thwart the distributional effects of the liability rule. Another problem to which Whincop calls attention to is the lack of sufficient information provided to the court by the parties, which makes the information ‘observable but unverifiable’. Imperfect verifiability leads to situations in which the court may tend to overvalue or undervalue the assets. Moreover, given the relational element dominant in these companies, the last thing shareholders and other corporate constituencies may want is to deal with a lawsuit and with providing documentation that could actually help the court assess the value of the shares. It is unlikely that shareholders and managers would be pleased to allow courts to undertake a ‘judicial due diligence’ and strip the company’s accounts, go through directors and general meetings’ minute books, private correspondence, and all manner of evidence that shareholders and managers thought would always be kept private. Consequently, despite the problems of overestimating and underestimating, which can lead to overcompensation or, conversely, to undercompensation of one of the parties to the dispute, this fundamental aspect in respect to the relational features of the PLLC is, I believe, a strong drawback in the choice of liability rules for the protection of entitlements in the PLLC. This is so, even though liability rules can be efficiently used, depending on the structure of bargaining and the amount of compensation claimed.

(iii) Allocation of shares when there is bargaining under conditions of asymmetries of information

Let us assume that \( S_A \) was told by Mr. D that he is in debt with Bank Y, besides having other small debts as a result of the business he runs. However, facing \( S_A \)’s ambitious offer, Mr. D guarantees he is up to the task and will pay the price as agreed. On his side, Mr. D. asks \( S_A \) for a guarantee that there are not hidden defects in the shares (vices cachés), nor environmental debts attached to it. In this situation, \( S_A \) knows the company’s valuation of the share and she also knows Mr. D’s valuation of the share. Nevertheless, neither the company nor Mr. D. is aware of the other’s valuations. Plus, as part of their respective bargaining

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845 See Whincop, Michael J., cit., pp. 37-38 (explaining that liability rules are said to surpass strategic bargaining including holdout and freeloader problems because a bilateral agreement is not a precondition for a transfer. This is even more so when the party who wishes to contract around the property rule has to deal with two or more owners. He seems to recognize, as I suggest in the text, that the number of parties makes it difficult to apply liability rules. So, he suggests as an alternative to liability rules, which corporate law adopts, the reliance on the corporate fiction. Putting it differently, each shareholder is bound by the majority decision taken at the general meeting approving the transaction, and which binds the company. Consequently, majority approval is described by Whincop as a likely solution to holdouts).


847 See Whincop, Michael J., cit., p. 38.
strategies, all of them make sure to confidentially hold information that could damage the transaction. Therefore, they know their own valuation of the share, but are not completely sure about each other’s valuations. In this sense, $S_A$ and Mr. D are in a better position towards the company when it comes to the setting of strategy to execute the sale.\footnote{In the background, it is the same scenario of freezing status quo. Moreover, each and every single one of them hides information in order to be in a position of competitive advantage toward the other. So, we end up in a situation where $S_A$ knows her own valuations, the company’s and Mr. D’s valuation. The company does not know anyone’s valuations but its own. Mr. D. knows his own valuations and $S_A$’s valuations. At this point, $S_A$ still valuates the share more than the company, which valuates its status quo more (including ownership and governance structures). In this situation, a property rule alone would not efficiently work. This is so because due to asymmetries of information coupled with strategic bargaining the share may not be transferred even when $S_A$ values it more than the company values its own status quo. The share could also be sold under $S_A$’s valuations just because the company is bargaining hard and playing strategically. This is when the problem of the un-consented transfer surfaces. Applying a property rule as such would result in inefficient effects. Nevertheless, applying a traditional liability rule to protect the company’s entitlements would not be any better. The problem with this rule is that it would raise the same difficulties related to unverifiable information, and make ‘judicial due diligence’ overly difficult.}

I suggest that a property rule be used to protect the company’s entitlement, but coupling the rule with the normative possibility of piercing the ownership veil.\footnote{In other words, the court would read the articles of association and other parallel contracts, as well as the offer of the transferor, and interfere in the consensual agreement to learn to what extent non-transferring shareholders and managers are sabotaging the transaction. Most importantly, courts should be well positioned to discover who controls the decision-making process in the company and, in this way, cause information to be spilled over. This would also cause information spillover on the side of $S_A$ and Mr. D., because the court would not only base its inquiry on incidents brought to it by the parties, but would also assume a more discretionary role. Moreover, it is the other non-transferring shareholders who control the company who would be in a better position to know about hidden defects in the share. But Mr. D. trusts $S_A$’s guarantee that no such defects exist, considering that $S_A$ is still a member of the company and should, therefore, have insider knowledge about it.} In other words, the court would read the articles of association and other parallel contracts, as well as the offer of the transferor, and interfere in the consensual agreement to learn to what extent non-transferring shareholders and managers are sabotaging the transaction. Most importantly, courts should be well positioned to discover who controls the decision-making process in the company and, in this way, cause information to be spilled over. This would also cause information spillover on the side of $S_A$ and Mr. D., because the court would not only base its inquiry on incidents brought to it by the parties, but would also assume a more discretionary role.

\footnote{This is so because $S_A$ is the only element in this complex relationship that is simultaneously linked to the company and to the buyer. The company and the buyer are third parties toward each other.} \footnote{See Part II, Chapter 3.}
role in the dispute.\textsuperscript{851} Most importantly, the default rules and the articles of association should signal the strong level of enforcement applicable by courts when piercing the veil of the ownership. One could ask: Does not this lead us to a problem of imperfect verifiability, as occurs with liability rules? Perhaps it does. However, in this case the court is not so much dependent on the evidence that parties bring to the dispute, but rather on the level of enforcement the default rule was designed to provide. The threat of enforcement of rules or provisions that parties included in the articles of association together with the oversight of the parties’ behavior by a third party would nudge them to be more cautious, and rethink their behavior.\textsuperscript{852} This need not necessarily be done under a liability rule. Obviously, the party that values the asset most would be willing to run the extra mile and unveil information, if doing so was essential for the execution of the transaction. However, it could be that this improved the bargaining position of the other parties, unless lawyers would be able to come up with a system through which the opposite party would also be driven to disclose information. This is reminiscent of a second-price auction by which parties would be forced to disclose their own valuations, or at least behave in a way that hints at what their valuations are. I refer to it in Layer 2 of the theoretical model.

In sum, property rules in this case are not only used to protect entitlements, but also used to create a fiction that nudges the bargaining structure towards efficiency (i.e., towards a point where no further transfer would make everybody better off). They can also be used to create a market where none exists.\textsuperscript{853}


\textsuperscript{852} This is an idea that illustrates how regulators can correct contractual relations by balancing costs and benefits. This effect is normally achieved through the exercise of property rights, in particular when transaction costs are not terribly high. This is another example of regulation as a substitute for property rights.

(iv) The case for inalienability protection: Is there really a case?

I now consider the inalienability of entitlements. None of the default rules of the selected jurisdictions regulating the transfer of shares protects entitlements through inalienability. This is so because the transferability of shares is one of the general features of the company. The question is: Would it be economically efficient if defaults protected entitlements through inalienability? Let us imagine that the relevant legislator thought that the best way to protect entitlements in the PLLC was to prohibit the sale of shares, or establish a number of preconditions for the validity of the sale. Additionally, let us imagine that this legislative policy was based on the idea that locking shareholders in the company by limiting transactions over their shares would necessarily induce them to invest in the company. Basically, the legislator assumes a paternalistic attitude and thinks of members of these companies as market agents that need to be guided on their own contractual options in order to prevent unnecessary externalities.

A possible externality would be the costs deriving from an un-consented transfer for Mr. D’s creditors such as distributors, suppliers, the promissory share purchasers, holders of a right of compensation or other creditors in general. Having been made aware of the conclusion of the share sale and purchase agreement, Mr. D’s creditors may hope for the inclusion of the purchased share in the debtor’s assets and be included in the debt recovery. I can also imagine claims of more diffuse creditors. Let us imagine that one of this company’s biggest financial burdens is its environmental debt. This will, in fact, constitute in the future the centerpiece of the company’s financial concerns. The full costs of developing the company’s industrial activity amount to millions of Euros. This amount of money, that is to say, externalities, corresponds to bills paid by the government to clear the nearest river, and to the costs borne by fisheries, local businesses, families and healthcare providers. So, in a way, buying factors of production such as carbon has not been that costly for the firm because it has been subsidized by the victims. This environmental debt is present in every transaction shareholders make, including the transfer of their shares. It does not mean that shareholders are responsible for the debts of the company, but rather that these debts depreciate the value of the shares. In the mind of a paternalistic legislator, allowing the transfer of these shares or any sort of market for shares to which environmental debts are attached would mean allowing the running of a business that perpetuates the harm done by the act of pollution. It

854 Shares are depreciated in their value for the society, but not for the members of the company who are indirectly subsidized by the lack of internalization of these externalities.
would mean lowering the value of local businesses or creating fiscal instability because municipalities, if not the state, would have to take money out of their budgets to face claims of the victims in respect to the overall damage pollution caused to the environment and directly to them. Therefore, the legislator targets SMEs (which more likely will adopt the legal form of a PLLC) and which business is likely to create harmful externalities. It will do so by taxing heavily certain activities harmful to the environment. It will also do so by taxing the transaction. The corresponding tax may be high, depending on the price of the sales contract. The price of the sales contract may include hidden defects, environmental debts, or any type of debts. Furthermore, protecting entitlements by making them inalienable would lock in shareholders to their shares and make them accountable for the environmental and social costs that should be, by all rights, introduced into the company’s accounts. Protecting entitlements in companies of this sort by making them inalienable would bring changes in business reporting and disclosure, even if in the context of PLLCs. The need to create more efficient infrastructures would boost the overall economy. The inalienability of the share would make members strive for new corporate policy innovative solutions, and open the door to clean development, and to accounts stripped of environmental debts. This would presumably avoid the bargaining failures often associated to property rules, and the difficulty of collective valuation of damages linked to liability rules.

However, shareholders are not better off if they are prohibited from transferring their shares, be it for policy-related, paternalistic or moralistic reasons. Additionally, the inalienability of shares is not the best form to protect entitlements in the PLLC and the society as a whole from harmful externalities. On the contrary, allocating property rights to market agents enables them to internalize externalities.

855 See Kaplow, Louis, and Shavell, Steven, ‘Why the Legal System is less Efficient than the Income Tax in Redistributing Income’, The Journal of Legal Studies, vol. 23, No. 2, 1994, pp. 667-681 (emphasizing that redistribution through legal rules is less efficient than redistribution through the income tax. They recognize, however, that normative economic analysis of legal rules should primarily focus on efficiency than on distribution of income. In this context, it is an interesting paper because it addresses the additional role legal rules may play).


857 See Holderness, Clifford G., ‘A Legal Foundation for Exchange’, The Journal of Legal Studies, vol. 14, N°2, 1985, pp. 321-344 (326) (arguing that ‘Alienable contract rights are more valuable than inalienable contract rights because after the formation of a contract, but before its completion, relative prices, incomes, or tastes could change such that completion of the contract is no longer efficient. In this eventuality it is in the interest of both the promisor and the promisee (assuming he is compensated) to terminate the contract and transfer the resources to more valued uses. When contract rights are inalienable, this flexibility is lost, and rights thus become less valuable’).

readjustment of property rights, which would not be possible if they were constrained by legal prohibitions to their sale. This readjustment is a dynamic process, which is not immediate. It should be aligned with social and market values and technology.\textsuperscript{859} Moreover, prohibiting shareholders from transferring their shares is not reflective of how the market works. Organic features of the market, which legislatures must inevitably cope with, have the ability to modify by contract the initial delineation of entitlements set forth by the legislature. If the efficiency standard is the shareholders’ maximization of individual utilities, inalienability as such creates market friction, that is, resistance to the relative motion of the market against the paternalistic rubbing effect of the law. The most likely consequence is that market agents will not become members of PLLCs in the first place. Therefore, there is no case for inalienability in respect to transactions of shares of PLLCs. It is not ‘genetically’ feasible.\textsuperscript{860}

B. Layer 2

I now turn to the second layer of the theoretical framework. I am here concerned with the aggregate, that is, the society and the effects that un-consented transfers may have on it. At this level, the role played by the regulator is crucial. It is also essential to keep in mind the enforcement costs borne by members, managers, employees of the company, as well as the society in general, if there is a change in the ownership structure of the company as a result of a transfer of shares. This is particularly so if this develops into a contentious dispute. Taking into account the role of the regulator (e.g., legislatures and courts) as well as on the impact of enforcement costs (e.g., informal or private mechanisms of dispute settlement, and formal mechanisms of dispute settlement provided by courts which are supported by taxation) is important, since different enforcement levels may affect the incentives of shareholders to hold onto their shares and invest in the company. It can also impact on the incentives of managers to care about doing their jobs right. For example, a potential buyer may think that if it is too costly to sell shares in the company, she might well not acquire them at the first place. In this layer, the question is: Which types of rules best maximize the benefits of the aggregate with the least costs?

The social costs of controlling market failures consist not only of designing general and abstract rules that are independent of which and how many individuals will probably commit

\textsuperscript{859} Refer to the model legislative policy in Part II, Chapter 1 where three levels are presented: L1, the society, L2, the legislator, the regulator and courts, and L3, the market.

the act foreseen by the law, but also of enforcement. In terms of policy, legislatures have opted to adopt default rules that facilitate bargaining between parties so that they find optimal solutions. This may also be thought of as a strategy to spare the aggregate from bearing enforcement costs, considering that parties, in principle, know what is best for them, and will bargain until they find an optimal solution. However, in most cases, parties do not expressly agree that, in addition to all other aspects established in the contract, enforcement costs should be kept to a minimum. Furthermore, this economic incentive legislatures give to market agents to efficiently design their own contractual framework is in many instances weakly enforceable, or just virtually enforceable. On one hand, this is the case because courts not always are technically fit to monitor the contract entered into and between the parties. The legislature provided default rules as a way to avoid courts being called upon to execute any sort of ‘judicial due diligence’ of contracts, in particular when both parties freely chose the rules to govern that contract. On the other hand, the policy choices as to the types of rules protecting entitlements in the PLLC were not undertaken in a setting where regulators specified a strong enforcement policy. This was a setting where regulators’ enforcement policy was limited to making sure that an un-consented transfer would not have any effects towards the company. This limitation on regulators’ policy choices derives from the fact that it is generally understood, as a matter of principle, that regulators do not have to monitor contractual relations or police their non-compliance.

Regulators provide economic incentives through default rules to avoid or minimize enforcement costs. It is a commonplace that reduced enforcement costs imply reduced costs for market agent compliance. However, this is not necessarily true. Where there are economic incentives for market agents to bargain and comply, surprisingly, enforcement costs can be quite high. Any un-consented transfer attests that the threat of a penalty was not enough to deter shareholders from selling their shares. Considering the protection of entitlements in a scenario like this, where the transaction costs and default rules are not strongly enforceable (as the un-consented transfer illustrates), I try to investigate how policy choices regarding the protection of entitlements will affect enforcement costs and the aggregate. The goal is to present an economic argument which suggests that a transfer would be welfare-maximizing if the regulator is required to intervene less, with consequently lower enforcement costs, depending on the kind of protection adopted to protect entitlements in the PLLC.

Let us return to the above-noted examples, in which individuals try to maximize their utilities when there is bargaining under conditions of perfect information, of unverifiable information and strategic behavior, and of asymmetries of information. Applying property
rules, liability rules or opting for inalienability not only affects the bargaining structure in different ways, but also entails different levels of enforcement and costs for the society.

a. The aggregate’s maximization of benefits with the least costs when there is bargaining under conditions of perfect information

I have submitted that if the parties bargain while having perfect knowledge of the terms of the business, and there are not asymmetries of information it should be irrelevant the fashion in which entitlements were allocated. This follows from the so called Coasean Theorem. I have explained that under property rules, and when there are not asymmetries of information and transaction costs are low, parties are able to bargain without major contingencies until they find an optimal solution. They can easily bargain to maximize their utilities. Additionally, this is the case because property rights are clearly defined and there are not harmful externalities. When this happens, property rights encompass the respective transaction completely. This also means that parties have found an equilibrium which is simultaneously socially optimal. So, this is valid for the corporation. In a scenario of low transaction costs shareholders and other corporate constituencies should not find any problems in acting together. There are zero costs of enforcement associated with the execution of the transaction.

b. The aggregate’s maximization of benefits with the least costs when there is bargaining under conditions of strategic behavior and asymmetries of information

Sometimes, parties have perfect information, but the information is unverifiable. Unless they get themselves into a contentious dispute, in which case liability rules would apply, the transaction costs should not be high, or at least not so high that the parties cannot bargain. This would lead us toward a situation similar to the one described above, in which the way entitlements are allocated is irrelevant. Thus, parties are able to bargain in order to reach an optimal solution under property rules. However, some cases involving unverifiable information boil down to asymmetries of information that originated in strategic behavior of the parties. It may be that in these circumstances even the party that most values the asset will be prevented from acquiring it because the other party is holding-out or playing hard. This is

861 I am thinking about the resolution of a company’s general meeting to consent to the transfer, or the register of the transfer into the register of members by the managers or directors of the company.
not efficient at the level of shareholders’ maximization of their own utilities, nor is it efficient from the point of view of social welfare.

I, however, do not immediately yield the advantages of liability rules in these circumstances, especially because liability rules may be problematic if information about value is unverifiable. The way by which the use of property rules in a setting where parties bargain hard and hide information from each other could be efficient at both layers is through the creation of a scheme similar to a second-price sealed-bid auction. A second-price sealed auction can be defined as a setting where ‘...each potential buyer is allowed to submit a sealed bid, $b_i \geq 0$. The bids are then opened and the buyer with the highest bid gets the good, but now he pays the seller an amount equal to the second-highest bid’.\(^{862}\) Going back to my case, $S_A$ wants to sell her share. She knows the company of which she is a shareholder is bargaining hard. $S_A$, the transferor, informed the other non-transferring shareholder, $S_B$, that there was a potential buyer for her share. Since the other non-transferring shareholder held pre-emption rights under the articles of the company, $S_A$ had to inform her and the company about the deal. The non-transferring shareholder says she will not pay more than 7, even though she values the share at 9. $S_A$ argues that the criteria to determine the share’s fair value established in the articles of association are outdated, and since this is a promising start-up, she asks for a higher price than the non-transferring shareholder wishes to pay for it. Mr. D is offering 10, but he values the share at 11. Neither the non-transferring shareholder, neither Mr. D reveal their own valuations. The two potential buyers, that is, the non-transferring-shareholder and Mr. D., know that this is an auction. Once the bids are opened, the non-transferring shareholder realizes she is about to let a new shareholder come into the company because Mr. D.’s bid is the highest, but he will only pay the price equal to the second-highest, which is 7. If the non-transferring-shareholder really wants to keep her status quo, she will bid for a higher price.

Hence, a second-price auction has the potential to nudge parties to disclose their own valuations.\(^{863}\) It has the potential to cause efficient solutions. In my case Mr. D., who values

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\(^{863}\) See, however, Ayres, Ian, *Optional Law*, cit. p. 99 (considering that both liability and property rules are special cases of what he calls reciprocal-takings options. In his opinion, reciprocal-takings options or second higher-order liability rules, if optimally structured, can be Pareto-superior to either traditional liability or property rules. This is so because they hold an auction-like structure which can potentially harness private information, for they favor truncated auctions. He affirms that ‘...if policymakers appreciate that property and liability rules are part of a larger family of auction mechanisms, they may turn to more traditional auctions … that will often be less cost to administer’. It appears, nevertheless, that this scheme is more appealing to those who believe liability rules are more efficient than property rules in gearing information held by the parties and implementing truncated auctions, even if transaction costs are low).
the share most, would get the share under his valuation. \( S_A \) would sell over the price offered by the non-transferring shareholder. Furthermore, the scheme of a second-price auction is likely to break situations of bilateral monopoly in the company that can appear due to an imperfect market structure or even due to the inexistence of a market for the shares of the company. Thus, modeling contractually something as such could help create a market for shares similar to the *e-bay* auctions market.\(^{864}\) The asset may not worth much, but its value is increased by the incentives competition creates on market agents to bid up for it.\(^{865}\) The transaction deriving from the auction would be welfare-maximizing, even though there were asymmetries of information and parties behaved strategically. This solution would be superior to that in which the asset goes to the party who has the greatest bargaining power. The reason for this is because it may be that their competitive advantage comes precisely from hiding information and playing hard, when the party who has the greatest bargaining power may not even be the one who values the asset most.

c. The aggregate’s maximization of benefits with the least costs. The case of liability rules

Let us suppose that, this time, the entitlement of the company is protected by a liability rule. I have noticed that even though efficiency can be obtained at the level of maximization of individuals’ utilities, the taking as such weakens shareholders' property rights. There are several possible scenarios. Let us consider a situation in which a welfare function maximizes the utility of all individuals.\(^{866}\) What I am trying to do is determine the best set of rules.

In the case of liability rules, one has to question first whether or not the system of compensation works better with the intervention of a court. Let us start with the picture of a ‘jungle economy’ where no courts exist. In this situation, anyone can take anything from anyone else. The asset is allocated to the strongest. It would not be possible to talk about welfare maximization here because it would not be possible to satisfy all individual


\(^{865}\) See Posner, Richard A., *Economic Analysis of Law*, 7\(^{th}\) ed., New York, Aspen Publishers, 2007, pp. 47-49 (referring to the auctions of broadcast rights and explaining how a broader concept of property rights in the economic sense of the word can be used as device by which divergences between private and social costs or benefits are reduced).

preferences of the members of the society. This is, nevertheless, a very strong assumption which is not in line with reality.

When courts are in the picture and have the power to observe everything, we have another sort of situation. There are no asymmetries of information. Mr. D., who took the share, and the company go to court. Both parties to the dispute bear the cost of going to court. Additionally, the asset (e.g., the share) has a value. The company (plaintiff) would go to court if the value of compensation is higher than the costs to file for a suit. On his part, Mr. D. (defendant) would pay because it is cheaper to pay the compensation than to be taken to court. In this context, there are reasons to create an economy where the asset can be taken, but the taker has incentives to pay. The company obtains full compensation. Mr. D. gets the asset, against the payment of compensation.

There may be, yet, a third situation. There still are courts, but this time they cannot observe everything. There are asymmetries of information. Parties behave strategically. Consequently, there is a risk of the court overvaluing or undervaluing the asset which will revert on the amount of compensation to be paid by Mr. D. If there is a concrete chance of overvaluation, the company may have more incentives to go to court. The contrary is also true, that is, if there is a bigger risk of undervaluation, Mr. D. will have more incentives to file a suit. Depending on the expectations of the parties to the dispute as to the result, there will be greater or fewer less incentives to litigate.

Courts should be ‘constrained efficient’ in the last two hypotheses for the purpose of welfare maximization. For example, in principle, it should not be too costly for an owner to go to court. It should, however, at least in principle, be more costly for the taker. One might imagine that the taker, Mr. D, values the share more highly than the company does, the latter of which is more concerned with the preservation of a status quo that will most likely cause the retrogression of the company in the long-run. Even if this is the case, the fact that Mr. D. most values the share should compel him to pay whatever price is being asked for it. So, from the point of view of welfare maximization and given the examples I have just drawn, property rules are superior to liability rules. These examples suggest that the social costs deriving

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867 I get away from the orthodox view that considers liability rules superior if transaction costs are high. One of this view’s flag wavers is Posner. See Richard A. Posner, *Economic Analysis of Law*, 7th ed., New York, Aspen Publishers, 2007, pp. 56-57 (noting that more important than the distinction between conflicting claims to a resource and conflicting or incompatible uses of resources is the distinction between low and high transaction costs. His arguments is that when transaction costs are low ‘…the law should require the parties to transact in the market, which it can do by making the present owner’s property right absolute (or nearly so), so that anyone who thinks the property worth more has to negotiate with the owner’. On the contrary, if transaction costs are high, Posner argues that in this setting ‘…people must be allowed to use the courts to shift resources to a more valuable use; the market is by definition unable to perform this function in those settings. This distinction is only
from the protection by liability rules are higher than they would be if entitlements were protected by property rules. Of course, one cannot be oblivious to the private costs market agents have to bear when entitlements are protected by property rules. But market competition has the ability to scatter them. Liability rules would only be advantageous for the moment, but not for the long-run. They would also be advantageous if the taker did not have all the money required for the investment, and would rather rely on the payment of compensation as a surrogate of the value of the asset.

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d. The aggregate’s maximization of benefits with the least costs: The case of inalienability.

I do not make a case for inalienability as an overall form of protection of entitlements which would be welfare maximizing. Shares of PLLCs are not public goods. Yet, one could think that the business object of these companies such as the sale of weapons to mercenaries, industrial activities that cause high levels of pollution and nuisance, traffic of human organs, drug trafficking, etc., could justify more active policy-oriented interference of the state and, therefore, the provision of the inalienability of entitlements. These could even be cases in which protecting entitlements through inalienability would be efficient and right from the distributive point of view. Yet, this would only be a second-best solution, if it would be a solution at all, considering that the law that directly regulates these cases, or any other law (e.g., criminal law, administrative law, constitutional law) should apply. Furthermore, there are no paternalistic reasons that justify the inalienability of shares of PLLCs. PLLCs are private business organizations. In this context, the state should not keep a close eye on them, or bring them under its wing, unless there are insurmountable market failures.

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 imperfectly reflected in the law’). Additionally, see Kaplow, Louis and Shavell, Steven, ‘Property Rules versus Liability Rules: An Economic Analysis’, cit. (considering that liability rules are superior where there are harmful externalities, but not when it comes to protect possessory interests in things).

868 This goes against an orthodox view which has always perceived tort law in general and liability rules in particular, as the best way to solve problems in law.

869 See Demsetz, Harold, ‘When does the Rule of Liability Matter?’, The Journal of Legal Studies, vol. 1, No. 1, pp. 1972, 13-28 (noting that when there are zero transaction costs, the function of liability rules is limited to wealth redistribution. When transaction costs are positive, or cannot be negligible, liability rules have the function to allocate resources. In principle, if information is available to the society, the legal system should be able to allocate resources by holding liable the party that was expected to avoid the costly interaction between parties most cheaply).

870 See Rose-Ackerman, Susan, cit., p. 969 (saying that ‘Inalienability is frequently justified not as an ideal policy but as a second-best response to the messiness and complexity of the world. It is generally possible to conceive of an alternative policy that would be superior if transaction costs were lower’).
3. Conclusions

The purpose of this chapter is to understand whether liability rules or inalienability more efficiently solve problems of governance in the PLLC, overcome bargaining failures, and protect entitlements in these companies than do property rules. I have looked at the default rules legislators have designed in each selected jurisdictions and to the form in which entitlements were allocated. I concluded that in some cases, legislators have opted to allocate entitlements to the companies, which are protected by property rules (Property Rule 1). This is also a choice that is taken by shareholders by including similar rules in the articles of association of the company by which they require the consent of the company to execute the transfer. However, transfer clauses in the articles of association are diverse, and entitlements can be allocated differently. Looking at the entitlements framework presented by Calabresi and Melamed, I suggest three other possible ways in which entitlements can be allocated and protected. The entitlement can be allocated to the company and be protected by a liability rule (Liability Rule 2); the entitlement may be allocated to the transferor and, in this case, there are no transfer restrictions (Reverse Property Rule 3); and, finally, entitlements can be allocated to the transferor, who can sell, but the other non-transferring shareholders can stop her by paying the same price (Reverse Liability or Rule 4).

I then examined the essence of property and liability rules and the possibility of inalienability within two layers of a theoretical model based on assumptions. If the goal is Pareto efficiency by which there is no further transfer that makes everybody better off, property rules seem to be sounder mechanisms than liability rules or inalienability to deal with market frictions and situations where private and social costs and private and social benefits diverge. In a scenario of high transaction costs, asymmetries of information and bargaining failures, and weak enforceability of rules, the problem of the un-consented transfer of shares is likely to occur. This is when the existence of an appropriate regulatory framework is of utmost importance. It may sound caricatural, considering that the most distinctive feature of the PLLC is the flexibility of its legal regime which is, in most cases, an ode to the principle of freedom of contract. The regulatory framework I propose is based upon the interference of courts into the consensual agreement of the parties by overseeing what they are doing when there are attempts to sabotage the interests of the party who most values the entitlements.

Rules of the articles of association vary. Sometimes entitlements are allocated to non-transferring shareholders, to the majority shareholder, or to directors. This means that the respective share cannot be sold without these individuals’ consent.

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asset. Of course, courts have to be called to the matter, and the way this happens is by filling a suit. Then, the courts’ task of adjudication should not only be carried out by the evidence parties bring to it, but also guided by the level of enforceability of default rules provided by the legislator and designed in the articles of association. The level of enforceability should be such that, once a court is called to intervene, this fact alone would cause information to spillover from both parties. Default rules should be able to induce this. I call these ‘incentive default rules’. ‘Penalty default rules’ are a subset of incentive default rules.

Additionally, I use assumptions to illustrate that it is possible that lawyers, as gatekeepers, engineer the articles of association of a company by creating well-crafted clauses and clever solutions based on Pareto efficiency.\footnote{See Gilson, Ronald J., ‘Value Creation by Business Lawyers: Legal Skills and Asset Pricing, Yale Law Journal, vol. 94, (year), pp. 239-313 (243) (referring to business lawyers as ‘transaction costs engineers’). Additionally, see Dent, George W., Jr., ‘Business Lawyers as Enterprise Architects’, The Business Lawyer, vol. 64, n.º 2, 2009, pp. 279-328 (criticising Gilson’s view and defining lawyers as ‘enterprise architects’; and Vany, Arthur S., et al., ‘A Property System for Market Allocation of the Electromagnetic Spectrum: A Legal-Economic-Engineering Study, Stanford Law Review, vol. 21, 6, pp. 1499-1561 (taking a multidisciplinarity approach in respect to the creation of a system of property rights in the electromagnetic spectrum by which it interweaves law, economics and engineering).} The scheme of a second-price bid auction to which I refer echoes this understanding. To this end, I find property rules superior. They more easily enable market agents to make transactions that improve their net welfare. However, in general, the protection of entitlements is not undertaken by one single type of rule alone. Such protection is mixed, and it is up to the lawyer to understand what the parties really want, and design legal solutions pursuant to the parties’ maximization of utilities. Concomitantly, lawyers should seek welfare-maximizing solutions. This is so because otherwise, market agents may not have incentives to acquire shares in these companies at the first place, and invest in them. This is the lawyer’s take on market design in a situation in which such design is missing. Nevertheless, looking at both levels – the market and the aggregate or society – to explain how resources can be used so as to maximize benefits with the least cost, implies that a decision be taken regarding the relative value one assigns to the society or the market. This is a tough call.

Normatively speaking, this chapter was driven by the goal of finding a balance between the ex-post bargaining inefficiencies and the ex-ante economic incentives shareholders are given to invest. I wondered whether such balance could be achieved through a certain type of rule. I submit that property rules constitute the most promising path to finding an optimal point between two extreme positions in respect to transfer of shares in the PLLC: absolute protection, and no protection at all. This hints at a legal reform that takes into full account the
empirical behavior of market agents (and this is in its true sense a bottom-up approach), but also designs default rules that are both facilitative and incentive-based. It seems simple, but it is not. In terms of legislative policy, this implies determining the best choice when it comes to allocate entitlements. It also entails serious thought about the design of defaults and how they can contribute to the development of contractual and corporate solutions which are primarily created from below.

This raises the question as to which form default rules should take, given the uncertain nature of market agents’ preferences. There has been no consensus in the literature on this issue. For example, Easterbrook and Fischel treat ‘…corporate law as a standard-form contract, supplying terms most venturers would have chosen but yielding to explicit terms in all but a few instances’. Their theory of standardization, however, falls short of explaining why market agents would call for standardization in the first place. On the efficiency level, this conception of default rules calls for the application of the Kaldor-Hicks criterion of efficiency by which the majority of the market agents would be driven to choose defaults that maximize their wealth. So, poor people would always be losers, regardless of their individual utilities. They would automatically be excluded from the flock of market agents whose voice is actually heard in respect to the implementation of legal policies for this matter.

873 Often in Europe, discussions about a bottom-up approach to the development of EU law and its relationship with courts and legislators at the national level do not really sound like discussions about a bottom-up approach. The contours of round-table discussions on this side of the Pond are still informed by constant attempts to push forward answers to a list of questions raised with primarily positive objectives. In other words, these discussions tend to look at the law as it is, and do not look at the law as it had been in the past. In these circumstances, the said bottom-up approach is missed. The top-down approach continues regnant.

874 This recalls the example of the reserve clause provided by Demsetz. See Demsetz, Harold, ‘When does the Rule of Liability Matter?’, *The Journal of Legal Studies*, vol. 1, No. 1, pp. 13-28 (dealing with the question ‘…whether the identity of the owner of a player’s baseball services will alter the allocation of his playing activities’. An application to the Coase theorem to the question suggested that a reserve clause, by which a baseball club may or may not authorize a player to leave the club even if their contractual obligations toward each other had terminated, should not have an effect on the identity of the team for which a player plays’. Reserve clauses were abolished in baseball in the 1970s. They have been generally substituted in sports for a scheme of free agency. Europe saw the well-known Bosman case (*Union Royale Belge des Sociétés de Football Association ASBL v Jean-Marc Bosman*). However, in this situation, transaction costs were prohibitive).


876 A similar question was asked at the workshop ‘European Regulatory Private Law – The Paradigms Tested’, held at the European University Institute on 16-17 May 2013, organized by Hans Micklitz and Guido Comparato. I had the opportunity to attend. My analogy with evolution in biology tries to provide an answer to this by describing the way law is and should be generated. I try to put forward the idea that, generally, changes in law come about when market agents feel that the changes would be advantageous to them. So, even if law offers a number of off-the-rack rules to overcome contract incompleteness possibly generated by transaction costs and information withholding, market agents may still refrain from adopting them because they are seeking something else.

877 See O’Connor, Erin O’Hara, and Stake, Jeffrey Evans, ‘Economics, Behavioral Biology, and Law’, *Supreme Court Economic Review*, vol. 19, 2011, pp. 103-141 (124) (claiming that ‘Since law and economics analysis often applies, whether expressly or impliedly, the Kaldor-Hicks criterion, policy makers ought not jump from the statement that a change is efficient to the conclusion that the change is desirable’).
according to the Kaldor-Hicks criterion, this would constitute welfare maximization, provided the gainers were in a position to compensate losers for their losses.\textsuperscript{878} As long as the transaction was potentially Pareto-superior, it would be welfare-maximizing.\textsuperscript{879} Ayres and Gertner opine differently. They say that courts, in order to set defaults efficiently, must go beyond ‘the parties would have wanted theory’. They suggest a theory of ‘penalty defaults’ that are purposefully set at what the parties would not want. This is a form to nudge the disclosure of relevant information, which parties may withhold as an element of strategic behavior.\textsuperscript{880} Ayres’ and Gertner’s ideas comport well with this notion.

It is inherent to the concept of efficiency I use in this chapter that each individual captains her own ship. Clearly, I use the criterion of efficiency with a normative objective which, starting from the assumption that an individual knows best what she wants for herself, is fuelled by the idea of free competition and by an organic setting for bargaining. In these circumstances, one who most values the asset is ready to show it, irrespective of the money with which she may have to compensate those who are not ready to do that. She who most values the asset would be ready to run the extra mile, and that would result in welfare maximization. This is a normative framework, centered on a normative analysis of entitlements. This construction gives shareholders of PLLCs the opportunity to affirm their hybrid property rights in shares, and try to profit from their investment in these shares.

\textsuperscript{878} The question is: Is wealth maximization the appropriate normative focus for a theory of defaults?
PART II OVERVIEW

Part II is the diagnostic phase, wherein I identify the differences and similarities between the laws of the selected jurisdictions. I assess the problems deriving from the establishment of restrictions on transfer of shares of PLLCs pursuant to the legal framework of each jurisdiction. This part is driven by the analogy between property rights in shares and the evolution of the silver fox. This analogy implies a universal interwovenness in law. That corporate law cannot be fully grasped without an adequate theory of contract law and property rights illustrates the principle of pleiotropy in law. Additionally, this analogy suggests that law can be designed to break paradigms or the status quo, when and if necessary, for the sake of economic development. I use this analogy in respect to the PLLC, which is contractual by nature. The public company, which is a business organization designed to operate in financial markets, with transferable shares (at least in principle) and restrictions imposed only in very exceptional cases, differs markedly. Hence, the problems deriving from the contractual limitation of property rights in PLLCs are not found in the public company. The analogy opens the floor to a discussion about the (re)conceptualization of property rights and classic principles of civil law such as the numerus clausus, and the principle of consensualism in France and other countries whose civil codes have been modeled on the Napoleonic Code (Code Napoléon). This is the case of Portugal, Italy and Spain. It ventures a less individualist conception of property. Restrictions introduced to the company’s contract are liable to alter the configuration of property rights, but also are liable to affect the physiology and morphology of shares which are objects of these property rights. This is yet another display of pleiotropy. I define shares in Hohfeldian terms. Share is an aggregate of rights (claims), privileges, powers, and immunities. Property rights in shares are hybrid because they have a mixed origin or composition determined by the contractual structures of the company’s contract in which shares or membership interests are defined. Additionally, these contractual structures are likely to enhance the power of corporate constituencies, especially managers who can simultaneously be shareholders, to the point that the ownership veil must be pierced to determine who effectively controls the company. The idea of piercing the ownership veil is framed by the debate on form and substance. The seminal work of Berle and Means popularized the notion that ownership matters. There is, nevertheless, a difference between the Berle and Means corporation and the PLLC. In the PLLC, shareholders are frequently
managers, and the lines dividing control and ownership are blurred. In the situations where there seems to be a strong dependence of the company on its shareholders, in practice, the decision-making process is led by managers or directors. Given the case law collected showing ex-post situations of opportunism, asymmetries of information, and holdups, and the structure of the companies, the proposal to pierce the ownership veil is meant to be a standard of adjudication. It calls for an inquiry into the ownership structures of the companies to resolve clashes of interests or contentious disputes. In fact, this is a standard of adjudication, but which also can be considered by lawyers when they face a scenario of contentious dispute caused by un-consented transfer. In these situations, it may be necessary to pierce the ownership veil and discover who really controls the company, and who is making the decisions that affect the interests of the transferor. If this is the case, the following questions should be asked. Should the design of default rules selected by the members be different? How is the design of defaults affecting the development of the company and the investment of members in it? The answers to these questions may be arrived at by using a model of legal policy that takes a bottom up approach to law. Also critical is the construction of original and efficient contractual frameworks that reinforce the hybrid property rights that shareholders have in their shares. This is a conundrum that requires a solution to be developed at the dual levels of policy and contractual experimentation. Toward this end, property rules are more suitable than liability rules or inalienability.
PART III

GOVERNING PROPERTY RIGHTS THROUGH CONTRACT:
THE PROMISE OF JURISDICTIONAL COMPETITION

(Connecting the dots)
CHAPTER I

THE COMPANY’S CONTRACT TO REARRANGE THE RELATIONSHIPS OF SHAREHOLDERS AND OTHER CORPORATE CONSTITUENCIES\textsuperscript{881}

‘The best structure cannot be derived from theory; it must be developed by experience. We should be skeptical of claims that any one structure – or even a class of structures – is best. But we can see the sorts of promises that are likely to emerge in the competition for investments’.


Introduction

As stated above,\textsuperscript{882} I try to avoid any sort of contractual determinism in providing a normative account of articles of association which is able to accommodate the introduction of contractual clauses establishing restrictions on transfer of shares. I also describe these restrictions provided by default rules as tools that legislators use to adapt property rights in shares to the nature and purpose of the PLLC. I have equated this with a process of artificial selection by which legislators enable corporate constituencies, in particular shareholders, to maintain the closed nature of their business, and to ensure that transfers or changes in the company’s ownership structure are approached from an entitlements perspective. At the same time, these restrictions influence market agents’ behavior as to the way they perceive their investment in the company, and the relationships of power between members and directors of the company. All in all, restrictions are contractual mechanisms of governance. The questions that pose themselves are the following. What is this governance of? What is this governance for?

\textsuperscript{881} I am thankful to the Institute of International Economic Law (KATTI) of the Faculty of Law of the University of Helsinki for having hosted me while I was preparing an earlier draft of this chapter. Research on this chapter has been partly supported by research mission funds of the Law Department of the European University Institute.

\textsuperscript{882} See Part II, Chapter 1.
Market failures, that is to say, asymmetries of information, negative externalities, restrictions on competition, collective action problems that cause a sort of institutional apathy, and opportunistic behavior in general, have traditionally been attributed to a need for more regulation. It is even said that these problems justify the restricting of shareholders’ freedom to contract and design the company’s articles both at the moment of its foundation, and beyond.\textsuperscript{883} I have stressed throughout this dissertation the contractual nature of company law. It is my strong belief, however, that this contractual core must be tempered with the right approach to property rights. This would include their governance by contract. Against this backdrop, the shaping of fundamental legal institutions executed by lawyers is of undeniable importance.\textsuperscript{884} Lawyers, by acting as gatekeepers, can engineer the company’s articles through well-crafted and clever solutions based on Pareto efficiency.\textsuperscript{885} However, default rules informing the contractual choices taken by market agents and their lawyers are designed by legislators. Oftentimes, these rules have revealed weak enforceability. They also fail to create incentives for market agents to change, particularly when the legal framework no longer fulfils their interests. In addition to managing with an outdated legal framework, market agents may also be ill-advised. Thus, I suggested a three-level model policy by which law can be generated from the bottom up.\textsuperscript{886} In general, formal changes to law occur at level 2 (the level of legislatures) after market agents’ behavior at level 3 (the level of the market) has consistently unveiled longstanding practices adopted at this level. Legal changes are likely to affect the society as a whole (level 1).\textsuperscript{887} In this context, this chapter explores the alternatives available to lawyers, from a contractual and property rights point of view, to (re)adjust the relationships between corporate constituencies. This creative endeavor can be compared to the drafting work of an engineer. The lawyer, like the engineer, understands the import of relevant information being effectively communicated (in the case of the lawyer, upon the

\textsuperscript{883} See Grundmann, Stefan, \textit{European Company Law: Organization, Finance and Capital Markets}, 2\textsuperscript{nd} ed., Cambridge, Antwerp, Portland, Intersentia, 2012, p. 51 (stating that considerations in respect to collective action problems that lead to ‘shareholders’ apathy’ ‘… are important for restricting the freedom to design the company’s statutes at the moment of its foundation, but they are certainly no less important for restricting the freedom to change the statutes later’).


\textsuperscript{885} See Part II, Chapter 4.

\textsuperscript{886} See Part II, Chapter 1.

\textsuperscript{887} There are, however, several reasons legislatures and regulators (politicians) will not always enact or reform law pursuant to the interests of the market. Market can be defined in economic terms as a transaction by which there is interplay between supply and demand. Markets have different structures and some of them have very complex structures. There is this view that markets are legally construed and can exist only in the framework set by law and government. This is the case of financial markets. See Pistor, Katharina, ‘A Legal Theory of Finance, \textit{Journal of Comparative Economics}, vol. 41, 2013, pp. 315- 330.
incorporation of the company and the drafting of its constitutional documents). She is keenly aware of the need for the ‘conventions of engineering drawing’ to be understood, and to remain functional throughout the life of the firm.

This chapter is about drafting the company’s contract. It proceeds as follows. Section 1 tries to explain the importance of the company’s contract by taking into account two. First, I consider the approaches taken in the literature to corporate law and the ‘corporate contract’. Second, I treat some of the proposed views that try to explain why firms are thought to be more beneficial than markets. Section 2 is an attempt to create a scheme of governance of the company’s contract. This scheme is mostly based on an analysis of property rights in different circumstances. Lawyers are described as reflexive intermediaries who assess current realities and harness them to create the best possible solutions. A scheme of governance of the company’s contract calls for mechanisms that strengthen property rights through contract. Again, not only lawyers play a special role, but also legislatures are important in this framework. Section 3 focuses on the definition of property rights ex-ante. It proposes two solutions to strengthen property rights at this stage – the dissolution of the company at will and the inclusion of lock-in clauses in the company’s contract. Section 4 concludes. This normative construction of the interplay among property rights, transaction costs and economic and political concerns owes a large debt to Ronald Coase.

1. The company’s contract: Why do members use it?

I shall begin with the economic question of why members need to draft a contract when they incorporate the PLLC. The answer is dual-pronged: it relates both to one's approach to corporate law and to the ‘corporate contract’, which has much to do with the structure of the firm and the definition of legal entity, and to the proposed view of interactions among individuals, which tries to put forward an explanation for the benefits of the firm in comparison to those of the market.888

The so-called ‘nexus of contracts’ theory stands out in any discussion of 'corporate contract'.889 This theory submits that the firm is nothing but a nexus of contractual

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888 See Coase, R. H., ‘Coase, R. H., The Nature of the Firm, *Economica*, 1937, pp. 386-405 (pp. 391-392) (arguing that whether a multiparty activity will be organized within a firm or through market transactions is dependent upon the respective transaction costs).
arrangements. In other words, the firm is what holds together a bundle of contracts such as employment contracts, supply contracts, lease contracts, and so on.\(^{890}\) Pursuant to this theory, corporate law is composed of a number of standard terms available to parties to use as they please.\(^{891}\) The nexus of contracts theory has been challenged by an increasingly strong property rights approach which maintains that some features of the company cannot be subjected to freedom of contract. Cases in point are limited liability, capital lock-in, and even fiduciary duties, when creditors and possibly members’ rights are at stake. It is indeed true that the contractual nature of the firm has long been recognized. For example, it has been framed within the conceptual lines of long-term contracts. It also has been defined as an alternative to the coordination offered by the market through the pricing system, and which is based upon a contract that sets the limits within which the entrepreneur directs the factors of production.\(^{892}\) I try, however, to put forward an explanation for the efficiency of some contractual solutions over others. This entails having an eye on the ‘residual rights of control’ that come along with the ownership of property rights in the firm.\(^{893}\)

With respect to the interactions among individuals that have fostered most of the theories of the firm, three lines of thought are worth mentioning. One is followed by the proponents of transaction costs economics (TCE),\(^{894}\) another emerges from property rights literature,\(^{895}\) and the third is supported by literature on incentives theory.\(^{896}\) The basic question


\(^{891}\) See Easterbrook, Frank H., and Fischel, Daniel R., ‘The Corporate Contract’, *Columbia Law Review*, vol. 89, N.º 7, Contractual Freedom in Corporate Law, pp. 1416-1448 (1445). It is important to note that default law is not an inherent consequence of nexus of contracts, although Easterbrook and Fischel have strongly argued in favor of default rules. There also are mandatory rules in many fields of contract law. Besides, the traditional view of fiduciary duties is that they are mandatory, and that one cannot, in principle, opt out of if one is a fiduciary. This view has been eroded somehow regarding the LLC.


\(^{893}\) See Coase, R. H., ‘The Institutional Structure of Production’, *The American Economic Review*, vol. 82, 4, 1992, pp. 713-19, which basically consists of his Nobel Lecture (saying that because in the world of positive transaction costs it is extremely costly and unprofitable for individuals to negotiate, even when a great deal of contracting is allowed by the law (e.g., defaults), the rights individuals possess are to a great extent determined by the law. In his words ‘It is obviously desirable that these rights are assigned to those who can use them most productively and with incentives that lead them to do so and that, to discover (and maintain) such a distribution of rights, the costs of their transfers should be low, through clarity in the law and by making the legal requirements for such transfers less onerous. Since this can come about only if there is an appropriate system of property rights (and they are enforced), it is easy to understand why so many academic lawyers (at least in the United States) have found so attractive the task of uncovering the character of such a property rights system, and why the subject of “law and economics” has flourished in American law schools’).


is: Why do companies exist? Putting it differently, why is it that individuals often prefer to organize their activities into a firm rather than transacting on an individual basis in the market? What drives integration? Classically, TCE sees the firm as an alternative method of coordination to the pricing mechanism. The firm appears out of an attempt to avoid transactions costs of carrying out transactions through the market (e.g., costs of drawing a contract, costs regarding inspections or policy costs of the contract, arrangements to settle disputes, etc.). Also, the allocation of resources is undertaken through administrative decisions of a board, which has drawn the attention of Coase, and later Jensen and Meckling, to what has been defined as agency relationships (e.g., master and servant, employer and employee). These considerations have been developed in modern writings, in particular in the field of new institutional economics (NIE).

The approaches taken by TCE and the property-rights literature can be distinguished from one another by two elements: transaction costs and the incompleteness of contracts. TCE takes the transaction as a ‘basic unit of study’.\textsuperscript{897} Private ordering (or private governance) is, therefore, the distinctive aspect of the formulation drawn by this literature. Driven by the token of efficiency, private ordering, in the form of the most diversified contractual arrangements, is considered to be in itself self-sufficient in terms of incentives to overcome contractual inefficiencies ex-post. Since there are transaction costs and, consequently, contracts are naturally incomplete, parties will manage to find the best solutions to overcome inefficiencies ex-post.\textsuperscript{898} Taking a different tack, the property rights literature centers on contractual inefficiencies ex-ante. It tries to create incentives such as ‘residual rights of control’ by which bargaining inefficiencies are surpassed ex-ante. It is interesting to note that TCE does not disregard the importance of ownership arrangements. Nevertheless, it rejects the construction of a scheme of property rights based exclusively on a centralized legal system that defines a priori the ‘dos’ and ‘don’ts’ when it comes to the allocation of ownership. TCE bases the construction of a system of property rights on private ordering. For


\textsuperscript{897} See Williamson, Oliver E., \textit{The Economic Institutions of Capitalism}.

\textsuperscript{898} It may be too late to solve contractual inefficiencies ex-post. The point of incomplete contract theory is that incompleteness leaves space for ex-post opportunism for which the parties need to find a solution ex-ante. See Maskin, Eric, and Tirole, Jean, ‘Unforeseen Contingencies and Incomplete Contracts’, \textit{Review of Economic Studies}, vol. 66, 1999, pp. 83-114.
the advocates of TCE, property rights matter because the owner wields decision-making power in those areas in which the contract is incomplete.

I do not see these views in an either/or context. Rather, this dissertation combines the two.\textsuperscript{899} I question whether the design of rules can affect the investment and consequent development of the company. This involves considerations of legal policy that set the tone on mechanisms of contractual efficiency ex-ante such as the terms by which ownership and control are allocated in the company. It implies thinking of property rights differently, in a context wherein the lines dividing ownership and control are often blurred. It demands an understanding of who has the residual decision-making power and how that affects the design of rules.\textsuperscript{900} It implies considering those situations in which control in the company may be acquired through an un-consented transfer, which allows that a third party interferes with the business of the company even if the so-called ‘owners’ have not given their consent to it. Ultimately, it is all about understanding, and making use of, the dynamics of control.

PLLC members use a company’s contract because they need to follow a standardized procedure that is implied in the creation of a PLLC. They are thus advised by their lawyers who draft the contracts for them. But even if, in reality, members often ignore the contract they themselves made sure to be drafted, either because of close ties amongst them or because they want to keep a certain status quo, the fact is that by using the company’s contract they allocate a priori the resources available for the operation of the firm and execution of the respective legal entity. It gives them the psychological wherewithal to move on with their business. However, the company’s contract cannot keep up with the company's business. Except for the alteration of the members of the company, the directors, the share capital or the registered office as well as other relatively easy alterations to do, business practices are likely to become rooted into a status quo that shields corporate constituencies. Governance of the contract can help break this status quo and induce the renegotiation of the contract ex-post.\textsuperscript{901} This is the other reason that members use the contract. It allows them to use governance

\textsuperscript{899} The incentives theory mentioned above in the text is basically a variety of the property rights theory of the firm. Therefore, I do not explore it.

\textsuperscript{900} It is true that managers and directors of PLLCs control the company in many situations. But it is also true that in the PLLC, unlike in the public company, members can pass binding instructions to the management, and they do not suffer from collective action problems as much as public shareholders, especially if the company is small. The concept of ‘piercing the ownership veil’ that is dealt with in Part II, Chapter 3 has much to do with who truly exercises the residual decision-making power in the company.

\textsuperscript{901} See Möslin, Florian and Riesenhuber, Karl, ‘Contract Governance – A Draft Research Agenda’, European Review of Contract Law, vol. 5, 3, 2009, pp. 248-289 (distinguishing four topics of contract governance – governance of contract law, governance of contracts, governance by means of contract law, and governance through contract. In theory, the lines demarcating these forms of contract governance are more or less clear. In practice, the dividing lines are not so evident).
mechanisms that will generate renegotiation at a future point in time.\textsuperscript{902} One way to conceptualize this governance opportunity is to think of governance of property rights by contract. Property rights of members, for example, should be strong enough to make other corporate constituencies such as managers feel that it is in their self-interest to behave in a manner that will put them in an advantageous bargaining position in the future regarding the members that have stronger property rights. This is true particularly if future transactions are planned. Let us imagine a situation in which managers or directors are appointed by one of the members. If a merger is planned by which the member that appointed managers in the company will obtain a greater stake in the new undertaking, managers or directors are naturally committed in aligning their interests with the interests of the member that appointed them. On the member’s side, it is useful to have allies in a company that now merges two different corporate policies, in particular regarding the distribution of dividends and retained earnings of the company. It may be that the only way to beat opportunism is by using opportunism itself. The question is, how do we strengthen property rights to this end?\textsuperscript{903}

2. Giving strength and substance to property rights through contract: How to manage the governance opportunity

The idea of governance of contractual relations goes back to late Coase and his groundbreaking work on the nature of the firm. The understanding that market agents can alternatively choose between the market and the firm for the organization of factors of production is in itself a governance choice.\textsuperscript{904} The problem with the word ‘governance’, however, is that it is often ill-defined in respect to its foundations, object, and purpose or

\textsuperscript{902} It is true that the theory of incomplete contracts treats the phase of renegotiation as one way in which parties can behave opportunistically ex-post. See, for example, Segal, Ilya, ‘Complexity and Renegotiation: A Foundation for Incomplete Contracts’, \textit{Review of Economic Studies}, vol. 66, 1999, pp. 57-82 (58) (stating that ‘Each inefficient future trade is a potential hold-up opportunity: each party may claim that it is efficient trade, in the hope of extracting a greater share of \textit{ex post} surplus’). However, this should not prevent the parties from being provided with tools that enable them to surpass high transactions costs involved in the revision or redraft of a contract or serve the company and the interests of its members by breaking a dominant status quo that is not beneficial.\textsuperscript{903} See Williamson, Oliver E., ‘The Economics of Governance’, \textit{The American Economic Review}, vol. 95, N.º2 (Papers and Proceedings of the One Hundred Seventh Annual Meeting of the American Economic Association, Philadelphia, PA, January 7-9, 2005, pp. 1-18 (14) (stating that property and contractual hazards invite the use of private ordering to infuse order, thereby to mitigate conflict and realize mutual gains from trade’).

\textsuperscript{904} See Williamson, Oliver E., ‘The Economics of Governance’, cit., p. 2 (claiming that ‘As against simple market exchange, governance is predominantly concerned with ongoing contractual relations for which continuity of the relationship is a source of value’).
functionality. The word *governance* is used by the layman in several ways to mean control, power, management, administration, the exercise of authority, or the act of governing. When it comes to the corporation, I try to give normative substance to the word ‘governance’ by framing it within a perspective that takes the relationships between shareholders, managers and other third parties (possibly creditors) into account. This is in line with the evolutionary thread of this dissertation, which suggests that in law, everything is connected. This also is true of corporate constituencies. Hence, it is in this setting that I try to design a scheme to govern the company’s contract, and the relationships between corporate constituencies. This scheme is based, for the most part, on tracing the shape of property rights in different circumstances.

(i) Governance as reflective of reality and lawyers as ‘reflective intermediaries’

The foundations of contract governance rest on the uncertainty that accompanies contractual incompleteness. The incompleteness of contracts may be associated with the extent to which shareholders can exercise residual rights of control, and managers can exercise their discretion and business judgment. In the context of this uncertainty that is part and parcel of the impossibility of foreseeing all possible future events that may originate losses of efficiency, the governance structure of a company by contract should be a reflex of reality. In this context, lawyers work as reflexive intermediaries. They look at the market and market agents’ demands and try to make the business go through by adopting a 360° degree perspective. Yet, market agents can shape the market for the benefit of a particular agent or group of agents. If this happens, what are the guarantees that lawyers will provide the best

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905 See Smith, Henry E., ‘Exclusion versus Governance: Two Strategies for Delineating Property Rights’, *Journal of Legal Studies*, vol. 31, 2002, pp. 453-487 (455), note 5 (referring to ‘governance’ to mean the ‘…high degree of delineation of rights to resources in terms of use.’). He clarifies that ‘…governance can be supplied by norms, regulation, or contract. This dovetails with prior usage, because we often use the term “governance” to refer to the norms of use in common-pool regimes, to the exercise of power of the state, and to organization of economic activity through contractual restrictions’. Later, on his paper (p. 470) he says that ‘Governance … consists of a set of norms picking out important uses of the asset. In between are proxies that target sets of uses of varying sizes. Along this spectrum are various hybrid rules, which deny access to attributes on the basis of features or activities of the potential entrant; for example, commoners may have a rule that limits the number of type of animal an appropriator can bring onto the commons’).

906 See Part II, Chapter 4 where I say that ‘…the firm potentiates the convergence of character of corporate constituencies through the business organisation, even if they do not share the same genetic background’.

907 I am clearly following modern property rights literature.

What happens if evolution encounters limitations? Law can still be used as a commodity, as is explained below.

(ii) A multi-stakeholder perspective of the company and a ‘chicken and egg’ question – what comes first: the market or the law?

The company must be viewed not only from the perspective of shareholders’ investment, but also from a perspective that considers the creation of economic value. This demands a holistic view of the company in which all corporate constituencies are viewed as potential contributors to the creation of such economic value. When these circumstances obtain, law can be seen as a commodity for evolutionary purposes. Putting it differently, law can be used as an instrument that is legislatively processed and put to the use of shaping the market when it comes up against evolutionary limitations.

One might ask whether the duty to ‘restore’ optimality rests upon the law or upon the market. It is notoriously difficult to answer this question. In fact, it can be perceived as a ‘chicken or egg question’ (what comes first: the law or the market?). In my view, however, law follows the markets in most situations. I argue that, in most cases, law comes afterwards. This can be illustrated with the cases of Portugal, Spain, and the United Kingdom, where the PLLC was first created by market agents with the support of lawyers and notaries, without the existence of a legal framework for these companies. Hence, I submit that law has the potential to restore optimality through a selective process based upon experimentation, where legislatures operate as selective agents, and lawyers operate as legal

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909 Apropos the role played by lawyers during and in the aftermath of the 2008 crisis, two popular European roundtable questions are: ‘Is there a role for lawyers today?’ and ‘What happened to the law during the 2008 crisis?’ since in those very recent circumstances law was overridden by economic rationality. It is important to note that many of these debates are informed by a sociological point of view from which law and economics are both approached. On this topic, see Coffee, John C., Jr., Gatekeepers, cit.

910 I am referring to the situations mentioned in Part I Overview where I explain that mutations are subject to limitations and change does not happen or, when it does, it does not go a long way. There are physical limitations to evolution. This also is true for legislation. In the context of drafting the company’s contract, which this chapter is discussing, constraints to evolution derive to a great extent from the pervasiveness or stickiness of the relational element that binds the parties to the company’s contract.

911 See Freeman, Mark et al., Shareholder Democracies?: Corporate Governance in Britain and Ireland before 1850, Chicago and London, University of Chicago Press, 2011 (analyzing the practice of governance in joint-stock companies in Britain between the Bubble Act of 1720 and the Companies Act of 1844. According to the authors, this was a period during which the legal status of the joint-stock company in England was most uncertain, and in Scotland and Ireland was still not entirely resolved. They explain that the reason for the choice of this period is that it was one in which corporate governance structures, whether in corporations or in unincorporated companies, were largely formed without state intervention. They refer to it as the ‘key era of experimentation in British corporate governance history’). This is a good illustration of how law sets its foundations from below.

912 See Part I, Chapters 2 and 3.
engineers. In this framework, experimentation trenches the traditional delineation of property rights to find cues for the using of property rights as a form to alleviate inefficiencies.

Experimentation can be undertaken through contract governance, the object of which is the respective contract (management of contractual relations). Articles of association analyzed for this dissertation are an elucidative example of how legal engineering and experimentation can be undertaken under the arrow of default rules. There are multiple ways to engineer the contract of the company. It can be performed by including clauses regulating the voting and structure of the general meeting, the voting and structure of the management board (e.g. the creation of a sort of supervisory board, or the inclusion of one particular member in the management board. This member frequently is the majority shareholder or an ‘activist’ shareholder. It can be a member that, alone or together with its representatives, possesses the expertise, knowledge and sophistication in financial and business matters, and in types of transactions in which the company proposes to engage. This member is expected to be capable of evaluating the merits and economic risks of acquiring shares or holding the units or shares. She should be able to bear all such economic risks in the present and in the future.

Other mechanisms to engineer the company’s contract can be, for instance, to provide additional warrants and representation clauses, pre-contractual agreements (e.g., promissory share sale and purchase agreements, escrow agreements, certificates, instruments and other documents foreseen in those agreements), transfer restrictions, the determination of situations in which only the company can take action, the regulation of ownership interests, capital contributions, the distribution and allocation of capital, tax allocations, limitation of fiduciary duties of directors to the company, any member and to other directors (this is mostly found in LLCs’ operating agreements), and limitation of corporate opportunities for directors, the regulation of deadlocks, accounting reports, tax matters, indemnification and compensation of members, employees and agents. All these are mechanisms of managing or directing the contractual venture.

However, giving strength and substance to property rights through contract work that lawyers can do, at the level of the market, and legislatures can do, at the level of legal policy, requires an accurate understanding of the mechanisms that can be used for that purpose. It is

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913 For example, LLC agreements may require that each member represents and warrants to the company and to each other member that (a) the member is acquiring membership interests in the company for the member’s own account and investment; (b) the member acknowledges that the interests have not been registered under the Securities Act of 1933 or any state securities laws, and may not be resold or transferred by the Member without appropriate registration or the availability of an exemption from such requirements; and (c) the Member agrees to the terms of the Agreement and to perform the Member’s obligations hereunder. This can be seen in the LLC agreement of Cornerstone Healthcare Partners, LLC included in the sample of US companies.
not just a matter of doctrinal knowledge or political convenience. It should be a matter of adequate reasoning and market sensitivity to the situations that can originate negative externalities and inefficiencies ex-post. The first question to ask is: are stronger property rights more likely to incentivize development and investment in the company? Let us consider the scheme of a second-price sealed-bid auction. This scheme has the potential to nudge the parties to disclose their own valuations. From a functional standpoint, the company’s contract can be drafted to meet this purpose. It can also be drafted to enable the periodic readjustment of property rights in order to internalize harmful externalities. It is likely that well-defined and strong property rights, which, again, can be achieved through specific clauses regulating voting rights, the composition of the management board, capital contributions, fringe benefits, loans that must be granted by members to the company or the procedure for the transfer of property rights in shares, will unleash behavior that may be socially beneficial. On one hand, bargaining failures may be constrained by virtue of the clarity and enforceability of the applicable rules. On the other hand, there can be a psychological effect that induces members, managers and employers of the company, for example, to be keener to align their interests with the interests of those who hold stronger property rights to benefit from the control they exert in the company. However, there are no guarantees that they will be rewarded by those holding the stronger property rights.

Part of the work of legal engineering has largely to do with choosing governance mechanisms with the potential to enable the above-suggested effects. This task is greatly facilitated by default rules provided by the legislator. However, it must be preceded by an effort to define property rights each corporate constituency holds in the company.

3. Mechanisms to define property rights as a management strategy of the governance opportunity

As put by Alchian and Demsetz, ‘The strength with which rights are owned can be defined by the extent to which an owner’s decision about how a resource will be used actually

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914 See Kobayashi, Bruce H., and Ribstein, Larry E., ‘Law as a ByProduct: Theories of Private Law Production, Illinois Program in Law, Behavior and Social Science Paper No. LBSS11-27 (referring to the lack or weakness of property rights in law held by private lawmakers, which prevents them from engaging in innovation).
915 See Part II, Chapter 4.
determines the use. Accordingly, the way the scope of property rights in shares is designed is likely to have an influence on the exercise of these rights. It also is likely to affect the management of the company. Hence, delimiting a workable and efficient system of property rights is vital, especially if experiments are to be made at the market and legal policy levels to test the best way to adopt the best rules or to adjust existing ones. Delimiting here means specifying rights, duties, privileges and powers that are certain in their content and enforceable. It means adding value to the rights of shareholders so that they will want to hold on to their shares unless a buyer is willing to pay the right price for them. This is an alternative to what is laid down above about renegotiation, which is undertaken through unspecified arrangements that encourage renegotiation ex-post to reach optimal results. Delimiting property rights ex-ante is equally important for a market to develop.

There are two types of contractual strategies that can be drawn to strengthen property rights: dissolution at will (or its threat) and the inclusion of lock-in clauses in the company’s contract. At this point, it is worth remembering Dawkin’s description of how genes cooperate and compete against the background of a process of natural selection. By resorting to the image of a rowing competition, he explains that in order to win the evolutionary race genes must not only compete, but also cooperate with each other in order to coordinate their actions. By the same token, it is important to find mechanisms that enable market agents to choose the best rules, and legislators to draft the best legislation through competition and coordination. Consequently, the question is: will the adoption of a particular governance mechanism induce market agents to cooperate and compete for the most efficient legal solution? I try to answer this question regarding the above-mentioned dissolution of the company and lock-in clauses.

(i) Dissolution at will as a remedy for the un-consented transfer of shares

Several cases in the sample of case law analyzed were brought to court following a deadlock, dissention between members, or equivalent situations of bilateral monopolies where shareholders switching costs were prohibitively high. Judicial dissolution has been treated in the literature as well as jurisprudence as a mechanism to overcome these situations and

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918 Refer to Part II, Chapter 2 wherein a Hohfeldian definition of share comprising rights and duties, privileges and no-rights, powers and liabilities, immunities and disabilities is presented.
respond to unexpected changes in the relationship of the parties.\textsuperscript{919} An interesting case worth pointing out is Kirksey v. Grohmann\textsuperscript{920} which was appealed to the South Dakota Supreme Court. It will serve as a springboard for discussing the same issues in the remaining jurisdictions.

Kirksey v. Grohmann deals with the feud between four sisters who inherited from their mother equal ownership interests in family land. They decided to incorporate a LLC to which they transferred their property interests in exchange for equal shares in the LLC’s share capital (25% each). They decided to create the LLC to avoid paying estate taxes; to keep the land in the family in light of the fact that it had been there for over 100 years, and to make sure that the sisters and not their spouses would retain ownership interests in the real property. Following early valuations of the land and to obtain the benefit of those valuations, not only were family members required to live there, but also the land was used for agricultural purposes. The eldest sister had lived there as a hired hand before their mother’s death. Additionally, two other sisters, together with the eldest, owned livestock on the land. So that agricultural activities could continue, the sisters decided that the LLC would enter into a lease agreement by which the land would be leased to three of them. However, soon after the LLC was created, the relationship between its members begun to deteriorate. One of the members complained that the others ‘failed or refused to share information’ to which she believed that she was entitled as a tenant to the lease. Moreover, the complaining member claimed that two other members subleased part of the land without notice to the LLC as required by the operating agreement. The eldest sister and one of the members the complaints were made against responded by saying that the necessary information was always given. Moreover, she argued that all members had received notice of the sublease as they were all aware of the sublease arrangement when the sublease payments were initially equally distributed. The complaining party ended up selling her interest in the livestock. At that point she was no longer a tenant. Nevertheless, this did not end the acrimonious relationship settled between the members of the LLC. Two members who were not tenants to the lease (including the complaining member and one other sister) hired a real estate agent to value the land. The price, which was estimated at several million dollars, caused those two members to seek the

\textsuperscript{919} See Ribstein, Larry E., ‘Close Corporation Remedies and the Evolution of the Closely Held Firm’, \textit{Western New England Law Review}, vol. 33, 2011, pp. 531-565 (561) (defending that judicial dissolution is a contractual mechanism for responding to unforeseeable changes in which owners cannot cheaply exit via sale of their shares).

\textsuperscript{920} Kirksey v Grohmann, Kirksey, 2008 SD 76, 754 N.W. 2d 825.
termination of the lease agreement, the dissolution of the LLC, and the partition of the land. These members filed a motion to terminate the lease agreement at the general meeting of the company. The two other members opposed the motion. Given that the company’s contract required resolutions be taken by majority vote, the motion failed due to the deadlock. In the face of the deadlock, the member who moved the action and the one who seconded it filed a petition with the circuit court of South Dakota requesting that the court dissolve the LLC because ‘its economic purpose was unreasonably frustrated and it was not reasonably practicable to carry on the company’s business in conformity with the articles of organization and the operating agreement’. They added that ‘the strained relationship between the sisters made it impossible for any major decision-making’ and that the two opposing members had ‘a personal financial interest in continuing the lease agreement and preventing dissolution of the LLC’ to the detriment of the plaintiffs. The circuit court denied the plaintiffs’ petition. Consequently, they appealed to the Supreme Court of South Dakota, invoking the error of the lower court in granting summary judgment against judicial dissolution of the LLC. The Supreme Court reversed the summary judgment granted in favor of the defendants and remanded the case for entry of an order of judicial dissolution and winding up pursuant to S.D. Codified Laws § 47-34A-806. The Supreme Court provided that

The sisters created their company with the understanding that they would have relatively equal say in its over-all management and operation. Although each sister has an equal vote, there no longer exists equality in the decision making. [G and R] have all the power with no reason to change the terms of a lease extremely favorable to them. Leaving two sisters, half the owners, with all the power in the operation of the company cannot be a reasonable and practicable operation of a business. Moreover, their deadlock certainly impedes the continued function of the business in conformity with its operating agreement. No procedure exists in the company’s documentation to break a tie vote and protect the company in the event of changed condition. As long as the company remains in control of, and favorable only to, half its members, it cannot be said to be reasonably practicable for it to continue in accord with its operating agreement.

The court goes on saying that in this case

… we have two members of an LLC that hold all the power, with the other two having no power to influence the company’s direction. We recognize that forced dissolution is a drastic remedy

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921 This is an example of opportunism. They were trying to dissolve the LLC that was set up exactly to prevent a split-up of the land.
and may produce financial repercussions for the sisters, but how can one reasonably conclude that the economic purpose of this company is not reasonably frustrated? The members cannot communicate regarding the LLC except through legal counsel. The company remains static, serving the interests [...] of only half its owners. They neither trust nor cooperate with each other. The sisters formed their company contemplating equal ownership and management, yet only an impenetrable deadlock prevails. [Highlighted by the author]

At this point, one might ask why dissolution is needed for this. Could not this situation of self-dealing be resolved under the duty of loyalty? If fiduciary duties do not provide a solution, dissolution is still considered an alternative. Next, one might wonder about less severe solutions for the problem, such as changes in the governance agreement. The rub lies in the idea that even though rights were foreseen statutorily, the reality was not reflexive of the agreement into which the members had entered. Furthermore, this is a case that mirrors how the relationships of power in small companies are liable to freeze the business purpose for which they were created. The astaticism that subverted the purpose of the ownership interests led the court to dissolve the LLC.

It is interesting that in this case the court opted for taking a drastic measure such as dissolution instead of reasoning about other remedies like, for example, breach of fiduciary duties, and breach of contract or invoking controlling shareholders’ opportunism. In this dissertation, I have treated a case in which restrictions on transfer of shares fail as a governance mechanism of the PLLC which, given its nature and purpose, frequently begs for a contractual structure that limits the openness of the market for its shares. The failure rests on the fact that shareholders end up selling their shares in breach of the requirement of consent stricto sensu stipulated in the company’s contract (un-consented transfer). It is true that, in

922 See Thompson, Robert B., ‘Corporate Dissolution and Shareholders’ Reasonable Expectations’, Washington University Law Quarterly, vol. 66, N.º 2, 1988, pp. 193-238 (stating that ‘The legislation and judicial decisions expanding dissolution rights and providing alternative remedies reflect this reality more accurately than the traditional statutory and fiduciary norms, which overlooked the intimacy of the participants’ relationship, the illiquidity of their investment, and the inability of participants in such enterprises to plan adequately for disharmony’). Courts have been keen to reiterate the principle stated by the US Supreme Court that ‘where a dispute arises from obligations that are expressly addressed by contract, that dispute will be treated as a breach of contract claim’. Moreover, any fiduciary claims arising out of the same facts that underlie the contract obligations would be foreclosed as superfluous’. On this, see Fisk Ventures v. Segal, 2008 Del. Ch. 158 (May 7, 2008); Vila v Bwwebties LLC, -- A3d --, 2010 Del. ch. Lexis 202 (Rel. ch. Oct. 1, 2010 citing Nemec, 991 A.2d at 1129 (citing Blue Chip Capital Fund, 906 A.2d 827, 833 (Del. Ch. 2006); Gale v. Bershad, 1998 Del. Ch. LEXIS 37, 1998 WL 118022, at *5 (Del. Ch. March 3, 1998).

923 This is, in fact, stressed by Gruebner, Meghan, ‘Delaware’s Answer to Management Deadlock in the Limited Liability Company: Judicial Dissolution’, The Journal of Corporation Law, vol. 32, 3, 2006, pp. 641-657 (arguing that ‘A buy-sell agreement is probably the best solution for management deadlocks, because it allows the communication of the company within the control of one of the original members. Furthermore, it does not
the United States, if the transfer is not consented, the transferor can still transfer economic rights. Furthermore, there are European countries where such a transfer may be considered by courts as entirely unenforceable. The problem is that often these measures are not sufficient to prevent the indirect influence of a third party in the company, which subverts the purpose for which the PLLC was created. One could think that the fact that the articles of association offer an exit mechanism such as rights of appraisal would be enough to prevent the bargaining failures and situations of bilateral monopoly we have seen in this dissertation. Nevertheless, in countries like the United Kingdom, such rights are not statutorily established. There are, in fact, situations of lock-in of shareholders if directors decide not to register the transfer in the register of members. Also in the United Kingdom, the validity of tag-along and drag-along clauses, for instance, introduced in the articles of association has not been tested in courts yet. Besides, when exit mechanisms are ‘consecrated’ in the company’s contract, they may be outdated because they were agreed upon at a time when the contractual expectations of the parties were different.

Thus, given these circumstances, the question is whether it is normatively acceptable to push the remedy of judicial dissolution beyond fault of controlling shareholders, as in Kirksey v. Grohmann. In other words, can dissolution be used in broader terms for protection of the interests of corporate constituencies? It is difficult to say conclusively, because dissolution is in and of itself a drastic measure. However, in the United States, LLCs like partnerships are often at will. That is, any member can send the company into dissolution. Even, otherwise, a court may order dissolution for some important reasons such as the frustration of the economic purpose of the company. Furthermore, I refer to dissolution because constituencies hold common interests in the company and, therefore, a possible scenario of dissolution has the potential to (re)adjust the interests of shareholders, managers, employees, and even creditors. This is so because, if the company ends, any economic rents they expect to draw from the PLLC will most likely be destroyed and managers and employees will lose their jobs if the company is dissolved.

force the members to continue the business in disagreement and provides the departing member with a fair value for his interest in the company'?

924 See Freeman, Mark, et al. Shareholder Democracies?; cit, pp. 179 – 210 (referring to special rights of dissolution in conjunction with the clause of limited liability).

925 In the context of the problems raised by dissolution, see Li, Jianpei, and Elmar Wolfstetter, ‘Partnership Dissolution, Complementarity and Investment Incentives’, CESifo Working Paper No. 1325, 2004, pp. 1-23 (analyzing the relationship between investment and the dissolution decision. The dissolution rule to which they refer is typically a buy-sell provision, which they propose be combined with a right to veto the proposed dissolution. Otherwise, dissolution will always entail an efficiency loss).
Portuguese law provides that the articles of association may determine penalties for transfer of shares that is executed without the consent of the company.\textsuperscript{926} Given that these penalties are not specified, it seems that the law gives the members considerable leeway on this matter, and dissolution may be included in a contractual clause as a mechanism to sort out or avoid drastic situations of holdups and bargaining failures.\textsuperscript{927} Portuguese law also foresees judicial dissolution following the petition of the interested party based on a fact determined in the law or the contract. The idea of dissolution at will, that is, the dissolution of the company as per the exclusive will of one of its shareholders, is alien to Portuguese law. There is a manifest legislative intent to preserve the substance of the company. Nevertheless, possible scenarios of feud between members can arguably justify a request for dissolution even if the majority of members are against it. This is, in fact, more understandable in those situations in which the company’s contract does not provide any sort of lock-in clauses,\textsuperscript{928} and the minority shareholder sees her opportunity of investment being corseted by the status quo promoted by the majority. Dissolution can be even more pressing when there is a deadlock between the members (e.g., in a 50%-50% PLLC). When this obtains, the design of the clauses of the company’s contract ought to play an important role.

Spanish law determines that companies are dissolved by the existence of a legal or statutory cause acknowledged by the general meeting or by a court order.\textsuperscript{929} The law lists several causes of dissolution, one of them being a cause foreseen in the company’s contract.\textsuperscript{930} Judicial dissolution is also established.\textsuperscript{931} Additionally, the company may be dissolved by mere agreement of the general meeting.\textsuperscript{932} Thus, a legislative intent to preserve the substance of the company is also manifest in Spanish law. Nowhere in the law is dissolution at will foreseen. Notwithstanding this fact, most rules are defaults and, therefore, the legislator gives a large amount of freedom to market agents to design the company’s contract in the manner

\begin{itemize}
\item See Article 229 of the Portuguese Commercial Companies’ Code.
\item See Article 141/1 of the Portuguese Commercial Companies’ Code determining that the company is dissolved in the cases foreseen in the contract.
\item As discussed below, lock-in clauses are contractual devises that can be used for holding the member and securing her investment in the company.
\item See Article 362 of the Ley de Sociedades de Capital (providing that ‘Las sociedades de capital se disolverán por la existencia de causa legal o estatutaria debidamente constatada por la junta general o por resolución judicial’).
\item See Article 363 / 1 (h).
\item See Article 366 / 1 (determining that ‘Si la junta no fuera convocada, no se celebrara, o no adoptara alguno de los acuerdos previstos en el artículo anterior, cualquier interesado podrá instar la disolución de la sociedad ante el juez de lo mercantil del domicilio social. La solicitud de disolución judicial deberá dirigirse contra la sociedad’). (‘If the general meeting is not called, held, or does not resolve in accordance with any of the agreements referred to in the preceding article, any part may request the dissolution of the company before the judge of the Commercial Court located where the company has its registered registered office. The petition for dissolution of the company must be filed against the company’).
\item See Article 368.
\end{itemize}
they deem fit. In this sense, contractual clauses providing not only judicial dissolution, but also dissolution at will besides any other type of penalties for the un-consented transfer of shares or irreparable situations of deadlock in the company and disputes between members can be drawn.\(^{933}\)

Italian law, unlike Portuguese and Spanish law, foresees the principle of free transferability of shares, unless it is otherwise determined by the company’s contract.\(^{934}\) However, it establishes that transfers of shares only have effects toward the company if the share sale and purchase agreement with the authenticated signatures of the parties is filed by the authenticating notary at the office of the Companies Registry in whose jurisdiction the company maintains its registered office.\(^{935}\) Thus, the refusal of the notary to authenticate the signatures or file the agreement may as well work as a sort of penalty for un-consented transfers before drastic resort to dissolution. Still, the law, like, for the most part, Portuguese and Spanish laws, provides that the public company, the limited partnership and the Italian version of the PLLC (società a responsabilita limitata) can be dissolved upon the occurrence of the causes listed in the law and upon any other clauses established in the company’s contract.\(^{936}\) As a consequence, the law makes the distinction between the causes for dissolution provided by the law itself, and those provided by the articles of association. Like the two previous jurisdictions, in Italy, the conservation of the company’s assets (conservazione del patrimonio sociale) is seen as a fundamental principle.

In France, a company may be early dissolved by resolution of the shareholders.\(^{937}\) Early dissolution may also be ordered by the court at the request of a shareholder for just cause (justes motifs), particularly when contractual obligations are breached by a shareholder, or there is a disagreement between shareholders that paralyzes the functioning of the company.

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933 The dissolution of the company is not seen by many in Spain as an optimal solution due to the principle of conservation of the company (‘conservación de la sociedad’). It even has been regarded as an easy way for parties to part ways, a situation that is not consistent with an economic policy to keep factors of production. Moreover, it is said not to benefit minority shareholders. However, if the parties value their business enough they will not want to dissolve the company unless that is imposed by a mandatory rule or by contract.
934 See Article 2469 of the Italian Civil Code.
935 See Article 2470 of the Italian Civil Code.
936 See Article 2484/7 of the Italian Civil Code (Codice Civile) (establishing that ‘Le società per azioni, in accomandita per azioni e a responsabilità limitata si sciolgono … per le altre cause previste dall'atto costitutivo o dallo statuto’). (The public company, the limited partnership and the limited liability company are dissolved … for the other causes established in the articles of association or by laws [of the company].
937 The transfer clause of the company’s articles (status constitutifs) of the French SARL, Boucherie Gilles is illustrative. This company is included in the sample of French SARLs that I scrutinized. Its registered office is in Paris. The company’s contract provides for the early dissolution of the company if consent to the transfer is not given within one year as of the date the transférer made the offer to the company and other non-transferring shareholders. This company had two shareholders at the time it was incorporated.
French jurisprudence has clarified the meaning of *justes motifs* in several instances.\(^n\) Furthermore, the company may be dissolved for any other cause established in the articles of association.\(^n\) French law does not provide for dissolution at will.

UK law regulates the striking off of the company in general, which can be carried out by the registrar when the company is not carrying on business or in operation (registrar’s power to strike off defunct company); or by voluntary application by the company (voluntary striking off).\(^n\) The application for striking off of the company may be withdrawn by notice to the registrar.\(^n\) Essentially, it mirrors the same principle of conservation of the company that prevails in the jurisdictions treated above. Besides, United Kingdom law foresees the winding up of a company by a court on just and equitable grounds.\(^n\) It is difficult to draw a taxonomy of situations in which courts will consider that it is just and equitable to wind up a company. The generality of the words is obvious. English courts take a case-by-case approach and evaluate each case on its own merits.\(^n\) It is, however, possible to set out a number of circumstances that have determined the granting of a court order of winding up on just and equitable grounds:

1. Dissent between members often involving minority shareholders oppression.\(^n\)
2. Feud between members and directors leading to a breakdown of trust and confidence.\(^n\)
3. Directors’ misconduct.\(^n\)

The power that courts possess to make a winding-up order, if they consider that it is just and equitable that the company should be wound up, has been provided by the Joint Stock Companies Winding-up Act 1848 and then by the Companies Act 1862. Neither the literature nor jurisprudence has established a consensus on the words ‘just and equitable’. For more than five decades as of its contemplation in the law, this expression has been interpreted to

\(^{938}\) See, for example, Cour de Cassation, Chambre Commerciale, N.º 08-22073, 23 March 2010; and Cour de Cassation, Chambre Commerciale, N.º 02-14750, 14 December 2004.

\(^{939}\) See Article 1844-7 /4.º, 5.º, and 7.º of the French Civil Code. The company is in liquidation from the moment of its dissolution. The French Commerce Code provides rules regarding the liquidation of the company. In this sense, Articles L 237-1 and L 237-2 are worth reading.

\(^{940}\) See Section 1003 and ff of the Companies Act 2006.

\(^{941}\) See Section 1003.

\(^{942}\) See Section 122 (1) (g) of the Insolvency Act 1986 (providing that a ‘A company may be wound up by the court if … the court is of the opinion it is just and equitable that the company should be wound up’).


\(^{944}\) See Virdi v Abbey Leisure Ltd and others; Re Abbey Leisure Ltd [1990] BCLC 342, [1990] BCC 60.


include a list of circumstances *ejusdem generis*. In order to limit the scope of application of the words, there has been a tendency to list the situations which they are to apply. However, jurisprudence has tended to use this power broadly to judge those cases where the shareholder has relied on any circumstances of justice or equity which influenced her in her relations with the company and other corporate constituencies such as managers and other shareholders.  

Another relevant aspect that singles out the hybrid features of the private company in the United Kingdom is the bridge to partnership law that is created by jurisprudence, in particular regarding companies that are, in substance, partnerships. Indeed, given the size of certain companies and the close ties normally binding its members, the analogy with partnership law is, in these cases, intuitive. In addition, it favors the design of creative mechanisms of governance, especially if the relationship between corporate constituencies may reach a stage which cannot be predicted by the parties at the time they draft the company’s contract.

In the United States, I refer particularly to the laws of Delaware and New York states. According to the Delaware LLC Act, a LLC is dissolved and its affairs shall be wound up upon, among other causes, the happening of events specified in a LLC agreement. It is apparent that, generally, the Delaware LLC Act focuses very strongly on the agreement. Courts are not very likely to overrule a governance agreement for which the parties explicitly bargained. This stands in contrast with older case law on close corporations. Additionally, case law on fiduciary duties emphasizes the priority of contracts. The Delaware LLC Act also foresees judicial dissolution. Courts may order dissolution for some relevant reasons such as when it is not reasonably practicable to carry on the business in conformity with a LLC agreement. As to the 'reasonably practicable' standard for judicial dissolution, and for the most part similarly to the case Kirksey v. Grohmann above, courts have ordered dissolution of a LLC where there is a deadlock. However, it is not infrequent that operating agreements

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947 See the words of Lord Wilberforce in *Re Ebrahimi v Westbourne Galleries Ltd.* Also see *Re Thomas Edward Brinsmead & Sons* [1897] 1 Ch. 406 (winding-up on just and equitable grounds due to the constitution of a company for fraudulent purposes); *Re Diamond Fuel Co* (winding up) (1879-80) LR 13 Ch. D 400 (oppression of a minority shareholder by majority); and *Re A&BC Chewing Gum Ltd* [1975] 1WLR 579 (winding-up following a situation of deadlock).

948 See § 18-801 (dissolution). This is a default rule, which means that members have considerable leeway to dispose otherwise.


950 See Fisk Ventures, LLC v. Segal 2008 Del. Ch. LEXIS 84.

951 See 6 Del. C. §§ 18-802 (judicial dissolution). Some court decisions stress that in cases in which the standard for judicial dissolution is met, the ultimate determination of whether dissolution should be ordered is committed to the relevant court's equitable discretion. See, for example, Haley v Talcott, 864 A.2d at 93.

include a waiver clause by which members agree that the initiation of a dissolution action will cause ‘irreparable damage’ and they, as a consequence, agree to waive their rights to seek dissolution or the appointment of a liquidator. Not differently from the Delaware LLC Act, the NY LLC Law determines that a LLC is dissolved and its affairs shall be wound up upon the first to happen of several cases, namely the happening of events specified in the operating agreement. The law also provides for judicial dissolution ordered by the Supreme Court in the judicial district in which the office of the LLC is located on application by or for a member whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement.

The LLC is often described as a hybrid entity (at times, referred to in the jurisprudence as an alternative entity) that combines characteristics of corporations, limited partnerships and general partnerships. It is not uncommon to see that not only partnerships are at will, but also LLCs frequently are. Perhaps the reason why LLCs are at will, but European PLLCs are not, is that the US LLC laws are based on partnership law (the statutes being very similar), while European PLLCs are small versions of the corporation. It has not always been like this, especially at a time the LLC had not been implemented yet.

At this time, however, when the Treasury Regulation §§ 301 – 7701-2 defining business association was still in force, Larry Ribstein, the recognized intellectual authority in the field, claimed that given the high costs related to the illiquidity of partnership interests, a partner’s power to dissociate from the firm at will was desirable. Nevertheless, he called attention to ex ante uncertainty and the costs that non-dissociating partners would have to bear. For example, the abusive exercise of dissolution at will by a partner ‘…may cause all of

In this judgment of the Court of Appeals of New York, it is stated that ‘Any corporation may arrive at a condition where dissolution is the right and necessary course’. This is true not only of the corporation, but also the LLC.

See the N.Y. LLC. LAW § 701: NY Code - Section 701 (dissolution), which is a default rule.
See N.Y. LLC. LAW § 702 NY Code - Section 702 (judicial dissolution). This is a default rule.

This is apparent if one reads the Bill Jacket of the NY LLC Law, where reportedly Chapter 34 of the Consolidated Laws Limited Liability Company Law was enacted at the same time that partnership and business corporation laws were amended. It was possible to learn through a letter of John B. Daily, Senator for the 61st District, dated as of 13 July 1991, addressed to Ms. Elizabeth D. Moore, the Counsel to the Governor, that the Bill of the LLC for the State of New York would not only allow the formation of LLCs under New York Law, but also the recognition of general partnerships that provided professional services as registered limited liability partnerships (RLLLPs) under state law, and the recognition of limited liability status of general partnerships that provided professional services that had registered as limited liability partnerships (LLPs) in other states. It is understandable that the joint treatment of LLCs and RLLPs, especially for tax purposes, determines similar legal solutions for different types of business organizations to be adopted.

This refers to regulations 26 C.F.R. §§ 301.7701-1 to 301.7701-3, also know as ‘check-the-box regulations’ which allowed members of LLCs to elect to have the business treated as a corporation given that LLCs were ‘disregarded’ as separate taxable entities, and were treated as sole proprietorships for tax purposes. See the US case described in Part I, Chapter 3.
the non-dissociating partners to give up partnership assets without adequate compensation or to lose the benefit of firm specific human capital’. One interesting idea is the fact that dissolution at will can not only be used by partners when they were not able to predict ex ante potential causes of dissociation, but also it can be used when there is no uncertainty in the face of the contractual obligations assumed by the parties. In these circumstances, dissolution can be used as a ‘threat of dissociation to force renegotiation of the bargain’. Another possibility is to utilize dissolution at will in order to induce a particular investor to invest more. This investor, who can be a ‘vital resource contributor’, will have considerable leverage to renegotiate the company’s contract if faced with the threat of dissociation by other members. If other members dissociate, the investor will lose the investment made to that point. Another argument put forward by Ribstein in favor of dissolution at will is the fact that this ends up being a cost-efficient contractual device that avoids higher costs of dissociation and prevents the withdrawal of firm-specific investments in human capital, for instance. Nevertheless, he points out that his conclusions do not necessarily apply to corporations (closely and publicly held alike). No reference is made to the LLC because it only would be created a few years after. Still, dissolution at will is an alternative that is plainly foreseen for partnerships, but which also is worth exploring in respect to the LLC. This is, in fact, done by the court in Fisk Ventures, LLC v Segal, where the court applies by analogy the statute for limited partnerships.

960 See Ribstein, Larry E., ‘A Statutory Approach to Partner Dissociation’, cit., p. 391 (arguing that ‘A related point favoring dissociation at will is the availability of cost-efficient contractual devices to protect against costly dissociation. If the statute provides for dissociation at will, the partnership can discourage dissociation and protect against withdrawal of human capital and other resources by developing firm-specific capital the partners would lose by leaving, by limiting the compensation to be paid to the dissociating partner, by providing for payment of liquidated damages, or by limiting post-dissociation competition’).
961 I am grateful to Larry Ribstein for having discussed this idea with me while I was a Visiting Scholar at the University of Illinois College of Law in 2011. See § 18-801 (b) of the Delaware LLC Act were it is foreseen that ‘Unless otherwise provided in a limited liability company agreement, the death, retirement, resignation, expulsion, bankruptcy or dissolution of any member or the occurrence of any other event that terminates the continued membership of any member shall not cause the limited liability company to be dissolved or its affairs to be wound up, and upon the occurrence of any such event, the limited liability company shall be continued without dissolution’.
Additionally, courts can generally order corporate dissolution or other relief when cases of deadlocked members or managers or manager misconduct make judicial dissolution warranted. The dissolution order may be issued based upon equitable considerations. This means that dissolution may be a sound alternative and, therefore, granted despite the LLC agreement containing an exit mechanism (e.g., a put right) because, for example, it would ‘not be equitable to force [the petitioning member] to use the exit mechanism where the member would remain liable on personal guaranty of entity’s mortgage after exit’, or it would not be fair to force a buy-out at all if, according to the operating agreement, the petitioner is given an option to leave and, depending on the circumstances, it decides not to do so. This is a business decision of the petitioner that does not necessarily imply a circumvention of the agreement.

As ‘creatures of contract, designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved’ LLCs’ legal framework, especially the one provided by the Delaware LLC Act, is meant to be very flexible. It allows the parties to structure their company as they deem appropriate. The wide scope of freedom of contract, private ordering and, consequently, flexibility enables members to draw property rights in their shares by experimenting with new solutions. Additionally, they can align their interests in ways that can seem innovative in the eyes of an outsider, but which make perfect sense considering the context of the company. The LLC is a good example of how contract law can create a laboratory – an analytical legal matrix – that sets the grounds for new conceptualizations of property rights and their delineation. It also sets the grounds for mechanisms to (re)arrange the members and managers governance relationship. The alternative of dissolving a company should be understood in light of the ample scope of freedom of contract and the enforceability of the company’s contract that statutory default

963 See Vila v. Bvwebties, LLC, -- A.3d --, 2010 Del. Ch. Lexis 202 (Rel. ch. Oct. 1, 2010); Phillips v. Hove – A.3d --, 2011 Del. ch. Lexis 137; Achaian, Inc. v. Leemon Family LLC, 25 A.3d 800 (Del. ch. 2011) (this case poses the following question: may one member of a Delaware limited liability company assign its entire membership interest, including that interest's voting rights, to another existing member, notwithstanding the fact that the limited liability company agreement requires the affirmative consent of all of the members upon the admission of a new member, or, must the existing member assignee be readmitted with respect to each additional interest it acquires after its initial admission as a member ?); and Fisk Ventures, LLC v Segal, --A3d --, 2009 Del. ch. Lexis 7 (Del. ch. Jan 13, 2009) aff'd 984 A.2d 124 (Del 2009). In this last case the court famously stated that ‘… if that deadlock cannot be remedied through a legal mechanism set forth within the four corners of the operating agreement, dissolution becomes the only remedy available as a matter of law. The Court is in no position to redraft the LLC Agreement for these sophisticated and well-represented parties’.


rules provide. By reading dissolution (including dissolution at will) in light of the principle of freedom of contract, the validity of contractual clauses that use it to avoid acute bargaining failures in the company is maintained. That does not jeopardize courts’ competence to order judicial dissolution.

The imposition of restrictions on transfer of shares is liable to create deadlocks and hold-ups and, consequently, prevent the company from operating or furthering its business object purpose (for example, the decision-making process of the company would be seriously affected if resolutions at the general meeting are subject to impasse). If this happens, it may not be reasonably practicable for the company to carry on its business. A clause allowing dissolution at will, by which a company may be dissolved as per the will of one of its members, is understandable because, pursuant to the reasons given above, is less likely to result in a destruction of going concern value. It would be, however, interesting to evaluate the costs and benefits resulting from the alternative parties are given by law to contract around such provision instead of drafting for it. This implies thinking about the principle of maintaining the substance of the company that all six jurisdictions, in one way or the other, consider in light of mechanisms of governance. Again, it may be that the only way to beat opportunism is opportunism itself (e.g., a threat of dissociation). This does not eliminate questions related to minority or majority oppression. Nevertheless, if bargaining is optimal, those who most value the company and their investment in it will take that threat seriously.

Hence, dissolution costs may work as a red light that pops up if members and managers threaten to jeopardize the enabling environment created by the defaults they have chosen when they entered into the company’s contract. Dissolution costs comprise those incurred from accountancy and legal advice (which include services regarding personal liability, restructuring, liquidation and insolvency, and taxation). These are costs that the parties to the company’s contract (including the transferor), much less the transferee, may not be ready to bear. Furthermore, the parties to the company’s contract as well as managers and the employees of the company may have sunk investments on human and physical capital they are not willing to lose with the premature dissolution of the business.967

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966 See Ribstein, Larry E., ‘A Statutory Approach to Partner Dissociation’, cit., p. 364) (enhancing the relative flexibility of closely-held firms by saying that ‘Despite variation among firms, the relatively closely-held firm is a suitable model for designing statutory dissociation provisions because economies of scale of transaction costs make large firms more likely than smaller ones to enter into customized agreements’).

967 See Guinnane, Timothy, and Rodriguez, Susana Martinez, ‘For Every Law, a Loophole: Flexibility in the Menu of the Spanish Business Forms’, Department of Economics Yale University, Economics Department Working Paper No. 103, Economic Growth Center Discussion Paper No. 1012, 2012, pp. 1-31 (24) (referring to one of their findings which was that Spanish firms they included in their sample and belonging to the ‘chemicals and pharma’ sector seemed to be more worried about untimely dissolution than other firms such as those in the
(ii) Lock-in clauses

Lock-in, in this context, means investment commitment. A lock-in contractual clause is engineered in such a way that it is reflective of the needs of the company and its shareholders in the long-run. For that reason, lawyers while drafting the company’s contract, which gives legal form to the firm, will tend to not ignore the importance of the ‘contractual technology’ they are using. Lock-in techniques are used intentionally to bond market agents to a commitment they made when they assumed contractual obligations. I have said that the stickiness of the relational element in PLLCs leads to a stable equilibrium that is difficult to upset. Putting it differently, when the relational element prevails, different contractual practices are hardly developed in the PLLC in the long-run, for there is stable equilibrium from which market agents appear not to deviate (even when deviating from it would seem to be beneficial). However, the case law collected illustrates how opportunistic the behavior of members and managers of these companies can be. Thus, the purpose of lock-in clauses is to enable institutional change and contractual innovation and simultaneously avoid opportunistic behavior or ‘treachery from within’. I explore one possible type of lock-in clauses: the periodic revision of the clauses of the company’s contract. However, there are other alternatives. It will all depend on the imagination, knowledge, intuition and expertise of the lawyer.

‘food and drink’ sector because the former type of firms ‘...had more sunk investments in intellectual property and firm-specific human and physical capital...’).


See Part II, Chapter 1.

See Part II, Chapter 1 where this expression is used. It tries to explain that, unlike certain forms of equilibrium in nature that are not subject to ‘treachery from within’ to use Richard Dawkins expression, contracts are, for the most part, subject to treachery from within, that is, opportunistic behavior.

I thank Henry Hansmann for having discussing this with me.

For example, drafting a clause providing a mechanism equivalent to a put-option or a ‘right to sell’ as an insurance or guarantee of minority shareholders’ investment and of shareholders’ investment in general may be an alternative to dissolving the company and, at the same time, overcome bargaining failures if they exist. The exclusion of the transferor from the company when there is an un-consented transfer could be drafted as another type of lock-in clause. The question that poses itself is: Which member - the transferor or the transferee? The answer is intimately connected with the system of transfer of property rights in the selected jurisdictions. On this, see Part II, Chapter 2.
The idea of creating revisable clauses is in line with the construction of an environment that potentiates longstanding investment of market agents in the companies of which they are members, and dissuades them from behaving opportunistically. These are clauses that make members, managers and employees of the company put their money where their mouth is. Unlike the dissolution clause, these clauses pay due respect to the principle of substance of the company. The regular update of clauses, and particularly the transfer clause, is meant to help surpass inconsistencies and ambiguities in the interpretation of the company’s contract. It also is supposed to trigger disclosure of information which, in these companies, is more likely to be omitted or kept secret since there are no mandatory requirements of disclosure as there are in respect to public companies, especially if listed in stock markets.  

Roberta Romano stresses that the standard pattern of financial regulation is the provision of legislation in a crisis atmosphere under conditions of great uncertainty followed by 'status quo stickiness', for the legislator somehow waits until she gets a consensus on an understanding of what has happened so that a tailored solution can be designed. In order to face this problem, Romano proposes that Congress and regulations include, as a matter of course in financial legislation and regulation adopted in the midst or aftermath of a financial crisis, procedural mechanisms that require automatic subsequent review and reconsideration of those decisions along with regulatory waiver powers which create enough flexibility in implementation and promote experimentation. She is dealing with financial regulation and suggesting solutions to be implemented, for the most part, at what I have defined as level 2 of the legal policy model. Her understanding echoes the idea that, in the face of substantial uncertainty followed by what she calls ‘status quo stickiness’, it is crucial that legislatures and regulators are in a good position to facilitate a change of paradigm. Lock-in clauses, however, should be contextualized in what I called level 3 of the policy model. They should be understood at the level of contracting. PLLCs are contractual in their nature and purpose.

Periodic clause review can be provided for in the company’s contract, but so can restrictions on transfer of shares. Thus, this is not a guarantee that members will abide by these contractual clauses. There must be incentives to reviewing. The problems do not differ very much from those which effect contracts to be incomplete – uncertainty, high transaction

974 Drafting or redrafting a contract normally requires the reviewing of the former contractual framework and the collection of new information from the parties so that the revised contractual setting matches their expectations.
976 See Part II, Chapter 1.
977 See Part II, Chapter 1.
costs, weak property rights that do not render their holders a strong bargaining position. The possibility for any member to trigger the reviewing process by convening the general meeting of the company or requesting this directly to the management board constitute build-in mechanisms to induce revision of the company’s contract. Triggering this process of periodic revision should be conceived as part of the managing rights of any shareholder.

It is difficult to say which contractual strategy will work best, for this depends on the circumstances of the business. Still, the transfer clause as well as other clauses of the company’s contract, especially those dealing with the governance and ownership structure of the company, should be attuned to the reality of changing circumstances in business. This may be achieved through experimentation at the lower level – the level of contracting - which is likely to determine that the environment in the company also changes. Lock-in clauses serve this purpose. The special aspect of these clauses is the fact that, if well drafted, they are liable to make market agents commit to their investment.

4. Conclusions

This chapter proposes a scheme for the governance of the company’s contract. In doing so, an eclectic language is used that makes reference to concepts of law, engineering, economics and biology. Default rules, which members normally include in the company’s contract, give members a governance opportunity. Members have the option to adopt these rules, or contract around them and choose other contractual solutions. One possible way to manage this governance opportunity is to adopt mechanisms that allow members to manage their property rights through contract. I point out two alternative strategies – dissolution at will and lock-in clauses.

In respect to the dissolution of the company at will, I make a connection with partnership law. This makes sense especially for PLLCs, which are in substance partnerships. There are obligations that are so basic that, if broken, the company can arguably be dissolved. However, the principles of partnership law depend very much on the law of specific countries. If dissolution at will is foreseen in the company’s contract, members are empowered in their ownership rights. The threat of dissolution at will is likely to encourage members and managers to align their interests by nudging them to act non-opportunistically. Furthermore, the mechanism of dissolution may work as an investment incentive since it gives members

978 If unanimity or majority requirements are foreseen, reviewing will be more difficult to effect.
and potential investors the idea that it is possible to leave the business, if particular circumstances obtain. This is a mechanism that can be used not only by the transferor to pressure other shareholders to provide their respective consent *stricto sensu*, but also by any other non-transferring shareholder. The latter can threaten to dissolve the company in the case of an un-consented transfer.

Lock-in clauses appear here as mechanisms that are supposed to be reflective of the needs of the company and its shareholders, and are able to lock-in investment. One possible clause is the periodic revision of contractual clauses. While drafting the respective clauses, lawyers act as reflexive intermediaries whose task is to craft the company’s contract to govern the property rights of members and (re)arrange the relationship between corporate constituencies whenever it is needed.
CHAPTER II

EVOLUTIONARY DYNAMICS AND KNOWLEDGE SPILLOVER:
CAN JURISDICTIONAL COMPETITION FORCE A POLITICAL CHANGE IN
EUROPEAN CORPORATE LAW?979

‘The principle of states’ rights and the idea that each state is a
laboratory are strong in this country.
On the other hand, one can fairly hope that the growth of the law in
a civilized society should be evolutionary’.

663-705 (696).

Introduction

The previous chapter provided some insights regarding mechanisms to govern the
contract of the company and give strength and substance to property rights. Experimentation
with the solutions suggested therein at the lower level (market) through the work developed
by lawyers, notaries, and other gatekeepers will, I believe, provide new legal grounds within
which the internal and external relationships of shareholders and other corporate
constituencies can be rearranged, especially if there is a scenario of un-consented transfer of
shares. This chapter explores the benefits of jurisdictional competition980 in creating new legal
solutions. For example, could national legislators feel compelled to adopt dissolution at will
as a remedy for bargaining failures in the context of PLLCs law? Additionally, this chapter

979 This chapter is based on a seminar paper titled ‘Bringing the Essence of Regulatory Competition Back:
Evolving Business Practices, Networking of Market Agents, and Competition as Sources of European Company
Law’. I presented this paper at the seminar ‘Territorial Laws in a Global Era’, which was organised by the
research project The Architecture of Regulatory Competition, at the University of Helsinki on 22-23 November
2013. I thank the participants for their helpful comments. I also am particularly thankful to Erin A. O’ Hara and
Jan Smits for their questions and comments on the ideas I brought to the seminar. These ideas are, for the most
part, exposed herein.
980 I preferentially use the term jurisdictional competition because in my opinion it emphasizes the competition
between states. However, the expressions jurisdictional competition and regulatory competition are
interchangeably used in the literature.
considers the differences and similarities between the corporate law families I have chosen for this study. It is against this background that I suggest a theoretical reasoning based upon an evolutionary market process. The aim of such reasoning is to explain if and how it is possible to create a common denominator or common standards on major principles of corporate law that enable jurisdictional competition in Europe. Jurisdictional competition is viewed here as a means to reach the best legal solutions. It is, therefore, related to the principle of Pareto optimality.\(^{981}\) As principles of company law I emphasize the concept of the company as a separate legal personality with limited liability, and in particular transferability of shares. I bear in mind that companies are incorporated for different purposes, even though the design of the respective companies’ contracts follow very similar patterns in respect to form and substance. On the other hand, I keep in mind that Member States have different market structures as well as different socio-economic standards. This being said, I look closely at jurisdictional competition, as a way to force a political change in corporate law when and if it is needed.

The focus of the competition dynamics is on corporate default rules. A parenthesis is due here. This chapter is not about how the judgments of the European Court of Justice (ECJ) on freedoms of movement, which have been the engine of jurisdictional competition in corporate law in Europe, are likely to affect transfer of shares of PLLCs. Neither is this chapter concerned with whether restrictions on transfer of shares of PLLCs breach the freedoms of movement provided by the EU Treaties. Most of the rules establishing restrictions on transfers are default rules, as we have seen. Arguing that they breach freedoms of movement would be equivalent to saying that they breach constitutional rights — and constitutional rights are inalienable. This is not the case of property rights in shares of PLLCs, which pursuant to freedom of contract may be disposable or not. Furthermore, if we assume that the ECJ would affirmatively judge such restrictions as violations of freedoms of movement like it did regarding the so-called金色 shares cases, we would be attributing a mandatory nature to the rules that regulate transfer of shares in private limited liability companies. This goes against their purpose, which is different from that of publicly held companies.\(^{982}\)

\(^{981}\) In the previous chapter, I have stated that policy-wise, it is important to find mechanisms that enable market agents to choose the best rules and legislators to draft the best legislation that come about through competition based on coordination. Law, in this sense is a commodity because, considering that there are limitations to evolution, it provides the infrastructure to transpose such limitations in the market. The major thrust of this chapter is: How does this work at the transnational level?

\(^{982}\) I thank Dhammika Dharmapala for having discussed my views with me while I was a Visiting Scholar at the University of Illinois College of Law in 2011. All mistakes and omissions are, of course, mine.
Default rules restricting transfer of shares may work for small companies. Nevertheless, this may not be the case for larger companies where it is desirable that membership be changed. This echoes the issue of non-competition agreements between employer and employee, which were non-enforceable in the American state of California. Ronald Gilson argued that the unenforceability of these restrictions in the State of California was partially responsible for the development of Silicon Valley because it encouraged employees to change. In my case, restrictions on transfers prevent third parties from entering into the company. This is the context in which I explore the possible inefficiencies of defaults establishing restrictions on transfers. I suggest that defaults restricting transfer of shares can potentially hinder a knowledge-spillover effect which would likely contribute to the development and investment in the company. This is particularly so if the rule is outdated or members have been ill-advised.

The market evolutionary dynamics and the idea of knowledge spillover as sources of competition, economic aggregation, innovation and growth provide the normative frame within which I investigate possible incentives for states to change their legislative policy agenda. It is the frame within which I try to understand if it is possible to create an adequate institutional framework for jurisdictional competition in Europe.

This chapter is structured as follows. Section 1 draws upon the concept of market and tries to put forward a definition that can accommodate the exercise of freedoms of movement as they are defined in the EU Treaties and have been forged in the judgments of the European Court of Justice (ECJ). This section tries to convey the idea that different markets have different structures, and that this point should be considered in any construction of jurisdictional competition in Europe. Further, it explores the relationship between market integration (for which freedoms of movement are crucial) and jurisdictional competition. Section 2 reviews the question as to whether jurisdictional competition creates a race to the bottom or a race to the top, to understand what could be the channels of competition, if they exist at all. It takes a bottom-up approach to the promise of jurisdictional competition in Europe and proposes the creation of a network between market agents, lawyers, notaries and other gatekeepers, at the market and society levels, and legislatures, at the political level. Section 3 extends the idea described in the previous section. It dwells on the construction of a

theoretical framework which is able to bring sustainability and a common ground to a scheme of jurisdictional competition in Europe. Section 4 concludes.

1. The definition of market and EU Treaty freedoms

(i) The concept of market

I have described a three-level model of legal policy by which legislatures (level 2) and markets (level 3) interconnect at a point where law is created from below. It is, however, important to define market. The judgments of the ECJ are relevant for this matter. ECJ’s judgments in cases such as *Centros*, *Uberseering*, *Inspire Art*, *Sevic* and *Cartesio* highlight freedom of choice. National law only is allowed to restrict such freedom for public interest reasons, and this only on a case-by-case basis.984 Another interesting point is the debate regarding the codification and creation of a European Civil Code because of the concept of market and the implications which may derive from it. For example, Stefan Grundmann asks: ‘A European Code on the use of private parties’ power to shape their relationships autonomously and on the regulatory prerequisites of such a freedom – too audacious a vision?’985 In respect to this question it is important to stress that markets vary. This variation depends, among other elements, on property ownership. The structure of shares and how property rights are contractually defined influences market structures. Legislators would do well to pay close attention to this, particularly when they undertake any codification actions with harmonization purposes.986

On the point of harmonization, some authors have suggested a process of reflexive harmonization by means of which regulatory innovation would be stimulated. One of the advantages of a process like this is that it would promote cross-border capital mobility. It also could be used for creditor and employee protection to avoid a situation of race-to-the-bottom if jurisdictional competition was in place. Additionally, harmonization would likely limit competition. As a result, the autonomy and diversity of legal systems would be preserved while the process of evolutionary adaptation of rules at the state level would be induced or

This is how these authors normatively craft the legitimacy of the regulatory process at the EU level which, in their view, should be based upon the transnational harmonization of markets. Labor laws constitute an interesting example within which standards are implemented as ‘floor rights’. The merit of this construction is evident, and even more so if one does not single out the fact that markets are different. If one does single it out, then, this aspect can be a problem. Moreover, ‘reflexive harmonization’ provides states with a number of options, but on the level of law implementation. I stress the merits of market integration and free movement law in stimulating jurisdictional competition and legal innovation as opposed to a procedural idea of law implementation. I understand, however, that some level of harmonization may be needed to facilitate a phenomenon of jurisdictional competition identical to that which obtains in the United States. Yet, the existence of different market representations should be taken into account. The two above-noted examples referring to the scope of the freedoms of movement and projects of codification in Europe can potentially be a showcase of different representations of market. For the purpose of this study, I am interested in understanding which definition of market best fits the concept of freedoms of movement as they are provided by the EU Treaty and have been interpreted by the ECJ in the cases abovementioned.

The concept of market has been treated in the literature in different ways. The market has been described as ‘economic organic’, a form of ‘social organization’. According to the transaction costs economics literature, markets as well as firms and other mixed modes are alternative instruments of governance. The underlying characteristics of the transaction(s) in question determine the suitability of these instruments to mediate a transaction or a set of transactions. Williamson interestingly refers to natural selection forces in respect to the operation of the market. He says that ‘Natural selection forces do not always operate quickly,

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988 See Korkea-aho, Emilia, ‘Implementation of Territorial Laws in a Global Era: An Emerging Arena for Regulatory Competition?’ (paper presented within the seminar Territorial Laws in a Global Era, organized by the research project The Architecture of Regulatory Competition, 22-23 November, University of Helsinki. This paper is not published and is on file with the author) (claiming that the focus should be put on implementation / enforcement if we want to think of jurisdictional competition as a feasible hypothesis within the EU. She suggests a sort of activism on the level of law implementation which should be undertaken at the states’ level and not so much at the transnational regulators’ level. The author, inspired by O’Hara and Ribstein’s Law Market, emphasizes jurisdictional competition on the implementation level based upon the use of voice by which a proposed law can be spoken out and/or it can be shaped after it has been adopted).


however. So the market can be compared, as I do, to a living organism’. 991 As he puts it, markets, unlike internal organizations, do not show a propensity ‘to manage complexity, to forgive error, and to engage in logrolling’. 992 ‘The market is a marvel … not merely because of its remarkable signaling properties (under the requisite preconditions), but also because of its remarkable capacity to present and preserve high-powered incentives’. 993 Additionally, he concludes that ‘… market mediated transactions rely more on high-powered incentives and less on the administrative process (including auditing) to accomplish the same result.’ 994 Harrison White says ‘A market is an ‘act’ which can be ‘got together’ only by a set of producers compatibly arrayed on the qualities which consumers see in them’. 995 This author explains how markets are a construction which is undertaken through a complex and erratic process that is liable to yield a number of outcomes. He affirms that ‘Markets are defined by self-reproducing cliques of firms, and not the other way around’. 996 In his words ‘… firms seek niches in a market in much the same way as organisms seek niches in an ecology’. 997 Gilson and Kraakman state that ‘… market discipline in the form of heavy trading losses will restrain idiosyncratic traders and may even eliminate them through a “Darwinian” process of natural selection’. 998 These authors agree that there is an evolutionary bias that pushes markets towards efficiency. They recognize, however, that market efficiency need not pertain to to any particular type of information. Referring to the efficiency of capital markets they hold that for some types of information, at least, there is fully efficient equilibrium. In an attempt to apply their analysis beyond the ‘specialized world of securities traders’ their view is that ‘Markets, after all, are pervasive phenomena. They mediate the allocation of far more than capital. Moreover, the extent of informational efficiency is surely a central determinant to the pricing behavior and institutional underpinnings of all markets, and not merely of the securities market’. 999 Oliver Hart says that the market is a ‘complex equilibrium process’. 1000 According to Easterbrook and Fischel, the market is a space where self-interested actors

991 See Williamson. Oliver E., The Economic Institutions of Capitalism, cit., p. 129.
992 See Williamson. Oliver E., The Economic Institutions of Capitalism, cit., p. 149.
996 See White, Harrison C.’, Where do Markets Come From?, cit., p. 520.
997 See White, Harrison C.’, Where do Markets Come From?’, cit. p. 520.
interact. This interaction has the ability to review the discretion with which market agents adopt contracts. These authors also say that “Markets” are economic interactions among people dealing as strangers and seeking advantage. They stress that all economic activity is an interaction between real people. They are careful, however, to stress that they do not personify markets. They also make reference to markets as products of natural selection and as places where competition has a space to evaluate the effects of contracts in general and the corporate contract in particular. Corporate governance devices that have survived in many firms for extended periods demonstrate that the durability of a practice both enables people to gauge its effects and allows competition among firms to weed out the practices that do not assist investors. Apparently, there is no similar process of winnowing out of academic ideas or regulations. In the words of Sir Arthur Salter, which were quoted by Coase, ‘The normal economic system works itself. For its current operation is under no central control, it needs no central survey. Over the whole range of human activity, and human need, supply is adjusted to demand, and production to consumption, by a process that is automatic, elastic and responsive’. As Coase himself puts it, ‘The market is a complicated structure with exchange transactions’.

Given the above, markets can be described as a social construction that creates the environment framing the expectations of market agents. In this sense, the word ‘ecology’ fits well, since it alludes to the relationship between organisms and their environment or even to the relationship between human groups and their social environment. Markets can be a political construction based upon a scheme that governs the exchanges between market agents. Markets also are an economic construction where the supply and demand lines intersect, and where transactions are incentive-based. It is an exchange of goods and services where a price is established. Since markets have different structures, it is understandable that different market structures diversely affect the supply and demand sides of law. This

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1006 For example, departures from perfect competition change the characteristics and outcomes of the market in various ways. A good comparison between different types of competition and the respective outcomes is between Bertrand competition and Cournot competition. Bertrand competition is a market situation in which firms compete based upon their decisions on market prices. Cournot competition is a market situation in which rival firms compete in light of their choices of quantity. The interdependence between the decisions of rival firms in terms of pricing or quantity decisions determines differences in industry structure.
1007 See Schumpeter, Joseph A., Can Capitalism Survive?, New York, Hagerstown, San Francisco, London, Harper Colophon Books, 1978 (saying that ‘… as regards practically all the finished products and services of
should not only be taken into account in the debate about the feasibility of jurisdictional competition in Europe, but also in the discussion of whether it can stand for an adequate path to create better law.

(ii) The definition of market access and ECJ’s criteria for interpreting rules of the Treaty on freedoms of movement

In the early judgments of the ECJ, criteria to interpret rules of the Treaty contemplating freedoms of movement and to understand whether national measures were restricting these freedoms were based on the principle of non-discrimination, and in particular on the grounds of nationality. In reviewing the relatively recent cases of the ECJ not only with regard to free movement of capital, but also to other freedoms, it is clear that there has been a paradigm shift, and that the language of discrimination has been increasingly complemented. The Court has developed the market access or restrictions test. This test provides that national measures likely to prohibit, impede, hinder, or make less attractive the exercise of freedoms of movement restrict access to the market. However, these formulations do not specify what it is meant by ‘impede’, ‘hinder’, or ‘render less attractive’. The concepts are rather loose and involve a considerable degree of uncertainty. Often the Court’s response has been rather intuitive. On the other hand, the ECJ has been developing and refining its techniques for interpreting the rules of the Treaty on the Functioning of the European Union (TFEU) to limit industry and trade, it is clear that every grocer, every filling station, every manufacturer of gloves or shaving cream or handsaws has a small and precarious market of his own which he tries – must try – to build up and to keep by price strategy, quality strategy – “product differentiation” – and advertising). Also see Gelter, Martin, ‘The Structure of Regulatory Competition in European Corporate Law’, Journal of Corporate Law Studies, vol. 5, pp. 247-284 (showing, from a legal standpoint, several aspects in which the structural conditions of European market for corporate law is different from the United States).


1009 To a certain extent, both principles of non-discrimination and market access overlap. For instance, in Cassis de Dijon the Court did not abandon the language of discrimination. However, the idea reflected in that judgment that goods lawfully produced in a Member State should have unrestricted access to the markets of other Member States’, that is, the consecration of the principle of mutual recognition, forms the essence of the market-access test.


the all-too encompassing nature of the market-access or restrictions test. The Court has played this role mostly by presenting the conditions of justifications, by using the principle of proportionality. As for the proportionality, the ECJ has held that rules or national measures must be appropriate to ensure achievement of the intended aim, and must not go beyond that which is necessary in order to achieve that objective.

 Freedoms of movement give individuals and companies the opportunity to invest in the internal market by promoting the openness of this market. To that end, Member States, and their legislators and courts must be aware of the effects that national measures or rules will have on investors of other Member States. Many of these rules regulate private relationships, and are enshrined in traditional codes, which are less vulnerable to EU law. It is important to note, however, that the ECJ has interpreted differently the concept of market access. Let us take as an example the case of special shares (golden shares) that used to be held by some Member States in public companies. Some of ECJ’s judgments considered that national measures, including the creation of circumstances or legislation that once adopted were likely to prevent or limit the acquisition of shares in the undertakings concerned or to deter investors of other Member States from investing in their share capital, fell within the concept of restrictions or barriers to access to the market. Other judgments defined as restrictions any rules, since rules impose compliance costs that can potentially render the exercise of freedoms less attractive. And, finally, rules whose effects on freedoms and intra-union trade could be intuitively grasped have also been considered restrictions.

Second, it is true that not
every restriction on the opportunities that individuals and companies have to invest must be considered a restriction on the exercise of economic freedoms. 1018 And, in this context, it is important to single out the principles of direct effect and supremacy of EU law. 1019 These principles bind not only legislatures, courts and the administration, but also private parties. The different approaches to this test made by the ECJ converge on the premise that rules stemming from legislation or any instruments of private regulation such as articles of association in the circumstances involving golden share cases, protecting positions acquired by economic operators established on the national market, by restricting the entry of new operators and rendering trade between Member States more difficult than internal trade, violate fundamental freedoms. 1020

Market access potentiates competition not only between market agents, but also between states. Thus, it is fair to say that freedoms of movement are likely to lay the ground for a market for law and competition among EU Member States. So far, however, the main reported vehicle of competition has been the mobility of companies under freedom of establishment.

(iii) The internal market and the supply and demand of efficient rules

Besides establishing a European legal order, the ECJ stated in Van Gend en Loos that the objective of the EEC Treaty was to establish a common market, the functioning of which was of direct concern to interested parties in the community. 1021 Fifty years after this groundbreaking decision, the current wording of Article 3, par. 3 of the Treaty on the European Union (TEU) states that ‘The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It

capacity as liquidator of the assets of Objekt und Bauregie GmbH & Co. KG v Land Niedersachsen (Rüffert) [2008] ECR I-0000.

Advocate General Poiares Maduro in his opinion delivered on 7 April 2005, case C-446/03 Marks and Spencer PLC v David Halsey (HM Inspector of Taxes) [2005] ECR I-0000, para. 40, claims that ‘...not every restriction on economic or commercial freedom is a restriction on the exercise of the freedoms of movement’.


Opinion delivered by Advocate General Poiares Maduro on 7 April 2005, case C-446/03 Marks & Spencer plc v David Halsey (HM Inspector of Taxes) [2005], ECR I-0000, paragraphs 39 and 40.

shall promote scientific and technological advance’. In spite of the different ways in which the Court and the provision of the law define internal market, both display a liberal understanding of the term.

Regulation is part of the integration process of the internal market. It is complemented by competition law and rules on freedoms of movement. The internal market has a life of its own. In this sense, it fits the definition of market presented above. It is within the internal market that challenges to the EU are generated either at the EU level, or at the national level. One of these challenges rests on discovering how far integration of the internal market can go so that it is truly competitive. The opening of markets, however, not only involves the supply and demand of goods, persons, capital and services, but also comprehends the opening of these markets to the supply and demand of efficient rules. What is, then, the relationship between the level of integration of the market and jurisdictional competition? Is jurisdictional competition institutionally possible in Europe? I try to answer these questions by looking at the ECJ’s jurisprudence on economic freedoms.

The European case is different from the American case, where the debate about jurisdictional competition has been going on for over thirty years. Firstly, the EU is not a federation of states, even thought it has been read by the ECJ through a constitutional lens that goes beyond the Member States. Hence, the political structure of federalism does not have a take on the dynamics of (re)incorporation of companies as it has in the United States. Secondly, in respect to company law, there is not a state in Europe that plays or is in a historical position to play the same role as Delaware in the United States when it comes to drive interstate competition. ECJ’s case law on freedoms of movement has been the leading engine of jurisdictional competition in Europe, despite the fact that in Europe the ‘endless dismal search by the ECJ for a principle to free movement law’ is often stressed. Still, cases such as Centros, Uberseering, Inspire Art, Cartesio have repeatedly

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1022 It shows the manifest influence of ordoliberalism.
1023 See section 1 (i).
1025 See Gelter, Martin, ‘Regulatory Competition in European Corporate Law’, Journal of Corporate Law Studies, vol. 5, 2005, pp. 247-284 (251-252) (explaining how Delaware historically obtained its monopoly position). Also see Romano, Roberta, ‘Law as a Product: Some Pieces of the Incorporation Puzzle, Journal of Law, Economics, and Organization, vol. 1, 2, 1985, pp. 225-283 (242) (claiming that Delaware is ‘… able to retain its commanding lead in the incorporation market by a mix of institutions with powerful incentives, visible to firms, that goad the state to be responsive. The dependence on franchise tax revenues is forward-looking, warranting that Delaware will continue to respond to corporate needs, while the constitutional supermajority voting provision is backward-looking, ensuring that the thrust of policies can be reversed only with great difficulty’).
1026 See Centros Ltd v Erhvervs- og Selskabsstyrelsen (Case C-212/97, 9 March 1999).
shown that the Court understands freedom of establishment as fundamental to form a company in a ‘single market’. Consequently, this opened a window of opportunity for jurisdictional competition in Europe. Open markets favor competition. Refining the understanding of free movement law, which is a necessary instrument of market integration, means creating a setting where Member States can compete on an equal and fair footing for the supply and demand of goods, persons, capital and services, and also law. This setting can favor jurisdictional competition in Europe. The higher the level of integration, the greater will be the possibility of competition. However, neither empirical research nor the social sciences have provided a clear picture of what make countries compete against each other, especially for the best laws or at least for laws that achieve certain goals (e.g., the goal of franchise fees in Delaware). At this point, it is worth recalling the case of Italy described in Part I, Chapter 2 wherein certain companies in the early twentieth century (perhaps even the late nineteenth century), in what was then the Kingdom of Italy, would incorporate in Trieste in order to take the form of limited liability companies, while having their seat of business elsewhere. This is a very interesting case of ‘regulatory arbitrage’ which took place in this Italian province in the beginning of the twentieth century (if not earlier), well before Centros. Despite this evidence, often the contemporary debate on jurisdictional competition in Europe is redirected to problems in the field of choice of law and conflict-of-law rules.

For example, in fields such as property law the terms of the discussion have been held solely at a normative level. Thinking about regulatory competition in this field will necessarily entail a new definition of property rights and a revision of objective connecting factors that determine the choice of law. The establishment of objective connecting factors such as the *lex rex sitae* or *lex situs* is a way for jurisdictions to internalize the costs and

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1027 See Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC) (Case C-208/00, 5 November 2002).

1028 Inspire Art (Case C-167/01, 30 September 2003).

1029 Cartesio (Case C-210/06, 16 December 2008).

1030 Freedom of establishment is provided in Article 49 of the Treaty on the Functioning of the European Union (TFEU).

1031 See par. 27 of Centros and par. 138 Inspire Art. Also relevant is Daily Mail (Case 81/87, 27 September 1988) (restricting the scope of freedom of establishment).

1032 See article 26 of TFEU, especially paragraphs 1 and 2.

1033 See, however, Murphy, Dale D., *The Structure of Regulatory Competition: Corporations and Public Policies in a Global Economy*, Oxford, Oxford University Press, 2006 (using a number of case studies to explain international regulatory competition. His findings and qualitative methodology do not allow the creation of a direct causal connection between firms’ behavior and regulatory competition. However, they create a theoretical framework that helps predict situations where there can be regulatory competition). Also see Eidenmüller, Horst (ed.), *Regulatory Competition in Contract Law and Dispute Resolution*, München, Beck; Oxford, Hart, 2013.

1034 I thank Teemu Juutilainen for having briefly discussed this aspect with me.
benefits of free choice of law. These connecting factors, which are, for the most part, linked to a traditional conception of property rights, easily corset the chances for states to compete. If real estate is located in Liechtenstein, then the laws of Liechtenstein should apply. However, there may be cases inevitably calling for a shift to party autonomy and creating, in this way, a playing-field for state competition. The case of securities law is illustrative.\textsuperscript{1036} The \textit{lex rex sitae} has proved unsatisfactory to determine the law applicable to securities held with intermediaries. This has most likely to do with the uncertainty caused by the development of new forms of register, which are made electronically and make it difficult to determine with precision the location of the intermediary or securities account. Additionally, the uncertainty is originated by the ambiguous definition of the rights of the account holder in the different legal systems (e.g., regular deposit, special deposit, co-property rights, other type of property rights?). It was in this context that the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary has moved away from the principle \textit{lex rex sitae} to embrace an express agreement between the account holder and the intermediary on the choice of law.\textsuperscript{1037} The problems with the definition of property rights in securities echo those regarding the delineation of property rights in shares.\textsuperscript{1038} Property rights in shares are changed in their substance due to the introduction of contractual clauses imposing restrictions. In this specific case, property rights are enabled by contract. This frames property law in a different way (almost as a component of corporate law) which, in principle, makes it more susceptible to change due to competitive pressures coming from other jurisdictions.\textsuperscript{1039}

I have used gene interaction, which is executed through a process of competition and coordination, as a metaphor to describe how law is created, for the most part, at the market level through a process of natural selection. While developing the work of comparison, I have dwelled on the idea of finding mechanisms that enable market agents to choose the best rules

\textsuperscript{1035} See Part II, Chapter 2.  
\textsuperscript{1037} See Goode, Roy et al., \textit{Explanatory Report on the Hague Convention on the Law Applicable to Create Certain Rights in Respect of Securities held with an Intermediary}, ed. Permanent Bureau, The Hague, Martinus Nijhoff Publishers, 2005, in particular the comments on Articles 2 (1), 4 and 5 of the Convention. The authors also explain the Convention did not completely move away from the \textit{lex situs} principle since it still provided the ‘Qualifying Office’ principle. This principle determined that the law chosen by the parties to govern the account agreement would only apply if the intermediary held an office in the state which law was selected at the time of the agreement.  
\textsuperscript{1038} See Part II, Chapter 2.  
\textsuperscript{1039} See Dammann, Jens C., ‘Freedom of Choice in European Corporate Law’,\textit{ Yale Journal of International Law}, vol. 29, 2, 2004, pp. 477-544 (480) (stating that ‘While European corporations may remain less mobile than their US counterparts, the efficiency gains to be derived from free choice in Europe may well exceed those reaped in the United States’).
and national legislators to enact the best legislation by favoring competition based on coordination. The riddle is whether this idea of law generated through a process of natural selection can be accommodated in respect to a market construed at the transnational level. This has much to do with the definition of market, and in particular the internal market. The views expressed above often compare the market’s dynamics and biological evolution (‘it works itself’). In the particular case of the internal market, in light of the difficulty of defining it solely in reference to the jurisprudence of the court, it has been accepted by doctrine that ‘… internal market is consistently understood throughout the Treaty in terms of an area of equal and undistorted competition – a level playing field for competitors and consumers’. The prospect of jurisdictional competition in Europe has been rather gloomy. As Martin Gelter puts it

The European level of legislation and regulation is less likely to influence the conduct of national actors in the market than the federal level in the United States, because Europe lacks an influential common public sphere, the legislative process is slow, and there is no court system or European securities authority with substantive influence on corporate law in place.

Hence, the key for jurisdictional competition in Europe, if one exists at all, lies in market integration backed up by the refinement of free movement law.

2. Jurisdictional competition in Europe: more than a promise or just a fallacy?

In the late eighties and early nineties, the discussion about jurisdictional competition in the United States revolved around the question whether jurisdictional competition would lead to a ‘race to the top’ or a ‘race for the bottom’, to use the expression that was epitomized by William Cary. The debate also created two factions comprised by the supporters of those

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1040 See section (i).
1042 See Gelter, Martin, ‘Regulatory Competition in European Corporate Law’, cit., p. 284. For an affirmative account, see Armour, John, ‘Who Should Make Corporate Law? EU Legislation versus Regulatory Competition’, Current Legal Problems, vol. 58, 1, 2005, pp. 369-413. Both authors, however, acknowledge some ‘defensive regulatory competition’. In this case, Member States do not actively compete for incorporations, but they try to stop their firms from leaving by reducing the required share capital, for instance. This arguably occurred in Germany with the implementation of the Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG). Additionally, see Dammann, Jens C, ‘Freedom of Choice in European Corporate Law’, cit. p. 486 (responding affirmatively to the question as to whether a member state will ever have the incentive to compete as Delaware).
1043 Generally, in the literature, the expression used is ‘race to the bottom’.
who considered that state competition would favour the interests of managers in detriment of the interests of shareholders and those who were convinced that state competition would lead to efficient rules that would enable shareholders’ wealth maximization. This chapter sidesteps these questions, and zeros in on the more fundamental question of why states might choose to compete.

Unlike US corporate law in respect to which states benefit from the revenue they obtain with franchise taxes and incorporation fees, Europe does not charge the payment of such taxes and fees for the incorporation of companies. Therefore, there is no market for incorporation in Europe. Additionally, most member states adopt the company seat principle (siége réel). The registered office of the company constitutes the connectivity factor with the legal system in the same way as nationality for a natural person. It is true that after Überseering, the company seat principle became of little significance, as the ECJ decided that companies incorporated in a Member State are entitled to move their actual centre of administration to any other Member State without having to reincorporate there to have legal capacity. However, there still exist costs involved not only in the change of real seat of the company, but also of its actual centre of administration such as those related with the language, lawyers, and all sorts of bureaucracies which often dissuade small and medium enterprises from reincorporating or moving elsewhere. On the other hand, there is not a predominantly responsive state to the demand side of laws which has invested in legal and human capital like Delaware did in the United States. In order for states to start competing there would have to be a steep increase in the inbound state migration rate of companies. Furthermore, in terms

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1047 Delaware is referred to in the literature as a ‘first-mover’. It is undisputed that first movers often cause the biggest impression. See Macey. Jonathan R., and Miller Geoffrey P., ‘Toward an Interest-Group Theory of Delaware Corporate Law, Texas Law Review, vol. 65, 3, 1987, pp. 469-523 (472-473) (stating that ‘…Delaware, over time, has developed an important capital asset in the form of a legal environment that is highly desired by consumers of its corporate law both for the present structure of its rules, and – perhaps more importantly – for the reliable promise it makes that rules adopted in the future will also be highly desired. These ‘first mover’ advantages cannot be fully emulated by other states’).
of policy, there would have to be a sort of ‘common component’ to the EU member states as is often said to be the case regarding the fifty-one American jurisdictions.\textsuperscript{1048}

Moreover, Europe has no incentive for firms to move in great numbers and concertedly to a particular state. One could venture the idea of transforming Luxembourg into the 'new Delaware' of Europe.\textsuperscript{1049} Not only is the ECJ located therein, but also this is a tax harbour in the heart of Europe. Nevertheless, in comparative institutional terms, the federal and state courts in the United States are much more functionally aligned than are the ECJ and the national courts. In the United States, federal courts have original jurisdiction. Even the United States Supreme Court, which is primarily an appellate court, has original jurisdiction regarding a small number of cases. It is, therefore, understandable that authors like William Cary, who advocated that jurisdictional competition led to a race for the bottom, claim for general public standards for the incorporation of companies in Delaware and elsewhere which would be subject to the jurisdiction of federal courts.\textsuperscript{1050} The scope of ruling of the ECJ is more limited than the United States Supreme Court. All in all, the jurisdiction of the Court is limited to EU law. Thus, the parties to a dispute on matters of national law cannot directly bring an action to the ECJ because it is not provided with original jurisdiction. For the most part, Europe lacks a common legal and institutional platform that creates a setting for competition between states. The political process in Europe that triggers new legislation is normally slower, public opinion’s judgement, and lobbying are not so likely to cut down existing legislation.\textsuperscript{1051} It is not clear (in many cases it is not even likely) that businesses and

\textsuperscript{1048} See Besley, Timothy, and Case, Anne, ‘Incumbent Behavior: Vote Seeking, Tax-Setting, and Yardstick Competition’, \textit{The American Economic Review}, vol. 85, No. 1, 1995, pp. 25-45 (41) (arguing that the United States is a good source to study yardstick competition ‘…given that there is a significant common component to incumbent’s environment’).


\textsuperscript{1050} See Cary, William L., ‘Federalism and Corporate Law: Reflections upon Delaware’, \textit{The Yale Law Journal}, vol. 83, 1974, pp. 663-705. For an opposite line of thought, see Winter, Ralph K., Jr. ‘State law, Shareholder Protection, and the Theory of the Corporation, \textit{The Journal of Legal Studies}, vol. 6, No. 2, 1977, pp. 251-292 (252) (despite advocating that proposals of federal regulation should not be automatically accepted, saying that ‘Existing federal economic regulation is so pervasive that the absence of federal control over the governance of major economic units seems anomalous to some’).

\textsuperscript{1051} See Macey, Jonathan R., and Miller Geoffrey P., ‘Toward an Interest-Group Theory of Delaware Corporate Law’, cit., pp. 469-523 (setting out an interest-group theory of Delaware corporate law, and stressing the interests of the Delaware bar for the making of corporate law in that state) Also see Carney, William J., ‘The Political Economy of Competition for Corporate Charters’, \textit{The Journal of Legal Studies}, vol. 26, No. 1, 1997, pp. 303-329 (saying that interest-groups have played a smaller role in American corporate law than in Europe. He essentially says that the reason for no jurisdictional competition in Europe is caused by the status quo interest
courts know the laws of other jurisdictions. So, it is difficult to draw a starting line for a race between states in Europe. It is even harder to establish the actual top and actual bottom.\textsuperscript{1052}

However, there have been legal reforms to the corporate law of Member States that could hint at a phenomenon of jurisdictional competition. For instance, the United Kingdom is often perceived as an attractive jurisdiction for incorporation. Courts enjoy a good reputation, and the law is flexible enough (also called ‘liberal’). In 2009, the Law for the Modernization of the GmbH and Stopping its Misuse (\textit{Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen} or \textit{MoMiG}) came into force. It reformed the \textit{GmbHG}, which had not been reformed since its enactment in 1892. This revolution in and for small-size companies came as a response of the German legislator to the allure of the UK private company. This was so, in particular after ECJ’s judgement in \textit{Centros} which favoured freedom of establishment over the real seat principle (\textit{siege réel}) that is in force in most Member States. This is a case of ‘defensive jurisdictional competition’ by which states are not as concerned to attract firms to (re)incorporate in their territory as they are preoccupied with seeing their national firms leave their borders.\textsuperscript{1053} Even though it could serve as an illustration of the phenomenon of jurisdictional competition, it is difficult to learn what the channels of competition were in this case.\textsuperscript{1054} This example shows that the reading of freedoms of movement, in this case freedom of establishment, by the ECJ and its relevant outcome are liable to compel national legislators to change the law and break with doctrinal and socio-economic manifestations of path-dependence, which in these circumstances were not surprising since it was a law dating from the late nineteenth century.

Jurisdictional competition in Europe can be more than just a promise. The actualization of this competition, however, must be supported by empirical and interdisciplinary work in economic history and political science. This work remains to be done. In the meantime, from a normative standpoint, the creation of mechanisms to encourage states to start competing can groups try to keep by pushing forward the adoption of directives that facilitate harmonization rather than competition).\textsuperscript{1052} See Bebchuk, Lucian Arye, and Hamdani, Assaf, ‘Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters’, \textit{The Yale Law Journal}, vol. 112, 2002, pp. 553-615 (challenging the idea of state competition in the United States. They argue that interstate competition for incorporations is weak or absent in the United States. In their opinion, this casts doubts on the advantages of state law rules in comparison to mandatory federal rules, which they consider superior. This scenario could be improved by federal intervention that would be ‘choice-enhancing’. In their view, this would be a measure of good public policy. The authors, however, refrain from engaging with the issue of the influence of interests groups in the implementation of this kind of measure).\textsuperscript{1053} In situations of defensive jurisdictional competition, it might be asked if states are still competing for the best rules, and if it creates a race to the top or a race to the bottom. These questions go beyond the limits of this chapter.\textsuperscript{1054} This gap could be filled in by the reading of preparatory documents, reports, parliamentary discussions and other relevant documents that can reveal the purpose of German legislators.
be envisioned. I suggest the creation of a network between market agents, lawyers, notaries and other gatekeepers at level 3 (the market level) and the ECJ and the EU legislator (Commission, Parliament, Council) at level 2 (legislatures) of the model of legal policy. This scheme is, however, complicated by the number of stakeholders in the political and legislative processes of the EU. One of the incentives to sustain this network could be the fees paid to lawyers. Talking about lawyers as leading elements for the delineation of jurisdiction competition in Europe could lead to a discussion on access to the legal profession, but this exceeds the bounds of this study. Once this network was created, jurisdictional competition would develop within an evolutionary framework, and be prone to experimentation. There must be, however, a common component that lends sustainability to a system like this in the field of corporate law. It is to this common denominator that I now turn.

3. Evolutionary dynamics and knowledge spillover as sources of regulatory competition in Europe and change in legal policy

Despite the fact that few empirical studies treat the problem of jurisdictional competition in Europe from the social sciences perspective and model-building in law, there seems to be an understanding that a phenomenon like this is likely to force a political change. Nonetheless, the project is closely linked to the institutional framework that is set locally, nationally and even regionally. If there is not enough jurisdictional competition in Europe after Centros, at least to the point of bringing considerable change to the EU Member States corporate legislation, one might ask whether there is an adequate institutional framework for that to happen. This section addresses this question, and suggests a theoretical platform

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1055 I thank Roberta Romano for having discussed my ideas with me during one of my visits to Yale Law School. In this context, see Sabel, Charles F., and Zeitlin, Jonathan (eds.), *Experimentalist Governance in the European Union: Towards a New Architecture*, Oxford, Oxford University Press, 2010. This book proposes an experimentalist architecture based on a revisionary rule-making process. The list of governance forms includes two levels of legislation, European Commission rule-making that relies on networks of national regulators, peer review, open consultation, and built-in mechanisms for monitoring and reviewing the regime. These governance modes comprise experimentalist architecture. However, they are still, for the most part, political and perceived from a top-down approach. I am not certain how effectively they can be in overthrowing an embedded status quo at the political and market levels.

1056 See Gelter, Martin, ‘The Structure of Regulatory Competition in European Corporate Law’, Journal of Corporate Law Studies, vol. 5, pp. 247-284 (p. 269) (saying that ‘… the direction of regulatory competition in corporate law is ultimately determined by which persons and interests groups are in position to create demand within the market, i.e. who decides whether and where to reincorporate, and what interests determine the decisions’).

upon which to erect a system of economic development and growth which compels states to compete and coordinate their actions. The assumption is that increasing market integration leads to more knowledge spillover, which favors innovation. These three elements are potential drivers of jurisdictional competition. Nonetheless, jurisdictional competition is associated here with the concept of Pareto efficiency. That is to say, jurisdictional competition is viewed as a promising means to implement the best rules. It is in this context that the purpose of default rules establishing restrictions on transfers may be questioned, especially if there is litigation that suggests the existence of bargaining failures. The argument rests on the idea that default rules as such may be desirable for small companies. The problem is with companies of larger dimensions and which are historically known for their significant output and their business activities abroad.\textsuperscript{1058} In the context of larger PLLCs, is a rule like this still a good rule?

(i) The evolutionary process of competition in the internal market

This dissertation assumes policy goals by exploring governance mechanisms and legal and economic frameworks for the development of small businesses. I focus, therefore, on private enterprise within a system of market economy. I look at this system within an evolutionary process. I also take into account the political, social and legal institutions on which it rests.\textsuperscript{1059} The argument is that capitalism is by nature a form or method of economic change.\textsuperscript{1060} Economic structures are changed, or even revolutionized from within in a dynamic process wherein destruction of old economic infrastructures is a prerequisite for the creation of new ones. This is an organic process that unfolds over time as it takes decades, and

\textsuperscript{1058} This is the case for many companies in the United Kingdom and United States which are private, but are similar to public companies in their governance and ownership compositions.

\textsuperscript{1059} I am inspired by the Austrian School of Economics and New Institutional Economics, which I tackle from the perspective of evolutionary theory in law.

even centuries. The threat of destruction of old economic infrastructures and, consequently, of
engrained positions of status quo through the implementation of new technologies and ideas
triggers a process of ongoing adaptation. This dynamic process creates an environment that
naturally tends to remove the barriers that private property puts in the way of development.\textsuperscript{1061}
This requires the creation of an economic strategy which is able to compromise between the
establishment of restrictive measures to private property in the short-run\textsuperscript{1062} and the need for
adaptation and consequent lifting of those restrictions in the long-run. This suggests a new
outlook on the facts, on social constructions, and on the design of legal institutions. It implies
a new reading of competition for laws that differs from textbooks’ explanations. The
competition in place derives from law that is seen as commodity, from the new technology
(‘contractual technology’), from the new type of business organization.\textsuperscript{1063} This kind of
competition disciplines market agents, the businessman, members and directors of companies
who, even if only faced with the threat of change, compete with themselves for the best
output. Besides being an economic process, this is, additionally, a social and political process.
Societies, governments and decision-makers in general, have a role to play. It is not only a
matter of biology. Still, they too are a product of this organic process. This idea can, at first,
be aligned with concerns pertaining to path-dependence that have been widely addressed in
the literature. However, more than that, it points out the need for a critical understanding of
institutions, and an openness to constant transformation in the economy, law and society.

It is difficult to know whether jurisdictional competition can effect change to the law in
the short run. However, in a globalized world and an increasingly integrated Europe, it is
difficult to elude a change in the socio-economic order that slowly works deep down below
and which eventually transforms the extant institutional framework, such as the legislation
applied to the private enterprise, property and respective contractual setting. One might ask if
such a system would not ultimately destroy itself. The answer is that it is not a movement
toward self-destruction. Rather, it is a movement toward cyclical transformation and renewal.
The process is not deterministic because transformation obeys a natural order of events. It is
this theoretical reasoning that could serve, in principle, as a common denominator for
competition between states in Europe.

\textsuperscript{1061} A clarification is in place. The process described in the text differs from socialism. Whilst in a capitalist
system this phenomenon would be developed by a natural order, in a socialist system it would be imposed by a
central authority.
\textsuperscript{1062} See Schumpeter, Joseph A., \textit{Can Capitalism Survive?}, cit. p. 103 (saying that ‘…in these things a century is a
“short run”’).
(ii) Are default rules establishing restrictions on transfer of shares beneficial for large PLLCs?

The bargaining problems that seem to derive from the selection of a particular type of default rules establishing restrictions on transfers call to mind the reported influence of California law on the building up of Silicon Valley. Business and Profession Code Section 16600 provided a prohibition of covenants not to compete. This meant that non-competition agreements prohibiting employees from working for a competitor of its former employer or settling with a firm with a competing business object were not enforceable pursuant to California law. Ronald Gilson calls attention to the effects prohibition of restrictions on competition such as post-employment covenants not to compete have had on the growth of industrial districts such as Silicon Valley. He compares the rise of this high-profile district with the decline of Route 128 in the state of Massachusetts, where post-employment covenants not to compete were enforceable. In his opinion, the decline of Route 128, which was the bastion district of technological innovation until Silicon Valley took over in the mid-seventies, was directly related to the respective legal infrastructures of the regions.

Coupled with the limited usefulness of trade secret law in California as elsewhere, Silicon Valley employers’ early efforts to prevent employees from leaving to compete by using employers’ proprietary tacit knowledge failed. Employees learned that they could leave; employers learned that they could not prevent high velocity employment and the resulting knowledge spillover. And that legal infrastructure cause employers, however reluctantly, to adopt a different strategy, one of cooperation and competition, that generated a dynamic process leading to Silicon Valley’s characteristic employee career pattern, lack of vertical integration, knowledge spillovers, and business culture. Thus, the initial condition supplied by Silicon Valley’s legal infrastructure ultimately generated the conditions necessary to support a second-stage agglomeration economy, which allowed it to reset its product cycle and thrive while Route 128 rode its product cycle down the curve.¹⁰⁶⁴

¹⁰⁶⁴ See Gilson, Ronald J., ‘The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants not to Compete’, New York University Law Review, vol. 74, 3, 1999, pp. 575-629 (609). Additionally see, Booth, Richard A., ‘Give me Equity or Give me Death – The Role of Competition and Compensation in Building Silicon Valley, Entrepreneurial Business Law Journal, vol. 1, 2, 2007, pp. 265-282 (arguing that equity compensation, which might have been used to bind employees to the companies given the non-enforceability of no-compete agreements in California, may have been the cause for the rise of Silicon Valley).
Gilson’s point is that California’s legal framework is partially responsible for Silicon Valley because it encourages employees (from the CEO to the lowest ranked employee) to change. Free competition, which originates knowledge spillover and a flurry of identical measures on the employer side (if one does not include a covenant not to compete in the employment contract, others will not either), favors innovation and growth. It is even reported that the enforceability of covenants not to compete in Massachusetts has led to litigation that does not exist in California because those restrictions were not allowed there. The saying 'secrecy is the soul of business' seems not to hold in these circumstances, since the fact that employees are not restricted on their changing plans allows them to use their know-how with a new employer. The new employer will partake in the maximization of value that the freedom of knowledge spillovers provides.

Along the same lines, a default rule which restricts the transfer of shares may hinder the spillover effect that Gilson thought was beneficial for the development of start-up companies in the San Francisco Bay. This may be so if the rule that is outdated, poorly drafted or ill-fitting to the needs of the members of the company keeps those who want to leave the company from leaving it, at least at low cost or no cost at all. Besides enabling the study of possible inefficiencies in the PLLCs, this context permits that a bridge be created to a broader idea of jurisdictional competition based upon a free market. A dynamic process of development would be put into motion by means of cooperation and competition to the point it is likely to echo the phenomenon of economic aggregation to which Gilson refers regarding the high technology industrial district of Silicon Valley. Pertaining to whether default rules establishing restrictions on shares are beneficial for large PLLCs, it is difficult to establish a causal effect between the existence of restrictions and output of these companies. However, in light of the above, it may be that restrictions on transfer of shares of large PLLCs, in

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1065 See Booth, Richard A., cit. p. 278 (noting that ‘For example, under Massachusetts law the corporation must show that it had a specific or express expectation relating to a business opportunity in order to show that an officer or director usurped the opportunity in violation of his fiduciary duty to the corporation. To be sure, this may be pure coincidence. And one must be careful not to make too strong a claim for a causal connection. But California appears to have been relatively free of such litigation’).

1066 Given the substance of the articles of association and the case law analyzed in all six jurisdictions, I am assuming that there is no knowledge spillover in these companies because restrictions on transfer of shares are imposed. It is true that since this rule is a default, members can in principle alter the articles of association. There is, however, in many situations a status quo that impedes members from changing the company’s contract.

1067 Finland, and in particular its main city Helsinki, have been called the next Silicon Valley of Europe because it is an appealing market for a number of startup companies in Europe. Much of it has to do with the prevailing culture in Finland where companies, after observing other companies’ success, are not afraid to take the plunge. Availability of public funding, the quality of the education system, and an open attitude towards a global market make this rather insulated country score high when it comes to the incorporation of startups. However, establishing a causal relationship between the content of labor, corporate and intellectual property rights laws and the development of these companies is beyond the scope of this chapter.
particular if they do not have a closed nature, may constitute unnecessary market frictions. This is an argument in favor of further European integration for the sake of competition in the internal market and the creation of aggregative centers of development.1068

4. Conclusions

This chapter explores the idea of jurisdictional competition as a means to create new legal solutions in corporate law. This question is informed by a concept of Pareto efficiency. I tend to answer this question in the affirmative. It is not clear, however, that even after ECJ’s judgments Europe has the necessary institutional framework for jurisdictional competition to be more than a promise. It also is uncertain whether, once implemented, jurisdictional competition would lead to a race to the top or to a race to the bottom. William Cary’s quote introducing this chapter makes sense not only for those like him who advocated the race to the bottom theory, but also for those who believed that jurisdictional competition can lead to a race to the top. It seems not to be so much a matter of principle, but policy. Thus, this chapter has focused on providing a theoretical reasoning based on the idea of market integration as a catalyst of jurisdictional competition. The Silicon Valley / Route 128 story tries to exemplify this. The openness of markets, which is guaranteed by freedoms of movement, is crucial for creating incentives to innovation, economic development and growth. Yet, the implementation of freedoms of movement, although it has opened the door to jurisdictional competition, has not created a system of corporate law that binds businessmen, members of PLLCs, managers, directors, employees, lawyers, notaries and other gatekeepers, interest groups, the society, politicians and regulators to strive for the best policies, and force a political change if necessary for the equilibrium of that system. Law should be seen as part of an evolutionary process of continuous innovation and renewal where everything is connected. The fact that the market, the economy and society are susceptible to being renewed should in and of itself serve as an incentive for periodic revision of legal policy agendas at the national

1068 See Caniëls, Marjolein C. J. and Verspagen, Bart, ‘Barriers to Knowledge Spillovers and Regional Convergence in an Evolutionary Model’, Journal of Evolutionary Economics, vol. 11, 2001, pp. 307-329 (arguing that the existence of spillover barriers such as borders between countries leads to convergence between regions. This is a paradoxical result which, as the authors recognize, goes against the main tenets of policies in favor of increasing European integration. They find a similar result due to structural differences between regions. They explain these contradictory findings with the existence of ‘local’ centers in the case of barriers to spillovers or (large) structural differences between regions. These ‘restrictions’ may benefit peripheral regions which may then become local centers. Other, even more peripheral regions that are located nearby will additionally benefit from this, which causes lower disparity between regions. In terms of policy, their argument is that regional policies matter for the purpose of further European integration).
and transnational levels. Legal categories and principles, as much as they help us understand the nature of law, fall short of being a common denominator for change. A proposal of a self-standing legal system for it can renew and recreate itself organically and, consequently, create an environment that removes resistance to development is a contribution of this chapter. Nevertheless, more interdisciplinary and empirical work needs to be done in this field to fully grasp the dynamics of competition among European states.

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1069 See Grundmann, Stefan, *European Company Law: Organization, Finance and Capital Markets*, Antwerpen, Oxford, Intersentia, 2007, p. 96 (providing that ‘As legislatures are certainly subject to limitations of knowledge and to conflicts of interest, a system, if functionally designed, which subjects legislatures to a mechanism indicating the level of performance and in which as much information as possible can be processed (from many sources) is certainly desirable. In European company law, this basic principle is not yet as clearly accepted as it is in the USA’).
CHAPTER III

COMPLETING THE PICTURE: COMPARATIVE SYNTHESIS

Quand nous instaurons un classement réfléchi, quand nous disons que le chat et le chien se ressemblent moins que deux lévriers, même s’ils sont l’un et l’autre apprivoisés ou embaumés, même s’il courent tous deux comme des fous, et même s’ils viennent de casser la cruche, quel est donc le sol à partir de quoi nous pouvons l’établir en toute certitude? sur quelle «table», selon quel espace d’identités, de similitudes, d’analogies, avons-nous pris l’habitude de distribuer tant des choses différentes et parreilles?

Michel Foucault
in Les Mots et les Choses

Introduction

At this point, the real work of comparison is done by the synthesis, which is the output of the intersection of both entries of the empty comparative table presented in Part I, Chapter 1. The synthesis has the effect of a periscope that enables the observation of the object of research. This chapter provides answers to the seventeen questions that were intuitively asked when the research question and the terms of the investigation were being designed. I decided to keep them as they were asked for the first time. This chapter also creates a full circle that brings the reader back to the beginning. It proceeds as follows. Section 1 provides the answers that result from the interconnection of the two entries. Section 2 concludes.
1. Synthesis: Filling in the Comparative Matrix

This section matches the answers asked in the left column of the comparative matrix with the jurisdictions indicated in the top row. The answers to each question are provided below.

<table>
<thead>
<tr>
<th>Question</th>
<th>Portugal</th>
<th>Spain</th>
<th>Italy</th>
<th>France</th>
<th>UK (England &amp; Wales)</th>
<th>US</th>
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<tbody>
<tr>
<td>1 - When and why was the law adopted?</td>
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<td>2 - What kind of restrictions on transfer of shares does the law foresee?</td>
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<td>3 - What is the purpose of restrictions on transfer of shares foreseen by the law?</td>
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<td>4 - Do these restrictions constitute a source of inefficiency (unenforceability) of the legal framework of transfer of shares?</td>
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<td>5 - How do legislators approach the transfer of shares and protect entitlements (inalienability rules, property rules, or liability rules?</td>
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<td>6 - What kinds of costs result from the transfer of shares according to the approach taken by legislators?</td>
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<td>7 - What kinds of agency problems derive from the transfer of shares according to the approach taken by the legislators?</td>
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<td>8 - In practice, do defaults reduce bargaining failures?</td>
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<td>9 - Is there a demand for efficient company (corporate) law rules?</td>
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<td>10 - What kind of ownership structure do these business organizations have?</td>
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<td>11 - On average, how big is the PLLC (i.e., how many shareholders do these business organizations have)?</td>
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<td>12 - What kind of control structure do PLLCs have (e.g., (i) one controlling shareholder; (ii) many controlling shareholders through a shareholder agreement or through occasional coalitions; (iii) no controlling shareholder)?</td>
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<td>13 - Which constituency is most likely to efficiently assess the transfer of shares (e.g., shareholders, managers, creditors, employees, consumers/customers)?</td>
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<td>14 - Are the company's and shareholders' interests well protected considering the constituencies intervening in the transaction process?</td>
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<td>15 - Is the choice of the constituencies which are competent for the assessment of the transaction liable to be affected by the environment in which the company operates (e.g., financial context, taxes, links with hedge funds, and with the uncorporation of larger dimensions?</td>
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<td>16 - Is the (competitive) context in which the company operates likely to be a source of efficiencies which may lead to: (i) containment of bargaining failures; and (ii) allowing the evaluation of the right amount of benefits which should be granted to the shareholder who wants to leave the company?</td>
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<td>17 - Do default rules adopted by legislatures allow any single corporation to submit transaction costs to the constituencies which are more likely to correctly assess its commercial value?</td>
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1. When and why was the law adopted?

In Portugal, the law was adopted in 1901. Portuguese legislators were essentially influenced by German legislators who had formally adopted the German GmbH, in 1892. Portuguese legislators also looked at the market and at the options market agents were taking at this level with the help of lawyers and notaries. The enactment of the law of the Portuguese version of the PLLC (*sociedade por quotas*) was pressed by business associations, professional organizations and syndicates.

In France the law of the SARL was adopted in 1925. Despite the existence of this type of business organizations before, the French legislature decided to regulate them, especially after the conversion of the territories of Alsace and Loraine where the GmbH had been incorporated under German law. However, the French legislature stressed its intention to follow the model of the United Kingdom private company, and create a law that was adequate to the features of these business organizations in France. The SARL in France was created at the contracting level. In these circumstances, lawyers and notaries played an extraordinary role. Jurisprudence also was important at the institutional level because it adapted the existing forms at the time, namely the joint stock company to the specific needs of small businesses.

After a relatively long period of indifference of Italian legislators, the SrL was legally adopted in Italy in 1942. This possibility had already been discussed in 1882, in the context of reform of the Commercial Code. These business organizations had existed already in the provinces of Venezia Giulia and Tridentina, which had been part of the Austro-Hungarian Empire. These provinces were annexed to Italy after the First World War. The SRL was adopted in Italy to replace the joint-stock company and be a legal form better adapted to the purposes of smaller businesses.

Spain adopted the SRL in 1952. For the Spanish legislator it was essentially a matter of opportunity, given that the legislation regulating the public company had just been reformed. However, these companies have existed in Spain at least since the early 1850s.

The private company was legally accepted in the United Kingdom in 1907. Its existence had been known for more than forty years, at least, since the enactment of the Companies Act 1862. The debate in the United Kingdom was rooted in the ambiguity of the concept of private company. The private company was created in the United Kingdom at the lower level of contracting, before it was finally foreseen in the law. It was created to avoid situations of fraud potentiated by the use of unregulated private companies.
The creation of the LLC in the United States is attributed to the State of Wyoming in 1977. Nevertheless, data suggest that there were forms of limited liability similar to the LLC in the late nineteenth century. Businessmen and interest groups lobbied with legislators for the creation of the LLC. But its breakthrough only occurred after a tax reform providing the members of these business organizations with a passthrough treatment.

2. What kind of restrictions on transfer of shares does the law foresee?

The articles of association of the PLLCs in the six jurisdictions foresee pre-emption rights and rights of first refusal, clauses prohibiting the pledge of shares, liens or any charges over the shares, and their usufruct, formulas determining the price of sale of shares, which are especially associated with the exercise of pre-emption rights by the company and the members (but not necessarily), and administrative corporate procedures prior to which a transfer will not be effective. I point out the complexity of many of the transfer clauses of the articles of association of Spanish PLLCs. They are based on an intricate scheme of notifications between the transferor, the company and other non-transferring shareholders. Furthermore, it is worth noting the complexity of the clauses determining pre-emption rights. Clauses of American LLC agreements also are complex. They include tag-along rights, rights of co-sale, sale purchase rights, buy-sell agreements, put-rights, and similar rights. These type of clauses are also included in the articles of association of United Kingdom private companies. However, there still is not a body of jurisprudence that helps define the validity of drag and tag along clauses in the United Kingdom. Both in the United States and the United Kingdom, management boards have wide powers to discretionarily refuse a transfer. There are other types of restrictions that can be tracked in the articles of association such as vesting requirements, forfeiture provisions, minimum retained ownership requirements or other similar provisions, clauses limiting transfers to competitors, and lock-up prohibitions.

3. What is the purpose of restrictions on transfers of shares foreseen by the law?

For the most part, restrictions on transfer of shares are drafted to safeguard the purpose of the company and the expectations of their members. They also are meant to adapt the ownership structure to the purpose of the respective business. In many other cases, they are introduced in the articles of association as a matter of imitation or crossover of legal knowledge.
4. Do these restrictions constitute a source of inefficiency (unenforceability) of the legal framework of transfer of shares?

In many instances, restrictions constitute market frictions. In this sense, they potentiate inefficiencies at the contracting level. The problems of bargaining failures revealed by the case law collected is likely to be increased in PLLCs with larger dimensions not only in terms of earnings, but also in terms of the number of shareholders. Bargaining failures in PLLCs call attention to the fact that, within the corporate form of the PLLC, there are several types of companies and firms. ¹⁰⁷⁰

5. How do legislators approach the transfer of shares and protect entitlements (inalienability, property rules, or liability rules)?

Legislators may choose among a contractarian approach, a statutory approach or an intermediary solution. The legislator takes a contractarian approach if she provides a number of default rules around which shareholders may or may not contract. Portuguese, Italian, Spanish, US and UK legislators follow this path. In the particular case of the United States legislators of the state of Delaware and New York assume a contractarian position. However, Delaware law can be more contractarian and less prescriptive than New York law. On the contrary, legislators take a statutory approach if they establish a prescriptive law that market agents are obliged to follow. This is the case in France, where a mandatory rule on the transfer of shares has been historically provided. The different configuration of these rules – default or mandatory rules – influences in different ways the conceptualization of property rights, specifically property rights in shares of PLLCs.

Rules on transfers of shares can be designed in different ways. A possible formulation is one that foresees four types of rules:

¹⁰⁷⁰See Lutter, Marcus, ‘Limited Liability Companies and Private Companies’ International Encyclopedia of Comparative Law, vol. XIII, ch. 2, 1998, s. 5; and Behrens, Peter, ‘Ein. B – Die GmbH im internationalen Recht in Rowedder, Heinz, and Schmidt-Leithoff, Christian, Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbH). Kommentar, 5. Auflage, München, Verlag Franz Vahlen, 2013, pp. 74-75 (arguing that in respect to small companies like the PLLC, there only are two possible alternative corporate forms from which to choose. These corporate forms are the private limited company or the public company. This comment, however, alienates the PLLC of larger dimensions, whose members are not interested in transforming it into a public company, at least for the time being.
- Property Rule 1: the sale cannot be executed without consent.
- Liability Rule 2: the sale can be executed, but the shareholder must pay for damages.
- Reverse Property Rule 3: there is no transfer restriction.
- Reverse Liability Rule 4: foresees pre-emption rights, often coupled with property rules.

6. What kinds of costs result from the transfer of shares according to the approach given to it by the legislator?

The costs resulting from the transfer of shares are transaction costs which include the costs of defining, strengthening and governing property rights. These costs are incurred by parties within a contractarian or statutory approach. They are more likely to happen, however, within a contractarian approach to transfers of shares. It is important to note that property rights have a complex dynamics which can not be sufficiently tackled within the framework of transactions costs economics. This interesting dynamics of property rights was revealed in all six countries. There is an unexplored dimension which has to do with their form and composition and the way they react to contractual measures. This calls to the fore the theoretical framework of new institutional economics. Although, there is this particular aspect which is the need to analyse the molecular composition of property rights (claims, duties, privileges) and how the relevant elements interconnect, depending on the circumstances. For this, lawyers are most suitable.

7. What kind of agency problems derive from the transfer of shares according to the approach given to it by the legislator?

Agency costs derive from conflicts of interests between shareholders and managers and from conflicts of interests between majority and minority shareholders. Considering that the line dividing ownership and control is frequently blurred in these companies, it is difficult to set a trend regarding this kind of conflicts. Conflicts between shareholders and directors are, however, more evident in UK private companies. Perhaps this is due to the fact that the law does not foresee rights of appraisal. Furthermore, the law does not regulate general meetings of shareholders. This leaves considerable room for enhancing directors’ powers by contract.

8. In practice, do default rules reduce bargaining failures?
In practice, default rules do not necessarily reduce bargaining failures. However, they can be drawn to do so.

9. Is there a demand for efficient company law?

The answer to this question may be given in the affirmative, even though the data collected do not expressly reveal this fact. There is, however, an element of jurisdictional competition to provide the most efficient rules.

10. What kind of ownership structures do these businesses organizations have?

In most of these companies the ownership is very concentrated. Only in very exceptional cases is this not the case. Furthermore, there is a strong dependence of the companies on their shareholders, which does not necessarily translate into the control that is exercised by managers at the governance level.

11. On average, how large is the PLLC (i.e., how many shareholders do these business organizations have?)

On average, the PLLCs in the samples have a small number of shareholders, which may range from two to four individuals. However, in terms of share capital, number of employees and earnings, there is a considerable number of big businesses in the samples. This is particularly true of UK private companies.

12. What kind of control structure do PLLCs have (e.g., (i) one controlling shareholder; (ii) many controlling shareholders through a shareholder agreement or through occasional coalitions; (iii) no controlling shareholder)?

There can be one controlling shareholder. In general, it is the majority shareholder who also is a manager of the company. Case law reveals that in certain circumstances, especially when there are conflicts between majority and minority shareholders, control in the company is exerted through occasional coalitions between members.
13. Which constituency is most likely to efficiently assess the transfer of shares (e.g., shareholders, managers, creditors, employees, consumers)?

Shareholders are generally the group deciding the terms of the incorporation. However, this may not be true if managers have at an initial stage and afterwards sufficient political representation in the company and can gain the support of other corporate constituencies, namely shareholders. Furthermore, decision-making about the terms of incorporation also depends on the types of incentives to efficient bargaining established in the company’s articles. The inclusion of dissolution at will in the company’s contract may create more incentives for shareholders to efficiently assess the transfer than for unpaid or badly remunerated managers.

14. Are the company and shareholders’ interests well protected, considering the constituencies intervening in the transaction process?

The answer to this question should be similar to the previous one. In addition, inherent to drafting the contract there should be a serious concern to allocate entitlements efficiently in the company. This may imply adopting or designing different types of default rules. If there is need for better rules there should be, eventually, an intersection between markets (at the contracting level) and legislatures (at the policy or institutional level) for the enactment of these rules.

15. Is the choice of the constituencies which are competent for the assessment of the transaction liable to be affected by the environment in which the company operates (e.g., financial context, taxes, and links with hedge funds and with larger PLLCs)?

This question should be answered in the affirmative. I have suggested that everything in law is connected. This is illustrated by the idea of pleotropy in law. Furthermore, given limitations to evolution, law can be used as commodity to affect the socio-economic environment, and point market agents in the direction of the best legal solutions.

16. Is the (competitive) context in which the company operates likely to be a source of efficiencies which may lead to: (i) containing bargaining failures; and (ii) allowing
the evaluation of the right amount of benefits, which should be granted to the shareholder who wants to leave the company?

I answer this question in the affirmative. There is another point that is related to jurisdictional competition. The effects of jurisdictional competition are relatively unexplored, especially within an evolutionary framework. Nevertheless, jurisdictional competition can be perceived as a promising force for legal reform which, in turn, affects the choices of market agents at the contracting level.

17. Do default rules adopted by legislators allow any single corporation to submit transaction costs to the constituencies which are more likely to correctly access its commercial value?

In principle, this will depend on how well market agents use the opportunity to govern their contractual relations by adopting the defaults provided by the legislator. However, this investigation has shown that there were cases of un-consented transfer in all six jurisdictions. They were originated in agency problems and bargaining failures, in general. It seems that, depending on the circumstances, defaults are not strongly enforceable. The corrective, however, may not rest in the default rules themselves, but in the techniques of legal engineering.

2. Conclusions

This table sketches the comparative work undertaken in this dissertation. In the absence of a standard method for comparative law, I created a comparative matrix which was based on legal intuition, the law and a preliminary treatment of jurisprudence in the six examined jurisdictions. The results not only create the image of a full circle, but also constitute a starting point for the final conclusions.
PART III OVERVIEW

In this part, I connect the dots. In other words, I make a concerted effort to understand the relationships that exist between jurisdictions. Jurisdictions are interrelated in three ways. First, I look at the company’s contract and use contract law as an instrument for legal design or legal engineering. The goal is to create efficient rules to overcome situations of bargaining failures across all six jurisdictions. Second, I connect the jurisdictions through a socio-economic model that is liable to trigger jurisdictional competition. It starts from the assumption that competition between states is likely to facilitate the creation of specific legal structures that may significantly contribute to business development in Europe. To this end, I draw a theoretical framework regarding the market process to contextualize the idea of legal evolution through jurisdictional competition. Third, I fill in the comparative matrix and yield the answers that derive from the intersection of the preliminary research questions asked for each jurisdiction. The connecting the dots phase is gone through, as it should be, by looking backwards. It sets the stage, nevertheless, for the coming final conclusions.
PART IV

FINAL CONCLUSIONS:
THE TALE OF THE SILVER FOX AND THE RE-VISIONING OF CORPORATE LAW THROUGH THE LENS OF EVOLUTIONARY BIOLOGY

The research question driving this dissertation is: How does the design of clauses establishing restrictions on transfer of shares of private limited liability companies affect investment made in these companies and their consequent development? I have set up a laboratory for the legal research by drafting seventeen ancillary questions which helped in the task of yielding an answer to the main research question.

I started with a hypothesis. There is a status quo that market agents like to preserve regardless of the default rules provided by legislatures which they can contract around, if and when necessary. The comparative work, the selection of case studies and case law, was intended to falsify my hypothesis – the existence of an inscrutable status quo. There were situations in which it was clear that the status quo was meant to be maintained. There were other situations in which bargaining failures were found to be related to other exigencies. These included the poor enforceability of the rules chosen by the parties, the uncertainty and the effects of un-consented transfers, and weakness in governance structures, which ended up affecting those with weaker property rights.

The main theoretical framework of this dissertation is evolutionary theory. It was chosen quite deliberately. When I initiated the research for this dissertation, the reading of private documents of companies and legislative preparatory works suggested a curious dynamic that could not be grasped entirely by reading the literature. The dynamics of the law-making and the use of legal rules resembled evolutionary processes in biology where everything (in this case, the civil society, legislatures and markets) appeared to be connected. This idea is illustrated here by the ‘analogy of the fox’ and situations of pleiotropy in law. The first impression may be that it conveys an idea of path-dependence of legal solutions, but it is not limited to that. The evolutionary framework of this dissertation yields the understanding that legal evolution becomes impaired if it is trapped into a paradigm. Indeed, law can be designed to break paradigms or status quo, if necessary, for the sake of the development of business organizations.
Methodologically, I am calling for a more general epistemological debate in law. I try to explain a sociological phenomenon – the status quo in PLLCs – through legal knowledge. Lawyers understand that corporate law, property law, intellectual property rights, tax law and other fields cannot be viewed as insulated categories, particularly, if the goal is to explain complex problems. The novelty of the methodology I use herein lies in the fact that it is more than a method wherein files of companies are analysed. It is a new method in legal research wherein social and economic facts are analysed through the lens of legal knowledge.\textsuperscript{1071} It involves the realization of a legal ‘due diligence’ by which businesses are evaluated in context. This is something for which lawyers are especially 'vocationed'. This dissertation takes a social sciences approach to law and legal doctrine.

On the normative side, this dissertation also tries to answer the questions it raises within system-building in law, which is a relatively recent topic. It takes a theoretical approach with a normative focus, which gives the necessary ground for analyzing the details of property rights in shares and the bargaining that undergirds property rights contracts. The analysis of articles of association and court decisions provide the empirical support for this task.

In terms of policy, this dissertation is based upon the economic goal of promotion of small businesses, and offers policy proposals regarding the legislative process. It bridges different corporate cultures with the purpose of creating a scheme of legal rules that attends to the goals of market agents, and that pays attention to the genetic features of the market. In this sense, jurisdictional competition is presented here as a promising tool to induce legal reform.

I have determined that there is no conclusive answer to my main research question concerning the design of default rules. It is, however, possible to guess what will happen if certain type of legal policy measures are taken. My thesis is that, if there is a status quo that is not beneficial, the types of legal policies that are likely to break it are those that promote the regeneration of business organizations at the lower level of contracting. Private ordering is one very important driving force of evolution in law, especially the law of the PLLC. This also says a lot about law itself. Law should be able to regenerate itself to comply with this function. This is illustrated, in this dissertation, by a new conception of property rights and the relationship between fields of law, in particular, corporate law, property law, and contract

law. Institutionally, this process of regeneration is sustained by a model legal policy that takes a bottom-up approach to law and promotes market integration.
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