Corporate Governance and Innovation
Venture Capital, Joint Ventures, and Family Businesses

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1. Introduction

Policymakers and lawmakers in Europe and Japan are taking steps to design new legal and institutional structures that could support innovation. Generally innovation in these regions tends to lag behind the United States. It is well-known that the number of start-ups, initial public offerings (IPOs) and innovative networks has yet to satisfy government predictions. How do we explain the different level of innovation and competitive performance between these environments? The differences in innovative outcome can partly be explained by management and organizational factors that contribute to the relative success of technology based start-ups in United States.

European industries and firms, in contrast, are constrained by technical measures and institutional and legal blockages that limit external investment, and capital market structures that curb the ability of portfolio firms to liquidate their positions in innovative firms. Throughout much of the 90s, the Japanese economy suffered from excessive debt-overhang and deflation which hampered corporate competitiveness and contributed to a slowed rate of innovation and regulatory reform. Thus, the core problem for both Japan and Europe concerns how to stimulate the development of an efficient institutional environment and regulatory structure that not only encourage risk-taking by large institutions and private equity investors, but promotes the creation of start-up companies with innovative ideas.

From a theoretical and practical perspective, the corporate governance literature links the relationship between a strong governance framework and firm performance and innovation. This study will examine, comparatively and functionally, the institutional factors that solve agency, adverse selection and moral hazard problems, and help create the conditions that promote economic growth. Corporate governance refers to the monitoring and control over how the firm's resources are allocated, and how relations within the firm are structured and managed. It acts as a facilitator, enabling business parties to move toward the development of new business practices that stimulate entrepreneurship and innovation. This study's analysis explores important questions for law reform agendas in Europe and Japan. In Europe, proponents recommend deregulation of mandatory company law provisions, looking to comply-or-explain based governance codes, and optional guidelines and recommendations to improve the climate for entrepreneurship and joint venturing. Along a similar dimension, Japanese policymakers have proposed a package of legislative reforms that are diagnosed to treat gaps in the prevalent model of governance, while introducing new legal business forms that should prove ultimately more compatible with facilitating innovation, promoting knowledge-intensive joint ventures and enhancing the productive outcome of firms.

Generally, corporate governance reforms seek to create an optimal legal, institutional and regulatory environment that protects the interests of external investors. Still it is difficult to establish a single model that fits in all situations. Given the broad and vague definition of corporate governance, there can be situations in which the importance of external stakeholders may be central to a corporate governance system. Clearly, good corporate governance does more than regulating the ownership and control arrangements inside the firm. Not only does corporate governance provide rules and institutions that enforce internal ownership and control arrangements, but it also contains rules that protect other stakeholders like employees and creditors from adverse selection and moral hazard problems that may arise from the opportunistic behaviour of insiders. This approach to governance, which mainly concerns a company's investors but extends to wider interests, provides a solid analytical basis upon which to create a framework for understanding the key components to a good corporate governance system.

Policymakers and lawmakers have undertaken reforms designed to enhance transparency and disclosure, improve the monitoring role and performance of boards, and ensure the independence of auditors and non-executive directors. These measures leave non-listed firms, such as family businesses, joint ventures and innovative firms, as more of a backwater. As the impact of non-listed companies on society is significant (these companies are considered to be the backbone of a robust economy and major employment generators), the lack of corporate governance analysis in this area is likely to be detrimental. The absence of complete risk diversification and an active market for corporate control holds out the potential for greater risk and reinforces the demand for a separate set of corporate governance mechanisms.

Although the current reform packages specifically address publicly held companies, they arguably affect non-listed companies. To be sure, given the limited market for and the restricted transferability of interests in non-listed companies, business parties should ideally be engaged in bargaining for contractual provisions that deal with the protection of a company's stakeholders. However, these contractual mechanisms are often very costly solutions due to drafting limitations, private information and strategic behaviour. That is not to say that economic actors do not use contractual mechanisms to deal with the possibility of opportunistic behavior, but the incomplete contracts paradigm shows that business parties are not always able to contract their way into governance structures that deal with every contingency *ex ante*. Moreover, the costs of designing corporate governance structures that minimizes the expected risks of opportunism and can be enforced by judicial process may be prohibitively high. Thus, policymakers, investors, lenders and other stakeholders prefer to recommend the application of the corporate governance rules and principles tailored to the requirements of publicly held companies.

The question of the economic effect of the 'one-size-fits-all' approach to corporate governance regulation on the performance of non-listed companies has produced mixed results. On the one hand, it is widely acknowledged that corporate governance rules and standards promote efficiency, transparency and accountability within firms, thereby improving a sustainable economic development and financial stability. On the other hand, some scholars argue that the corporate governance movement has gone too far, entailing nothing more than a box-ticking exercise to ensure compliance with current corporate fashion trends. In this view, non-listed companies do not seem to benefit from the spillover effect of the application of disproportionate corporate governance rules and principles. Not only are the compliance costs exorbitantly high, their typical organizational structures demand an approach different from publicly held firms. Indeed, a corporate governance framework that is considerably out of step with the social and economic requirements of most non-listed companies can lead to inefficiency.

It seems to follow from the above discussion that non-listed companies cannot simply adopt the corporate governance norms of publicly held firms and arguably require a separate set of guidelines. That is not to say that policymakers should completely change course and redirect their focus to corporate governance issues of non-listed companies. Corporate governance reforms for publicly held firms tend to have some positive effects on non-listed firms in general. First, as this study will show, these reforms improve the investment climate and business environment in regions. Second, they help to better facilitate the conversion from non-listed to listed companies. It is therefore suggested that, in order to maintain momentum, the corporate governance projects for listed companies and non-listed companies should be pursued separately, but simultaneously.

We will argue that a separate focus on non-listed companies would be more effective in providing firms at different levels with separate sets of legal rules and governance norms. In this respect, individually designed corporate governance frameworks will not only assist firms to conform their organizational structure to their specific business needs, but may reinforce in practice the crucial role of good governance in the performance outcomes of companies. Furthermore, firms may have incentives to adopt a particular framework which can attract and accommodate (foreign) investors, who are usually more accustomed to working with such governance structures.

This study will fill the gap in the corporate governance debate on family-owned businesses, joint venture firms and high-potential companies by signaling the importance of governance reforms in this area. While it is now commonplace that strong governance is considered essential, there remain nagging questions concerning which set of corporate governance rules and standards will most likely boost economic growth in the era of internationalization. It has been argued by scholars that, due to the unique characteristics of each non-listed company and the different conditions surrounding them, the design barriers are simply too high to create an efficient corporate governance framework that is facilitative to firms' success and growth. The overarching purpose of this study, therefore, is to explain the dynamics of these firms, in particular venture capital-backed companies, joint ventures and family-owned firms and to recommend a framework that may create a positive effect on the performance and development of these firms.

This study is divided in two parts. The first part evaluates the relative merits of the contemporary corporate governance debate. It recounts the history of corporate governance from the development of a joint venture business form (*commenda*) that facilitated the networking of entrepreneurs and investors with their opposing interests to the recent initiatives that help to foster the legal infrastructure needed to keep a modern economy in gear. This part shows that the company and securities law framework that gradually emerged in the wake of earlier stock market bubbles and governance failures is not sufficient to the task of curbing abuses within non-listed companies and inadequate to fostering a competitive environment which assists business parties to write equilibrium contracts. We argue that policymakers and lawmakers should draw attention to other legal measures that may very well serve to minimize the specific agency, adverse selection, and moral hazard problems inherent in the governance of non-listed companies.

In recent years, a burgeoning movement calling for deeper and more fundamental corporate governance reforms has arisen. Current reforms are characterized by legislative developments and proposals designed to lead to the increased accountability, transparency and enhanced organizational performance. To be sure, substantial progress has been made in some areas of corporate governance, bringing improvements from country-to-country to the legal, regulatory and commercial environments. While shareholders and investors usually benefit from higher returns, questions persist about which rules are likely to promote welfare, and whether they can be transplanted. Thus, such considerations suggest that caution is warranted, particularly as lawmakers have, in attempting to promote economic growth, caused the proliferation of corporate governance laws, regulations and codes that function quite differently than expected, and could ultimately have counterproductive effects. A striking example is the post-Enron reforms which, despite much skepticism, have induced rapid convergence in some areas, which is particularly costly for privately held, non-listed companies.

Economic evidence shows, moreover, that the recent and aggressive corporate governance reforms have resulted in uncertainty among legal professionals and business parties as to the extension of codes of best practice for publicly held firms to non-listed companies. The second part will take up arguments for and against separate sets of corporate governance mechanisms and techniques for the variety of these non-listed firms. Although scholars and practitioners are increasingly of the opinion that good governance is also of signal importance for these companies, a question remains regarding which legal strategies will cultivate their long-term success and boost economic growth overall. This part identifies the three pillars of corporate governance mechanisms: company law, contracts and optional guidelines. While it is commonplace that business parties themselves are in the best position to bargain for the optimal governance structure of their venture, examples from family-owned businesses, joint ventures, and venture capital indicate that company law rules and optional governance recommendations could nevertheless assist the business parties in overcoming the costs and deficiencies of legal contracting. Part 2 shows, furthermore, that several 'soft law' initiatives in this area have been heralded as a solution to corporate governance issues in non-listed companies. After having discussed this 'new corporate governance movement', this study concludes with a short set of policy recommendations and considerations for further research.

2. The History of Corporate Governance: The Emergence of the Corporation

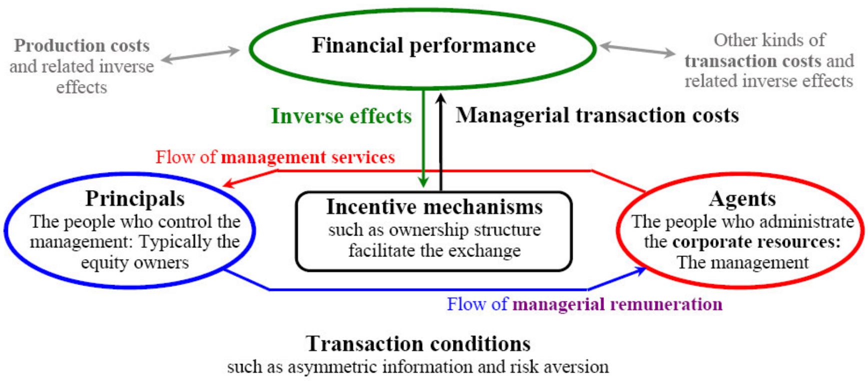
2.1 The Managerial Agency Problem: An Introduction

In the last decade, corporate governance has become a top-priority not only for international and national policymakers and lawmakers, but also for performance-oriented companies wishing to attract investors. The corporate governance reform debate, jump-started by the internet-bubble and recent fraud and accounting scandals,[1] takes up the challenge to promote more effective incentive and monitoring structures that are crucial to designing and controlling the complex set of relationships among management, the board, shareholders and other stakeholders within firms.[2] Recent corporate governance reforms have altered, among other things, the role of non-executive directors, executive pay, disclosure, the internal and external audit processes, and sanctions on managers' misconduct and self-dealing transactions. The objective of these corporate governance measures is to protect the primary stakeholders of the publicly held company, i.e., the shareholders, from managerial opportunism, thereby creating shareholder value. That is not to say that the interests of other stakeholders are neglected. A culture of honesty and responsibility towards employees, customers and suppliers enhances business performance and finance growth.

The corporate governance movement, however, focuses mainly on creating mechanisms that are intended to curtail the agency problem between self-interested management and dispersed shareholders (see *Figure 1*). Indeed, the core governance problem of the firm can be explained by the 'agency relationship' in a corporation in which the managers are the agents and the shareholders are the principals. It would be overly costly if shareholders, who are often small and numerous, were involved in the daily management of the firm. Since they are usually only interested in the company's dividend policy and share price levels, shareholders may lack the expertise and competency to take part in the strategic decision-making process.[3] The transfer of effective control to a team of specialists (i.e., the board of management) avoids the bureaucratic costs of collective decision-making. The delegation of control, however, leads to substantial monitoring costs, as opportunistic managers may be inclined to exploit collective action problems that bar effective monitoring by shareholders.[4]

It is generally recognized that this principal-agent problem is due to managers having superior information on investment policies and the firm's prospects. Managers tend to be better informed, which allows them to pursue their own goals without significant risk. Consequently, shareholders find it difficult, due to their own limitations and priorities, to prompt managers to pursue the objectives of the firm's owners. Information and collective action problems not only prevent close monitoring of management performance, but also enable directors and managers to develop a variety of techniques to extract profits and private benefits from the firm for their own interests. The disparity between ownership and control leads, besides monitoring costs, to a number of other managerial transaction costs that are likely to frustrate firm performance: (1) exorbitant compensation and remuneration; (2) replacement resistance; (3) resistance to profitable liquidation or merger; (4) excessive risk taking; (5) self-dealing transfer pricing; (6) allocation of corporate opportunities; and (7) power struggles between managers.

***Figure 1:* The managerial agency problem**



Source: www.encycogov.com (AcadData).[5]

Box 1. Principal-Agent Conflicts in Venture Capital Transactions

Some characterize the relationship between the entrepreneur and the venture capitalist also as a 'pure agency relationship' in which the entrepreneur is the agent and the venture capitalists are the principals. From this perspective, the venture capitalist may encounter many complex and costly problems that need to be addressed contractually. Monitoring costs are substantial in high-growth start-ups. Venture capitalists invest large stakes in entrepreneurs about whose abilities they have less than perfect knowledge. They consequently need to monitor and bond the entrepreneur closely, as basic problems of shirking and opportunism exist from start-up and expansion until the financial buyout stage. The impossibility of complete risk diversification and the absence of an active market for shares emphasize the importance of monitoring. Empirical research shows that monitoring costs will increase 'as assets become less tangible, growth options increase, and asset specificity rises'.
Nevertheless, venture capitalists tend to monitor their investments through active participation, namely by due diligence, establishing a relationship with the start-up businesses' managers and by sitting on their board of directors. Whilst involvement in key corporate functions tends to limit moral hazard problems, information asymmetries are likely to persist and can potentially create significant value dilution for investors. Information asymmetries are likely to arise from two principal sources: (a) the entrepreneur has information unavailable to the venture capitalist, and (b) the entrepreneur's information is often distorted by overestimating his chances. The first kind of information concerns the actual product, technology and market, as well as the quality, ethics and fortitude of the entrepreneurial team, whereas the second kind could diverge dramatically from reality due to the entrepreneur's personal attachment to the venture and the feeling that his bright idea will definitely yield the expected wealth. Nevertheless, to a certain extent the venture capitalists must contemplate the opposite interests of the business's founder in order not to destroy the incentive to the latter to be prepared to go to any lengths to make the venture a success.
Conflicting interests bear particularly on the control over the business and issues involving the venture capitalists' means of exit. Venture capitalists typically, choose to exit the venture either through an initial public offering (IPO), transferring their shares piecemeal, or by trade sale. In the final stage, the venture capitalists reap the fruits of their investment, while the entrepreneur hopes to recoup control over 'his' firm. It comes as no surprise that the

nature and costs of exit are also shaped by the venture's internal governance structures and ex ante contracts. Whilst the literature on venture capital emphasizes the one-sided moral hazard issues that characterize the relationship between venture capitalists and start-up firms, this relationship cannot be explained exclusively in such terms. We now recognize that to a certain extent the relationship resembles a 'double-sided moral hazard problem', with each party contributing resources so as to maximize their joint wealth. In order for the venture to succeed, the (leading) venture capitalist must be willing to provide the entrepreneur with 'value-added' services, if the venture has the chance to raise its performance. The importance of these services has recently been demonstrated by the setback of the 'new economy', which showed that the provision of capital alone is usually not enough to fertilize promising ventures. Value-added services involve identifying and evaluating business opportunities, including management, entry or growth strategies; negotiating further investments; tracking the portfolio firm and coaching the firm participants; providing technical and management assistance; and attracting additional capital, directors, management, suppliers and other key stakeholders and resources. Since these non-financial contributions are a substantial element of the venture capital relationship, it might be argued that the entrepreneur, in obtaining these services from the venture capitalist, is also subject to shirking and opportunism. Entrepreneurs often believe that venture capitalists either fail to meet their obligation to provide value-added services, or try to renegotiate the contract, including their promise to add services, as soon as they obtain more leverage.

Source: Erik P.M. Vermeulen, The Evolution of Legal Business Forms in Europe and the United States, Venture Capital, Joint Venture and Partnership Structures, Kluwer Law International (2003)

2.2 Corporate Governance: The *Commenda*

Naturally, the managerial agency problem and the corresponding governance concerns have existed as long as investors have allowed others to use their money and act on their behalf in risky business arrangements. In this respect, reputation concerns have always played a pivotal role in structuring and managing the governance framework of the contractual arrangements between investors and entrepreneurs. Business parties in medieval and early modern times relied heavily on the self-enforcing norms of kinship and family ties to align agents' and principals' interests. Yet the emergence and development of long-distance trade prevented long-term business relationships from operating spontaneously without a legal governance structure that prevented deviation from the contractual arrangements and norms. Since non-legal internal and external mechanisms offered only a partial solution set to the governance problems in risky ventures, disclosure and enforcement mechanisms were devised through a system of notaries, guilds, and mercantile courts. The rise of legal gatekeepers and institutions resulted in a rapid expansion of the Law Merchant throughout the Western European regions which arguably helped to lessen the costs of writing and enforcing legal contracts, thereby giving an important impetus to commerce in the Middle Ages.

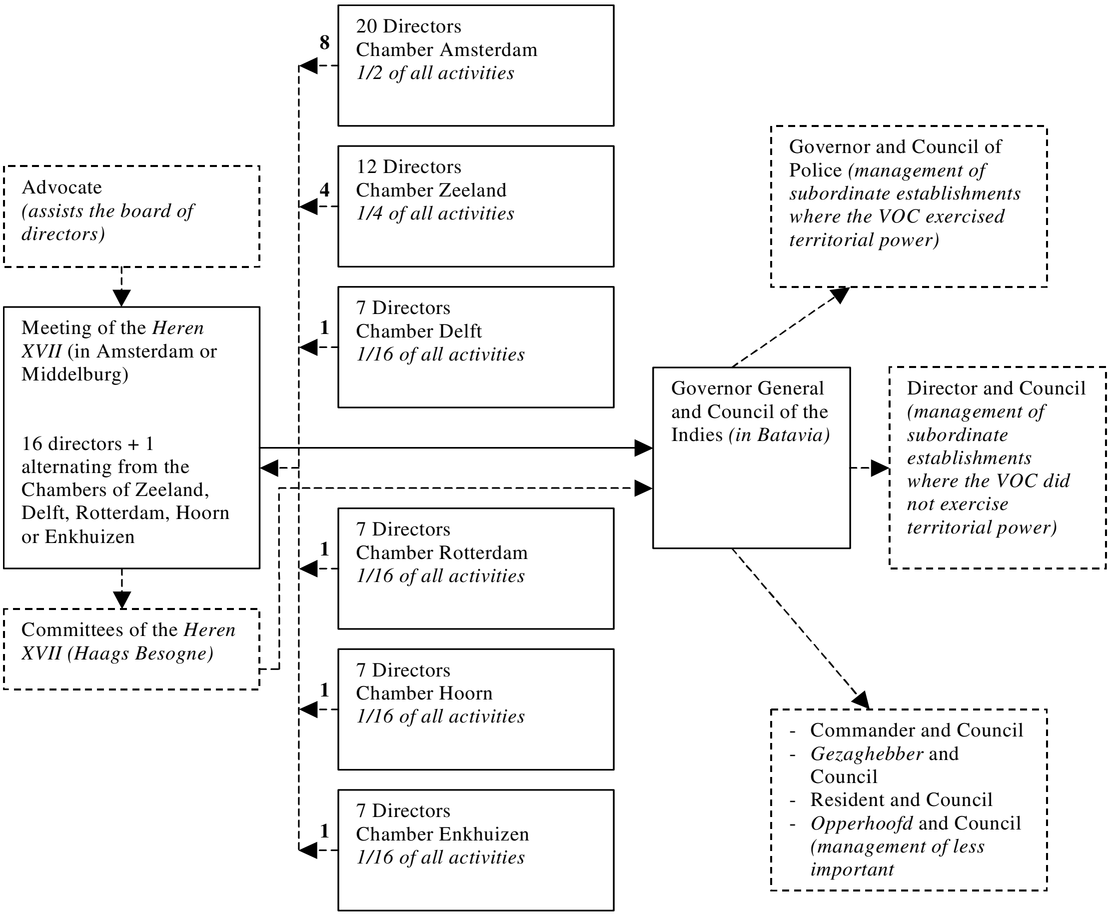
In fact, when trade started to revive in the Middle Ages, after a long economic slowdown, mediaeval merchants needed a legal business form that could bring together scarce capital and adventurous entrepreneurs willing to undertake difficult and perilous overseas voyages.[6] In response to the influence of powerful interest groups such as the nobles and the clergy, the Mercantile system began to acknowledge the *commenda* with its Jewish, Byzantine, and Muslim origins. The *commenda*, which evolved from a loan contract into a partnership-type business form, was intended to mobilize risk capital for short-term overseas commercial ventures.[7] This limited partnership-type business form offered investors limited liability and anonymity, and thus made it possible for investors to pour money into lucrative ventures without risking being condemned for usury or violating inhibitions against engaging in trade. Because the investors could not be involved in the decision-making process, the limited liability feature was viewed to be efficient as it introduced the prospect of limiting the managerial agency costs. The function of limited liability is to reduce investors' monitoring costs, increase liquidity, and promote diversification, which reduces the level of risk overall. In fact, by having access to limited liability they only risked losing their initial investment, which furthered the emergence of risk capital.

2.3 Corporate Governance: The Corporate Form in Europe and the United States

At the end of the 16th century, the Dutch employed variations of the *Commenda* – so-called *voorcompagnieën* or precompanies – in order to reduce information asymmetries and agency problems that were characteristic of perilous Dutch Asian trade journeys. These precompanies consisted of a number of *commendas*, each with its own investors and active merchant. With wars and conflicts with the Portuguese and the English, there was an urgent need for an integrated approach. In this regard, the city-based precompanies, which faced fierce competition for market share, decided to coordinate their actions by conducting a kind of merger in 1602, which led to the inception of the Dutch East Indian Company (*Vereenigde Oostindische Compagnie (VOC)*). Gradually the *VOC* evolved into a peculiar form of the modern corporation.[8] With the transformation of the *VOC* came a change not only in organizational form, but also in the venture's investor base. At the same time, the cities, in order to coordinate and structure the collaboration between the independent precompanies, created a charter which dealt with potential collective action problems and conflicts of interests. Despite these governance reforms, investors continued to express their dissatisfaction and frustration with dividend policies, the murkiness of the company's accounts, and the lack of disclosure and transparency.[9] Additing the problems for investors, was the limited involvement of the the main board of directors – the Board of Seventeen Lords (*De Heren XVII*) – which convened only a few times a year and directly reported to the Dutch governmental authority rather than to investors (see *Figure 2*).[10]

It appears that the design of the *VOC*, despite the key features of limited liability and readily transferability of shares, made this business arrangement prone to fraud and deception. In response to these shortcomings, the government mandated full and open disclosure of accounts in 1622. Subsequently, the committee of nine and audit committee, an early form of the supervisory board consisting of 'chief participants',[11] were introduced in 1623 to advise management and inspect the financial information of the *VOC*. With these major changes in the *VOC* structure, the corporate governance movement was initiated. Nevertheless, it could not solve effectively the problems surrounding the complex and cumbersome management structure inherent to the *VOC* arrangement.[12]

Figure 2: **The organization of the *VOC***



Source: F.S. Gaastra, De geschiedenis van de *VOC,* Zutphen 1991 (2) 150.[13]

The precarious nature of the early corporate form was again perfectly exemplified by the collapse of the French Mississippi Scheme and the burst of British South Sea Bubble in 1720. The Mississippi Company and South Sea Company succeeded in attracting shareholders and creating a robust market for their shares by manipulating information and talking up share prices with rumors and speculation about the companies' value and prospects.[14] In France, domestic and foreign investors were lured into the scheme by the sheer fact that the government granted the corporation monopoly control of Louisiana, which was conceived as the actual key to unlimited wealth creation. The government and the Mississippi Company kept the investors' imagination baffled with vague objectives to promote immigration and control the tobacco industry until confidence collapsed and the corporation ceased to exist, ruining the lives of many disappointed investors throughout Europe (see *Figure 3*). For the same reason people rushed to invest in the British Company which was granted 'important' monopolies over English trade in South America. However, vital information about the Spanish being in control of these regions was concealed from the potential investors. The South Sea Company was in fact nothing more than an empty shell without any future cash flows and expectations.

Of course, the deflation of the bubbles fueled the anti-corporate sentiment and chilled the investment interest by the public, but the corporate form never disappeared completely. Even though the corporate form was only available to certain types of businesses due to the formal concession of a sovereign person or government, its organizational and structural advantages – such as continuity of life, the possibility to sue outsiders and members in its own name, the distinction between corporation's assets and the personal assets of its shareholders, and the transferability of shares – prevailed over its susceptibility to fraud and abuse.

Figure 3: **The Mississippi Company besieged by unhappy and angry shareholders.**

Source: 'Groote Tafereel der Dwaasheid', Amsterdam, 1720.

As the economies in the United States and Europe developed, numerous new corporations were chartered for the building of highways, canals, railroads, and telegraph lines. The improved transportation and communication systems led to many larger-scale firms which would also benefit from availing themselves of the management and finance structure of the corporation. In order to give effect to capital-intensive industrial and technological innovations, these larger-scale firms were compelled to amass substantial sums of equity capital from a relatively large number of investors. The use of the typical partnership form – in which investors share ownership, control and profits – entailed shirking, opportunism, monitoring and decision-making problems. Indeed, the integration of ownership and control often leads to a cumbersome, costly and restricted decision-making process.[15] In order to circumvent the flaws of the partnership form – as well as the almost insuperable incorporation requirements – commercial businesses and their legal advisors started modifying and mixing legal structures so as to obtain free transferable financial participations and a differentiated management decision-making process. However, the legality of these hybrid business forms was increasingly challenged by incorporated competitors.

With the growth of commercial and industrial activity, the pressures from politically influential industrialists to abandon the specific governmental approval of a corporate charter – and to introduce fully-fledged limited liability for corporations – grew steadily during the period of industrial revolution.[16] In the United States, the charter approval, which invited intensive lobbying, became increasingly standardized. By 1890, all states had adopted statutes providing for incorporation with limited liability by simple registration.[17] The introduction of a relatively simple incorporation procedure in France in 1867 resulted in the rapid proliferation of general incorporation statutes throughout continental Europe, which already embraced the corporate limited liability doctrine since the enactment of the Napoleonic Code de Commerce in 1807.

By embracing the new concept of incorporation by registration, policymakers and lawmakers generally furnished industrial business firms with the corporate form with (1) full legal personality, (2) fully-fledged limited liability, (3) centralized management, (4) free transferability, and (5) continuity of life. These principles facilitate the separation of ownership and control, thereby reducing agency costs associated with the delegation of control rights. For instance, limited liability facilitates the diversification of the investors' investments, which obviously leads to low risk-bearing costs. Consequently, agency costs are reduced overall.

Centralized management is probably the most important – and precarious – feature of the corporate form.[18] The delegation of control rights is not only necessary to facilitate management's participation in the firm, but also to attract specialized and competent managers and, more importantly, to give them sufficient incentives to encourage innovation and wealth creation. Although corporate law typically limits the shareholders' ability to intervene in management's decision-making power, it would be erroneous to conclude that shareholders are deprived of every control right within the firm. In order to mitigate shareholder hold-up by management, board members have a fiduciary obligation to the shareholders who, in turn, are given the right to elect and remove managers and to be involved in de decision-making process regarding 'major corporate actions' and 'fundamental' changes within the firm.[19]

As the ownership position of the shareholders evolved from that of a more active to that of a passive principal, the fundamental agency problem became more evident,[20] thereby justifying the design and promulgation of more legal mechanisms to protect shareholders' rights and interests. Indeed, the individual shareholders losing the ability to influence corporate decision-making and the subsequent stock market crash in the United States in 1929 served as a justification for the first corporate governance intervention by the US federal government. In order to maintain an orderly and fair stock market, Congress enacted the Securities Act in 1933, establishing the Securities and Exchange Commission (SEC). The Act, which has been modified extensively but is still in operation today, demands registration with the SEC of shares offered to the public and allows defrauded investors the possibility to bring an action against corporate wrongdoers in federal court. It also requires the disclosure of relevant transactions. As the stock-exchange watchdog, the SEC investigates and imposes sanctions on violations of the Securities Act. In addition, the Securities Exchange Act of 1934 required the continuing disclosure of relevant information about the corporation.[21] For example, issuing corporations must file periodic information, such as financial statements and proxy statements containing details on such matters as remuneration of directors and officers, insider training and conflict-of-interest transactions. Corporations are also obliged to report the occurrence of material events. Thus seen, disclosure has a prophylactic effect: It discourages managerial theft, fraud and self-dealing transactions.

Other jurisdictions, like Germany and the Netherlands, introduced equivalent mechanisms in their corporation laws so as to minimize agency costs resulting from individual shareholders losing the interest and ability to influence how corporations were managed. A mandatory supervisory board, for example, not only had to monitor management activities within large companies, but was also furnished with shareholder competencies, such as the election and removal of managing directors. By doing so, policymakers and lawmakers attempted to prevent irrational and opportunistic decisions caused by voluntary shareholder absenteeism and strong corporate insiders.

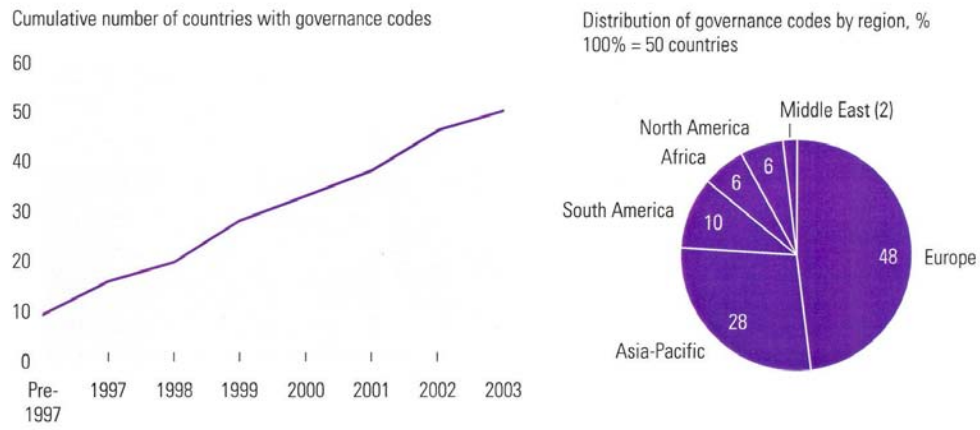
In general, however, policymakers and lawmakers saw little further need for government regulation other than providing the legal procedures under which corporate decisions are taken and the improvement of transparency. It was submitted that market mechanisms,[22] reputational concerns, remuneration systems, bankruptcy systems, and creditor structures offered positive incentives that minimize the managerial agency problems (see *Figure 1*). Clearly there is something to this hands-off governance approach. The worldwide development of the Internet and other new information and communication technologies and systems should make it easier for shareholders and other stakeholders to protect themselves. Still recent events have transformed this approach. For a start, the burst of the internet bubble in early 2000 caused policymakers and lawmakers to take a closer look at remuneration practices, accounting and transparency of business information. The financial collapses at Enron and Worldcom and the accounting, fraud, and governance failures in the United States and Europe rapidly awakened voters to the high stakes risk of poorly regulated firms. The pressure of medium voter concerns prompted policymakers and lawmakers on both sides of the Atlantic to propose legal mandates to protect a corporation's shareholders from fraud and poor board performance.[23]

3. The Contemporary Debate on Corporate Governance

In reaction to the catastrophic financial collapses, US Congress promulgated the Sarbanes-Oxley Act of 2002,[24] which is designed to create improvements in governance by inducing increased oversight and monitoring of companies. The SEC has followed on from Congress, drafting new regulations needed to interpret and enforce the Act. There is no question that the recent scandals in the US caused EU regulators to react by devising a set of legal strategies to constrain diversions by officers, board members, and controlling shareholders of publicly listed companies.[25] The European Commission (EC) launched, for example, a number of initiatives that were announced in its May 2003 Communication on the statutory audit.[26] Moreover, the EC, in its Action Plan on modernizing company law and enhancing corporate governance,[27] announced plans to increase transparency of intra-group relations and transactions with related parties and to improve disclosures about corporate practices.[28] Attention quickly turned to accounting and audit reforms when Parmalat collapsed with debt of €14.5 billion in December 2003. The debacle, which shattered any illusions that accounting and boardroom scandals were uniquely an American phenomenon,[29] led regulators – who were already active on the implementation of the International Accounting Standard (IAS)[30] – to propose additional conflicts of interest measures concerning transactions involving related parties of a company, including family controlling shareholders and key managers, and special purpose entities (SPEs).[31] At the same time, the Commission has issued a recommendation on the independence of the statutory auditor and also a directive on the duties of auditors.

What is more, policymakers and lawmakers have devised and adopted codes of corporate governance, which cover in varying scope and detail the protection of shareholders in publicly held corporations. These codes supplement traditional legal mechanisms, such as corporation law provisions that address the shareholders meeting, the election and removal of members of the board of management, auditing requirements, and disclosure.[32] The attraction of codes is the greater flexibility combined with the potential to enhance the role of gatekeeper institutions who are taking steps to enforce them at the firm level – *Figure 4* indicates the growing popularity of corporate governance codes.

Figure 4: **The increasing number of corporate governance codes**



Source: 'European Corporate Governance Institute, McKinsey analysis' (published in Paul Coombes and Simon Chiu-Yin Wong, Why codes of governance work, The McKinsey Quaterly 2004 Number 2).

The codes usually address several important issues:[33] (1) an active and fair protection of the rights of all shareholders, (2) an accountable board and management and proper supervision thereof, (3) transparent information about the financial and non-financial position of the firm, and (4) responsibility for the interests of stakeholders, including the minority shareholders. Because it is imperative that firms adopt the corporate governance codes as much as possible without any amendment, it might be argued that a 'comply-or-explain' strategy is the preferred mechanism for policymakers and lawmakers. Whilst the 'comply-or-explain' approach encourages the compliance with the governance norms, it is nevertheless sufficiently flexible to permit firms to set aside particularly cumbersome provisions that increase costs. The obligation to give an explanation in the annual accounts induces firms to consider corporate governance provisions carefully, thereby creating awareness and a more healthy corporation. Indeed, as *Figure 5* shows, shareholders are willing to pay a premium for well-governed corporations.

Contrary to the mandatory force of the Sarbanes-Oxley Act, the self-regulatory best practice codes, updates and upgrades offer a high level of flexibility by following the 'comply-or-explain' rule. However, it is submitted that firms tend to adopt and comply with the boilerplate and standardized provisions of the codes rather than explain – even though more optimal – such non-compliance. In fact, it might be argued that the 'comply-or-explain' approach contributes significantly to the 'lock-in' effect in the context of the rules and norms of corporate governance. This type of inflexibility can foster inefficiency, as the codes' provisions and mechanisms fail to respond to changes in the underlying social and economic conditions. In this view, the attempts to determine detailed 'best practice' codes could entail a costly and 'sticky' mechanism, which turn the corporate governance codes into nothing more than blue-prints for box-tickers.[34]

***Figure 5:* Average premium that investors are willing to pay for a well-governed company, by region, percent**

Source: 'McKinsey investor opinion survey' (published in Combes, P. and Watson, M., Three surveys on corporate governance, The McKinsey Quaterly 2000 Number 4: Asia Revalued)

This governance style is even more aggravated by the progressive convergence of corporate governance codes throughout the world. A closer look at current developments shows countries, fueled by powerful forces of globalization, eventually display similar patterns of legal evolution. Facing many of the same challenges and difficulties, policymakers and lawmakers are becoming increasingly aware of the need to ensure that national laws and corporate governance codes are suitably adapted to the requirements of global product markets and international practices. At the national level, the question is whether alternative mechanisms identified in an international comparison can help domestic firms solve governance problems and enhance their access to external finance. In a world in which national boundaries are of diminishing significance, the cross-fertilization of legal concepts appears to be not so much a choice as a necessity.[35] This is particularly true for emerging markets and transition economies, where reform-minded policymakers and lawmakers have pointed to the efficiency-enhancing characteristics of the corporate governance reforms in other countries.[36]

It is relatively costless for policymakers to take notice of foreign corporate governance systems that have already been tried and tested in legal systems with similar business, social and political dimensions. Thus, if we take this a step further, globalization and the drive towards modern corporate governance frameworks will eventually lead to convergence, as jurisdictions adopt rules and institutions representing the 'best practice'. This theory is based on the premise that unless a country's policymakers consider foreign legislative approaches and solutions, the domestic economy and firms will fall behind competitors.[37]

However, domestic experimentation by cross-reference to other foreign developments only works if the different jurisdictions have divisible components. If corporate governance characteristics and institutions tend to be indivisible, returns may be nonexistent because frictions prevent these techniques from being carried out in practice or because such experiments as are carried out fail to bring improvements.[38] Alternatively, losses could result if experimentation occurs but unforeseen interconnections among components within a given legal system lead to perverse effects.

In the case of corporate governance reforms, for instance, there are generally two systems of corporate governance which show significant differences: (1) the market-oriented corporate model and (2) the relationship-based (or network-oriented) corporate system. In continental European legal systems, where the relationship-based systems prevail, the claims of non-shareholders (stakeholders) have a more profound influence in the process of corporate governance. In contrast, the Anglo-American governance system (market-oriented model) is more attuned to the norms of shareholder wealth maximization, stringent financial disclosure and investor protection. As a consequence, some argue that European legal systems provide a comparatively weak governance structure for monitoring and enforcement of minority shareholder rights.

It is submitted that the differences in shareholder protection between Anglo-American legal systems and continental European legal systems can be partly explained by differences in legal institutions, particularly the experience and influence of judges. The judiciary in Anglo-American systems seems to play a much more proactive role in shaping the actual contents of the corporate governance framework than in Continental European jurisdictions, which are more confined to interpreting the statutes and codes enacted by legislators. This example shows that convergence of corporate governance codes should not be pushed too far. The increasing emphasis on the protection of minority shareholders may make the US mechanisms less relevant for European countries, where it is more common to take the stakeholders' interest into account.

Inefficient convergence and persistence in governance frameworks may detrimentally affect the quality of firms' corporate practices, in particular now that the growing corporate governance awareness in countries increasingly leads gatekeeper institutions to second-guess managers' business judgments. Indeed, today's corporate governance movement tends to replace the procedurally based duty of care standard with a detailed and specified blueprint of good governance rules. Under the new corporate governance regime, business judgments by controlling parties, such as majority shareholders and strong managers, have to stand the test of regulatory scrutiny. The unanticipated results often lead to increased and costly monitoring by gatekeepers, who seem to rely more and more on the 'stick' rather than on the 'carrot'.[39] Increasingly, policymakers and lawmakers recognize that a comprehensive approach to reform, in which all potential risks and agency problems are anticipated and addressed, does not completely ensure the elimination of future governance failures. Even though most of the regulatory resources and policymaking energy continues to be invested in dealing with the problems of publicly listed companies, most countries would be better off if they focused their legal reform strategies on the needs of non-listed firms. The next section identifies the reasons why such a shift in governance reform may occur in the near future.

4. The Future of Corporate Governance: ‘Refocus’ on Non-Listed Companies

As discussed above, the governance failures that showed up in large, publicly held firms, have captured the political and scholarly interest. Reflection on the burgeoning corporate governance reforms in the United States and Europe has generated a growing body of research on the function and influence of legal rules and institutions that influence the performance and competitiveness of companies which must respond to rapid market and technological changes. In the contemporary debate on corporate governance, the importance of non-listed companies has largely been ignored. Four major developments on the horizon, however, could trigger a transformation of the corporate governance movement, refocused on the typical problems of non-listed firms.

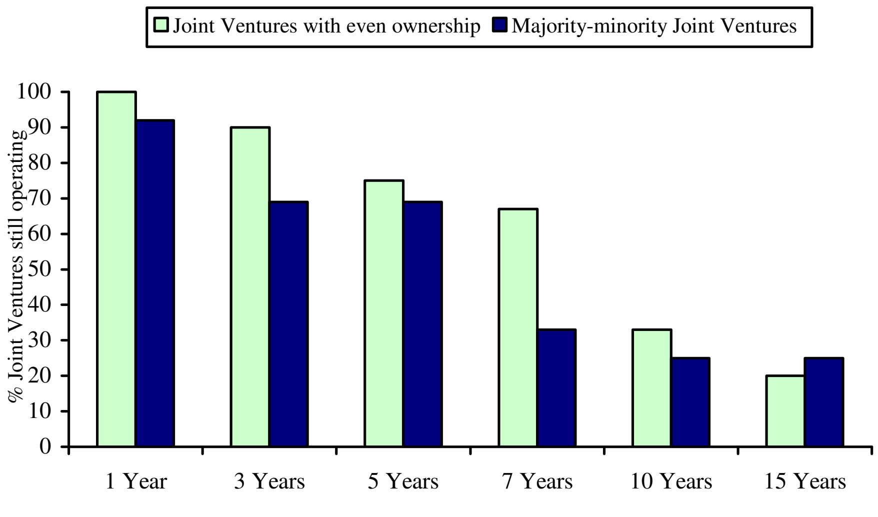
The first is closely related to the over-regulatory, heavy-handed and stifling approach to dealing with corporate governance concerns. To the extent that policymakers and lawmakers possess few-revenue-based incentives to research the specific characteristics of non-listed companies, they are inclined to recommend the application of the corporate governance structures tailored to publicly held corporations. It is certainly reasonable to infer that rules and principles that ensure 1) the basis for an effective corporate governance framework; 2) define the rights of shareholders and the responsibilities of management; and 3) set out guidelines for enhanced disclosure and transparency, could also improve the governance of non-listed firms. In fact, many of the ‘best practice’ rules and principles are imposed on non-listed firms by government, investors, insurance companies, lenders and others. This leads, however, to the question of whether such a ‘one-size-fits-all’ approach to corporate governance regulation is justified in economic and social terms. Indeed, non-listed companies do not seem to benefit from this spillover effect. For instance, the compliance costs are exorbitantly high. This is especially true of corporate governance provisions that are still being evaded by publicly held corporations due to their cumbersome, complex and time-consuming nature. Moreover, the increased information costs and uncertainty about the application of the ‘comply-or-explain’ terms by courts may have a detrimental effect on the performance of non-listed companies. It is therefore suggested that the typical organizational structure of these firms demands an approach different from publicly held firms.

Second is the new 21st-century organization. Under the ongoing pressure of competitive global markets, joint ventures and strategic alliances have become an important means of limiting risks, decreasing costs, and increasing economies of scale and scope. Many large firms enter into worldwide alliances and joint ventures to obtain technological know-how.

Ten to twenty percent of a large firm's revenues, income, or assets come from joint venture activities.[40] In addition, globalization and consumerism increasingly push small and medium-sized enterprises to get involved in international joint ventures, both among themselves and together with larger multinationals, when access to manufacturing, distribution and other assets is either too difficult or costly to create internally. At the same time, these joint ventures and alliances encourage the further development of new technologies and the reduction of international barriers.

Even though the benefits of joint ventures are relatively straightforward, they are, for structural reasons, highly sensitive to conflict-of-interest situations. In terms of limiting these problems, parties may choose from a range of economic and legal instruments and institutions to organize their business relationships. By contracting their way into a governance structure, they endeavour to make credible commitments that serve as a means of creating a relationship of mutual reliance.[41] Relationships in joint ventures are mainly sustained by self-enforcing ingrained norms of honesty and reputation. However, in many cases, the reliance on mutual expectations and implicit norms cannot prevent the failure of a joint venture. For instance, the majority of the joint ventures break down or fail within 7 years (see *Figure 6*) due to the lack of trust at the start and the difficulty in gaining trust midstream due to parties' conflicting interests.

Figure 6: **Lifespan of Joint Ventures**



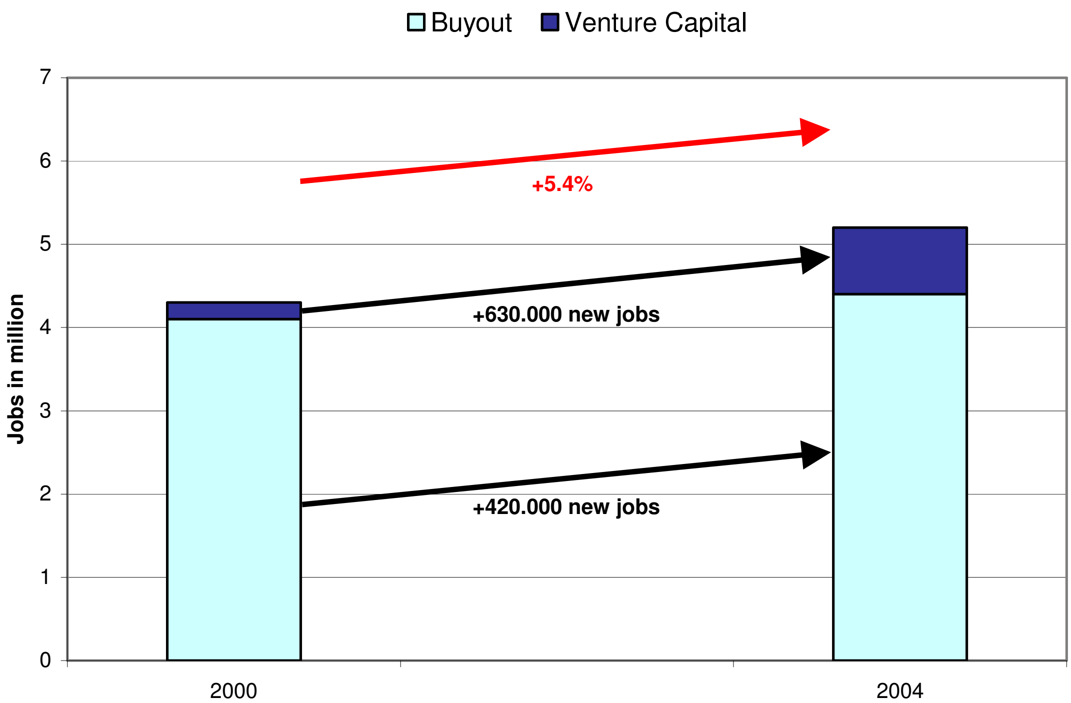
Source: 'McKinsey & Co' (published in Ernst, D. *et al.*, Crafting the Agreement – Lawyers and Managers, in Bamford, J.D. *et al*, Mastering Alliance Strategy, A Comprehensive Guide to Design, Management, and Organization, San Francisco: Jossey-Bass: 88-106.

Naturally a well thought out governance system can facilitate the development and implementation of trust norms in joint ventures, but so far these mechanisms and techniques are largely ignored. Partly due to the tension between lawyers and managers,[42] legal best practice and organizational issues tend to be kept away from the negotiation table for as long as possible. However, in an era of growing emphasis on corporate governance issues, it is only to be expected that firms interested in sustainable growth and risk management will extend the need for good governance beyond publicly held companies. The next part of the study will argue that the implementation of norms of good governance, which could be available in the form of legal rules, standards or optional guidelines, is equally crucial to prevent deadlock, weak performance management, mistrust and stagnation in joint ventures.

Third, the challenges confronting advanced economies, as well as emerging markets, and large conglomerates from China's cheap factors of production demands policymakers focus on the job-creating sector of the economy. In many jurisdictions, family-owned businesses – in which a family has either significant influence or a controlling stake – are the leading force in many sectors of the economy. Family-owned businesses continue to be highly competitive, particularly in emerging markets, due to their informal structure that provides: (1) a timely and effective decision-making; (2) a deep and intimate understanding of their local market; (3) close ties with regulators and government officials; and (4) strong horizontal and vertical relations in the market. Despite these built-up competitive advantages, family-owned firms are under increased pressure as a consequence of market liberalization and competition from large multinational companies. As the market has transformed the ability of family-owned companies to compete effectively, they are less able to draw on previous strengths which eventually lead either to bankruptcy or a change in control. Nevertheless, some family-owned businesses with clear governance rules and guidelines, a strong brand or access to leading edge technologies, are likely to survive and remain successful. While there are a number of successful strategies for family-owned businesses, policymakers and lawmakers should concentrate their resources on developing solutions that enable families to embrace strategies that promote their long-term success. Not only will improved governance provide a more effective means to deal with family matters that affect business, but also frees up managerial resources that are necessary to run the business well, and thereby make possible capital-intensive work to remain in a country.

Empirical research supports the view that policymakers and lawmakers must become more enganged in providing non-listed companies with a governance framework that will foster strong decision-making, accountability, transparency and ultimately firm performance. An improved corporate governance framework arguably encourages private equity and venture capital investment in fast-developing, high-potential companies and hence facilitates the provision of sustainable, high quality jobs (see *Figure 7*). For example, Figure _ shows that job creation of venture-backed firms over the period between 2000 and 2004 grew by an average annual rate of 5.4%, which is eight times the annual growth rate of total employment in the EU. At the same time, the rapid pace of technological change and the decreasing international barriers to trade over the past decade have not only created new strategic and organizational opportunities for firms, but have also made them more vulnerable to risks. Thus, in order to assist these companies to fully exploit the new investment opportunities and effectively deal with the information uncertainities and other risks, policymakers and lawmakers must endeavour to devise the most efficient corporate governance rules and standards as part of their long-term strategy to foster investment, innovation and entrepreneurship. Indeed, a shift in the focus from publicly held companies to non-listed companies is important, because, as we have argued earlier, the preponderance of firms worldwide are non-listed and ownership and control are usually not completely severed. Even though governance is but one of many determinants of investment and expansion decisions by firm owners and investors, there is little doubt that the core considerations affecting these decisions are operational and macro-economic. Still the changed economic environment in which firms operate makes them increasingly sensitive to governance issues. It is, therefore, necessary to obtain a better appreciation of the design and content of the legal corporate governance framework of non-listed companies.

Figure 7: **Job creation by private equity and venture capital financed companies**



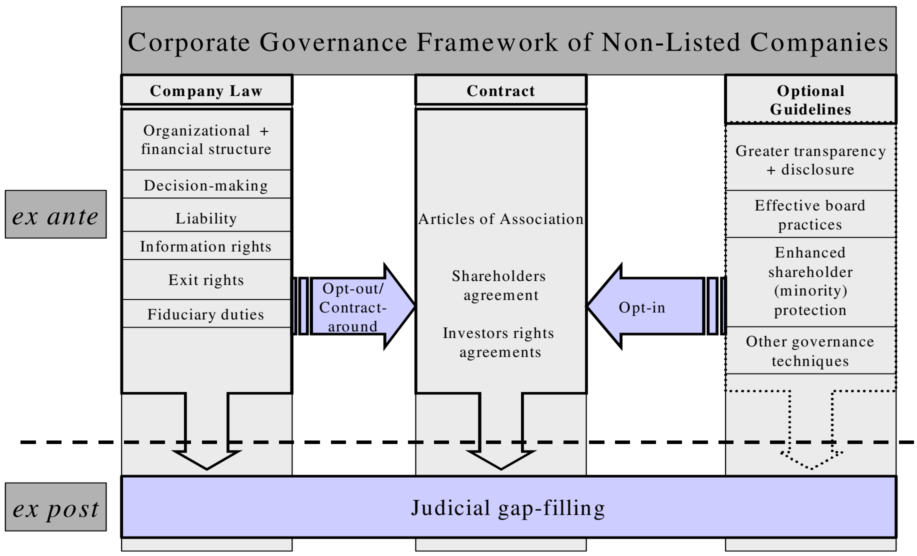
Source: CEFS/EVCA – Employment Contribution of Private Equity and Venture Capital in Europe – November 2005.

The fourth development is the Basel II accord, which aims to govern risk for financial service organizations and embraces a comprehensive approach to bank supervision. Basel II demands that banks and other financial firms have internal monitoring systems and processes in place that make them Basel II compliant. This process may very well speed up the awareness and demand for corporate governance principles in non-listed companies across the board, as it arguably induces non-listed companies to comply with best-practice principles as part of the process of credit rating and risk assessment. That said, it is predicted that these four developments will induce policymakers and lawmakers to refocus their attention to the governance needs of non-listed companies. In fact, we can already foresee a pattern of demand for and supply of corporate governance institutions that prompts policymakers and lawmakers to devise and introduce corporate governance rules and best-practice principles that are better equipped to tackle difficult problems and challenges typical to family businesses, joint ventures, and venture capital backed firms. In the next part, a typology of categories of non-listed companies is discussed along with the governance framework and the role guidelines could play in the helping firms achieve their goals.

5. The Legal Corporate Governance Framework for Non-Listed Companies

The legal corporate governance framework of non-listed companies can roughly be split in three separate pillars (see *Figure 8*). The core pillar focuses on company law which provides rules and standards for registration and formation, organization and operation, distribution of powers and decision-making, exit and dissolution, information and disclosure, fiduciary duties, and limited liability protection.

Figure 8: **The three pillars of the legal corporate governance framework**



The second pillar includes contractual mechanisms, such as articles of association, investors rights agreements, and shareholder agreements, that enable parties to contract around irrelevant and inconvenient company law default rules and tailor rights and duties that are more consistent with their organizational priorities. Due to information asymmetries and bounded rationality which limit the ability of firms to contract into the most optimal organizational structure,[43] soft-law measures are needed to fill gaps in the first two pillars and allow firms to achieve a stronger governance structure.

Indeed, the final pillar includes best-practice principles to help participants to organize and manage their business in the most effective manner. Such measures should not enshrine principles and norms that are a "must" for adoption. These principles should be viewed as a form of advice. In that respect, they serve several functions: (1) they provide the business participants with recommended solutions to complement the contractual flexibility of the company law rules; (2) they provide focal point solutions to corporate governance problems among business participants; and (3) they are meant to assist business participants in the interpretation and implementation of good governance practices.

5.1 Pillar 1: Company Law

Traditionally, company law serves a myriad of functions from encouraging the separation of ownership and control to curtailing managerial agency problems. It gives the general meeting of shareholders an *ex ante* incentive to make investments of financial capital, and delegates the control rights to management. In a publicly held company the shareholders are, as discussed earlier, usually unable to exercise the managerial rights of control. Company law sets the internal ground rules for each of the parties, their decision, information and financial rights.

From an efficiency standpoint, the business parties would always prefer to use a legal organizational form that defines and sets forth the ownership structure and provides important contractual provisions in advance.[44] This makes the law governing the organizational form key to the corporate governance framework for non-listed firms. The main question then is: Which legal business form to focus on when analyzing the persistent governance features that serve to protect business parties from the misconduct by fellow members? Publicly held firms are predominantly organized as joint stock companies or corporations. The close corporation is, however, the prevalent business form around the world.[45] This type of company accounts for more than 55% of registered businesses and 90% of output in OECD countries. The close corporation is also the preferred vehicle for non-listed firms in emerging and transition markets. Although the development has been quite different depending on the legal system, the close corporation has been adopted in almost all countries of the world.

In the United Kingdom, the close corporation – the limited – has a single legislative base. It was initially developed in practice and later recognized by the legislature, which furnished it with certain distinct features.[46] Most countries that once belonged to the British Empire included the close corporation form into their own company laws, as they were already familiar with basic legal principles of the donor jurisdiction. The second strand of development is the enactment of a separate statute for the limited liability company. Germany is renowned for its close corporation (*Gesellschaft mit Beschränkter Haftung*), which was the precursor of separate close corporation legislations throughout the European continent, Latin-American jurisdictions, Asia, and former Socialist countries. The United States offers only a single corporate form which can be contractually tailored to the needs and wishes of closely held firms.

Generally the close corporation has developed in the image of the joint stock company with its capital-oriented structure. Since the joint stock company is designed to attract substantial amounts of capital into the firm from passive investors and, consequently, to regulate the rich and intricate principal – agency problem, this structure is not sufficient for non-listed firms. Despite its perceived cumbersomeness and costly features, the close corporation has nevertheless become the preferred vehicle for closely held firms.

In order to meet the specialized needs that arise from the idiosyncratic relationships in non-listed firms, legislative and judicial adjustments have been constructed, over the years, in a piecemeal fashion across jurisdictions. Two sets of problems have arisen repeatedly due to the publicly held character of the close corporation forms. The first arises out of contractual attempts by participants to modify and sidestep rigid legal rules intended primarily for publicly held corporations. Today, most jurisdictions either provide more flexible corporate laws or allow privately held firms to contract around the rules provided by the corporation law statute. The second set of problems falls under the category of protection of minority shareholders' interests. Case law sometimes assumes that close corporations and partnerships are functionally equivalent business forms with the similar organizational needs. This approach is based on the assumption that business participants choose the close corporation over the partnership form only to take advantage of limited liability and tax benefits. Advocates often propose modifications of the exit rules so that business participants can enjoy the same exit options as partners in a partnership. Moreover, they also claim that shareholders in a closely held firm owe each other a strict fiduciary duty of good faith and loyalty.[47]

In order to give maximum effect to the principle of the freedom of contract, hybrid business forms that combine the best of partnership and corporate law have attracted a great deal of attention from policymakers and companies in recent years. This focus away from corporation law is not accidental. In the US, the rapid increase in partnership-type business forms has grown much faster than anticipated. Several factors contribute to the growth of new and more efficient partnership law structures. First, states have responded to the needs of a wide variety of firms for a more flexible set of forms, which has reduced reliance on or eliminated inefficient older forms. Second, the liberalization of partnership law has been accompanied by the virtual elimination of the distinctions between partnerships and corporations accompanied by a move toward the recognition of partnerships as entities. Third, the increase in the choice among business forms has resulted in the erosion of traditional restrictions of the internal structure of company law forms.

The emergence of new limited liability vehicles in Europe has been influenced by both domestic and international factors. Undoubtedly, the US reforms have stimulated policymakers' expectations that new legal business forms will create significant investment opportunities, increased employment and higher growth rates. At the same time, legal innovation in the European Union has been encouraged by changes in European Court of Justice case law,[48] which has triggered jurisdictional competition in European business law and hence the introduction of various new entities designed to meet the needs of small and medium sized firms (SMEs) and professionals. Like the US and Europe, Japan has recently embarked on the reform of its company law framework. This has resulted in the development of two new legal business forms, the Limited Liability Partnership (LLP) and the Limited Liability Company (LLC), as well as the modification of traditional corporate entities. This trend can be seen as a response to the demand for the reduction of regulation and improved legal vehicles that are better tailored to meet the governance needs of different types of firms.

If, for example, the economic environment is uncertain, entrepreneurs who seek venture capital must contract into a legal business form that attenuates information problems (board structure and control) and incentive concerns (stock options), while retaining a flexible structure and providing tax advantages. In this context, entrepreneurs have a variety of legal business forms to choose from. Although the success of the US venture capital market has been attributed mainly to the combination of a vibrant and liquid capital market that facilitates IPOs, the critical use of financial instruments that mitigate the double-sided moral hazard problem (see *Box 1*) and support the efficient structuring of staged financing, and the sustained level of new entrepreneurs with a high capacity to realize their commercial aims. Yet the success of the venture capital market is arguably due to the availability of a corporate form that combines strong management and control characteristics with contractual flexibility.

In the United States, start-ups are predominantly structured as public corporations. Contracting into this regular corporate form even seems to attract venture capitalists in their own decision-making about one-time legal decisions. From a fiscal perspective, this is surprising in that the choice to incorporate entails that the predictable tax savings arising from the pass-through tax treatment are not accessible. These alleged tax savings may provide them with a respectable sum of money. The usual losses from the start-up venture do not flow through to the 'partner-shareholders' in a corporation, while these tax-deductible losses could offset other sources of income at the parties' level. The use of other business forms, such as a general partnership, limited partnership or limited liability company (LLC), which couple internal flexibility with limited liability for all players and pass-through tax treatment, can yield more favourable benefits.

Naturally, a question arises as to why venture capital players forgo tax savings by selecting the corporate form.[49] The factors prompting venture capitalists to prefer the corporate legal form to other vehicles are the subject of considerable controversy in the United States. Commentators have argued that the governance structure, rather than the lower tax rate, is the main consideration for entrepreneurs and venture capitalists selecting the corporate form. With respect to determining the optimal business arrangement, it is submitted that the general partnership is not a viable alternative, due to the excessive risks and agency costs in combination with personal liability for the partnership's debts. As for the limited partnership, it may be that taking part in the control of the business could render the limited partner personally liable. Consequently, even though venture capitalists try to avoid taking control of a start-up firm, the limited partnership is not a viable option due to the higher liability costs associated with downside risks. Furthermore, at least in Europe and increasingly in the United States entrepreneurs are unlikely to leave well-paid employment without *ex ante* liability protection.

The reluctance on the part of high-tech start-ups to choose the LLC is explained in terms of a preference to save on transaction costs and time in the course of the venture capital cycle. By forming a public corporation, for instance, they avoid the costs of converting the LLC into the corporate form before an IPO. Underwriters in the United States rarely employ unincorporated business forms that can be utilized to issue equity interests. Yet from an efficiency standpoint, the legal, accounting and organizational costs of a conversion do not explain why venture capitalists and their legally literate advisors are reluctant to experiment with other business forms if tax savings exceed these costs. Paradoxically, venture capitalists and entrepreneurs, usually fond of innovations, are apparently not eager, in the absence of high-powered incentives, to experiment with other legal forms. This is especially true if these other legal forms fail to supply a comprehensive statutory template with regard to the governance structure, fiduciary duties and possible waivability of default rules. The fact that parties in an LLC may be subject to broad fiduciary duties that may require a party to forgo other interests appears to act as a deterrent to venture capitalists. If entrepreneurs are allowed to bring an action based on a venture capitalist's breach of fiduciary duty when their high-risk gamble does not pay off, thereby circumventing the contractual mechanisms put in place to overcome information problems, the transaction costs will increase significantly.

In this context, entrepreneurs tilt away from other business forms relative to the corporate form, because their investors and independent advisors prefer a vehicle that provides parties with a set of well-developed, standardized and widely used contractual structures, in addition to a strong management and control structure. Thus, the learning and network effects arising from prior and future usage of terms and/or statutes confer benefits such as existing and prospective judicial precedents, common business practices, cheaper legal services and positive effects on the valuation of businesses. The use of stock options as a compensation system for entrepreneurs reflects the prevalence of standardized venture capital contracts. Stock options, as distinct from fixed cash salaries, function as a contingent compensation linked to the performance of the business. Ideally, stock options provide entrepreneurs with an incentive to benchmark their performance in accordance with the venture capitalists' expectations, and prevent overly risky actions and opportunism. Although the great flexibility of the LLC statutes warrants a similar compensation system, parties may prefer to use stock options, thereby forgoing alleged tax savings. Indeed, even though the US LLC allows for publicly traded 'units' – depository receipts for the owners' property interest – the efficiency of selling units is called into question because underwriters are probably unwilling to employ ‘units’ on a large scale. Furthermore, the competition for corporate charters among states has broken down anachronistic mandatory state laws in the United States. As a result, general corporation laws have gradually transformed into an all-purpose vehicle, becoming more flexible and allowing non-listed businesses to modify its charters in accordance with their special needs.

Commentators who point to the success story of the close corporation in both Europe and the United States view them as the only necessary link between partnerships on the one hand and publicly held corporations on the other. In their opinion, close corporations can take the form of a limited liability partnership as well as that of a public corporation, thereby covering the smallest start-up firms, joint ventures and firms financed by debt and venture capital. However, even in jurisdictions where the actual costs of forming a corporation are considered as rather trivial, an all-purpose vehicle, while apparently simple and uncomplicated to implement, may involve significant costs: increased information costs and uncertainty, distortions in the signaling function of business forms, decreased coherence of terms, erroneous gap-filling by courts and negative spill-over effects. It is therefore suggested that a menu of separate business statutes would be efficient in providing different firms with better tailored default rules and standards that assist business parties in achieving efficient contracting ends.

In this context, the differences between jurisdictions that provide companies with cost effective company law rules and best practices and countries that are less established in emphasizing cost effectiveness and legislation that increases opportunities for innovation, growth, and job creation is worth emphasizing. European economies, faced with growth challenges, are taking steps to modernize their company law arrangements and create the policies necessary to eliminate barriers to investment, with the emphasis on governance mechanisms that contribute to sustainable development and a robust venture capital market. There are a number of variables that effect the quality and development of an entrepreneurial environment.

In *Table 1*, a common performance benchmark measures the company law policy environments of 21 European countries. The benchmark that focuses on both private and public companies shows that, along three variables (time, administrative cost, and minimum capital requirements), the best jurisdictions have a positive score of 1, which indicates that the variables are below the overall average. Conversely, weaker jurisdictions have a score of 2 or 3, equal to the overall average or above respectively. The performance indicators, which focus on price, cost and barriers to entry, is based on the methodology that was originally developed by Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer in "The Regulation of Entry, *Quarterly Journal of Economics*, 117, 1-37, Feb. 2002. As can be seen, in assessing the costs of alternative company law arrangements against the performance benchmark, the lowest score is to be preferred. For instance, the costs associated with setting up a company, meeting the minimum capital requirements, and time required to satisfy the legal formalities would be significant, lowering the competitiveness benefits of entry in a particular jurisdiction. The aim is to identify the least-costly option consistent with meeting the needs for new firms and entrepreneurs.

An equally important component of the competitiveness benchmark, however, might be the role of choice among the different statutory arrangements. Recent empirical evidence from the EU suggests that the increased choice between business forms provides the necessary impetus to help erode antiquated and burdensome entry regulations. To illustrate this point, let us return to *Table 1*. If we look at the minimum capital variable of the competitiveness measure, the survey shows that European Member states are responsive to demand pressures and consequently are taking steps slowly to abolish the requirement of minimum capital for the private company. In moving toward the provision of company law legislation that is both cost effective and lowers the administrative burden for firms, countries are able to set in place the conditions for renewed economic growth and expansion.

Table 1: Benchmarking time, administrative costs and capital requirement in 'EU Company Law'.
Source: Adapted from EVCA, Benchmarking European Tax and Legal Environments, May 2004.

	Score for private limited company	**Typical elapsed business days**	**Typical administrative costs**	**Minimum issued capital**	**Score for public limited company**	**Typical elapsed business days**	**Typical administrative costs**	**Minimum issued capital**	**TOTAL SCORE**
Austria	2.3	1	3	3	2.3	1	3	3	**2.3**
Belgium	2.3	3	1	3	1.7	3	1	1	**2.0**
Czech Republic	1.7	3	1	1	1.7	3	1	1	**1.7**
Denmark	2.3	1	3	3	2.3	1	3	3	**2.3**
Finland	1.0	1	1	1	1.7	1	1	3	**1.3**
France	1.0	1	1	1	1.0	1	1	1	**1.0**
Germany	2.3	3	1	3	1.7	3	1	1	**2.0**
Greece	1.7	1	1	3	1.7	1	3	1	**1.7**
Hungary	1.7	3	1	1	3.0	3	3	3	**2.3**
Ireland	1.0	1	1	1	1.7	1	3	1	**1.3**
Italy	2.3	3	3	1	3.0	3	3	3	**2.7**
Luxembourg	1.7	1	3	1	1.0	1	1	1	**2.3**
Netherlands	2.3	1	3	3	1.0	1	1	1	**1.7**
Norway	1.0	1	1	1	1.7	1	1	3	**1.3**
Poland	1.0	1	1	1	1.7	1	1	3	**1.3**
Portugal	1.7	3	1	1	1.7	3	1	1	**1.7**
Slovak Republic	2.3	3	3	1	2.3	3	3	1	**2.3**
Spain	1.7	3	1	1	1.7	3	1	1	**1.7**
Sweden	1.7	1	3	1	1.0	1	1	1	**1.3**
Switzerland	1.7	1	1	3	1.7	1	1	3	**1.7**
UK	1.0	1	1	1	1.7	1	1	3	**1.3**

Thus, if we accept the view that a modernized and flexible company law helps to fill gaps in non-listed firms' contracts by defining and setting forth techniques and strategies that parties would have reasonably opted into if there were no costs involved in drafting a governance arrangement, policymakers and lawmakers must become more engaged in providing company law provisions that efficiently serve to protect insiders' (equity-investors, managers) and outsiders' (debt-investors and other creditors) interests. In this section, we will discuss information duties (*section 5.2*), stringent distribution procedures and participation rights (*section 5.3*), and minority shareholder protections (*section 5.4*).

5.1.1 Disclosure and Transparency

Disclosure and transparency are important elements in any corporate governance system. Minority shareholders may gather public information. The main source of public information is the periodical publication of the company's annual reports. In Europe, larger non-listed companies are obliged to publish audited annual reports under law.[50] For instance, the Fourth European Companies Directive extended disclosure requirements in general to all close corporations.[51] The Fourth Directive contains detailed requirements for the preparation of balance sheets, profit and loss statements, and annual reports. Although the Directive demands that the accounts give a true and fair view of the assets, liabilities, financial position and results of the company, the information is not always accurate. For instance, in the Netherlands, the annual accounts must be adopted by the shareholders within five months following the end of the financial year. But companies may, subject to shareholders approval, extend this period to 13 months, which, obviously, will severely diminish the reliability of the disclosed information.

Moreover, annual reports do not fully disclose information about the possible expropriation of the company's benefits. Direct and indirect transactions between the company and the controlling shareholder can affect the accuracy of the financial reports. There is satisfactory transparency regarding such transactions for all listed companies within the European Union under IAS 24.[52] Publicly held companies will be required to prepare, for each financial year starting on or after 1 January 2005, consolidated accounts in conformity with the IAS. With respect to related party transactions, this change implies that publicly held companies be mandated to disclose the nature of the relationship, the types of transactions and the details of the transactions necessary for an understanding of the financial statements.[53] In related party relationships where control exists, disclosure of the relationship is required even if there have been no transactions.[54]

The purpose of mandatory disclosure is twofold. First, shareholders and other stakeholders will have access to financial and non-financial information about the company. Second, and perhaps more importantly, it encourages business parties, in particular, managers to analyze and understand the business. When they are used to communicate openly and clearly, the costs of mandatory disclosure will diminish significantly. To be sure, companies' shareholders may have other direct techniques to acquire information about the performance and financial situation of the company.[55]

However, the benefits of mandatory disclosure may be overstated. On this view, the costs outweigh the benefits due to loss of personal privacy, loss of competitive position, undermining of private property rights, direct compliance costs, and administrative costs. Naturally, business participants have an incentive to avoid mandatory disclosure because they are reluctant to disclose sensitive information. Another significant problem is that the information is not always timely and accurate and therefore few sophisticated parties would rely on such financial information alone. Even though the benefits and costs of disclosure do not impact all firms equally, mandatory disclosure is nevertheless likely to promote a more effective, low cost regulatory landscape that generates significant economic benefits by disciplining entrepreneurs, on the one hand, and offering enhanced protections for stakeholders, on the other hand.

Whilst private companies are not required to provide the same flow and rate of information as publicly held firms across the board, they should have strong incentives for doing so. Indeed, the best run companies, which are more attractive to investors, signal their accountability by supplying information about: (1) the company's objectives; (2) principal changes; (3) balance sheet and off-balance sheet items; (4) financial position of the firm and its capital needs; (5) board composition and company policy for appointments and remuneration; (6) forward-looking expectations; and (7) profits and dividends.[56]

5.1.2 'Shareholder' Participation and Dividends

In non-listed companies, controlling shareholders dominate the election of directors and influence directly the fundamental decisions, establish company policy, perform the main monitoring functions, and sometimes act as the firm's agents. That said, minority shareholders are particularly vulnerable to opportunistic acts by the controlling shareholders. Indeed, the controlling majority shareholder has a range of strategies at its disposal of to extract resources from firms they control. These include: (1) distributions of cash and property to confer benefits on shareholders; (2) dilutive share issues; (3) interested transactions; (4) allocation of corporate opportunities; (5) allocation of business activities; (6) selective disclosure of non-public information.

In order to prevent opportunistic behaviour by the controlling shareholder, company law may discourage divergence from the minority shareholders' interests by providing rules that limit the managers' power to act solely on the directions and instructions of the controlling shareholder. For instance, a legal rule could instruct director-managers to take into account the interest of minority shareholders and other stakeholders in exercising their powers.

Moreover, shareholder approval may be required when weak management intends to enter into substantial property dealings on behalf of the company.

The safest way, however, to ensure that the interests of minority shareholders are represented on the board of directors is the use of different classes of shares that have identical financial rights but are entitled to vote separately as classes for the election of specified numbers of board members. Another option is cumulative voting: a voting system found in a number of jurisdictions that gives minority shareholders more power, by allowing them to cast all of their board of director votes for a single candidate. Cumulative voting, however, may easily be eliminated or minimized by the controlling shareholder. For instance, a controlling shareholder can simply alter the articles of association or remove the minority shareholders' director without cause and replace him or her with a more congenial person. Given the experience in East Asia and US, controlling shareholders are reluctant to adopt cumulative voting.[57]

Unlike participation rights, it is much easier to protect the financial rights of minorities. Company law plays an important role in solving problems involving *non pro rata* distributions.[58] First, it can provide the participants with a rule stating that all shareholders share in the profit in proportion to their stake in the company, unless otherwise agreed upon. In the event of dissolution, the law can mandate that the residual assets of the firm – anything left after creditors are paid and other obligations fulfilled – will be divided *pro rata* among the shareholders. Moreover, shareholders in closely held companies can be bestowed with a legal mechanism that give them a statutory pre-emptive right to subscribe for newly issued shares proportional to their existing shares in the capital of the company.[59] Such measures tend to align the interests of the controlling and minority shareholders in private companies.

5.1.3 Minority Shareholder Protection

Business parties can bargain to an efficient contract most of the time without resort to legally enforceable norms. However, there are circumstances in which, due to information asymmetries or another contracting infirmities, parties are unable to rely upon contractual provisions that deal with dissension and deadlocks. This often leaves minority shareholders unprotected and vulnerable to oppression. While vague legal standards are often available in statutes, these provisions may be insufficient to cover the full range of contracting circumstances. In this case, the role of courts must play a central role in completing contracts *ex post*. Despite the beneficial effects of such judgments, reliance on judicial gap-filling is not always an effective means of conflict resolution. Not only is *ex post* gap filling imprecise, but it also tends to involve significant transaction costs and is time-consuming. Moreover, some commentators point to large variations in judicial decision-making, supporting the view that gap-filling is often haphazard and costly in redistribution terms. More significantly, whilst intra-firm conflicts may be observable to the contracting business parties, they may not be easily verifiable by judges and other conflict resolution bodies, and even less so when personal relationships in the family or between friends is involved.

Nevertheless, as we have seen, minority shareholders' interests can be protected by clear and simple rules that restrict managers' power to act in response to directions given by the controlling shareholders. At the same time, fiduciary duties can play a role in preventing oppression and supplementing the firms' organizational structure. But, open-ended fiduciary duties in markets with less experienced courts and legal systems may prove less effective. The duty of loyalty, for instance, provides an important safety mechanism to protect investors against the abusive tactics of controlling shareholders. From the perspective of continental Europe and emerging markets, however, these duties are not easily enforceable unless they are clearly enunciated as formal legal rules.[60]

In this view, *ex post* enforcement can serve to protect minority investors in non-listed companies. Naturally, shareholders are expected to resort to this mechanism if other gatekeeper institutions are insufficient (clearly the case in non-listed companies). Given the limitation of direct actions by individual shareholders, it is important to enforce the principle of *non pro rata* distribution on behalf of the company. In some jurisdictions, derivative suits provide minority investors with the possibility of clawing back their investment appropriated by managers or controlling shareholders.[61] The success of these actions depends on investors' access to information, the financial incentives provided to lawyers and the sophistication of the court system. While these factors may vary across countries, the promulgation of clear and precise legal rules is, as we have seen, essential to the adequate protection of the minority's interests in non-listed companies. For instance, in order to produce guidelines for the duty of loyalty, lawmakers could define specific duties that comprise this fiduciary obligation. By providing more clarity, company law could reduce litigation costs since disputes could more easily be resolved at a preliminary stage before trial. However, these variations should not be exclusive.

Finally, it could be argued, as noted above, that minority shareholders should have identical exit options as partners in a partnership. Standard economic theory suggests that the partnership could have some traction. Company law default rules traditionally lock in the participants by giving them only a very limited right to dissociate.[62] This is not surprising in view of the fact that company laws were originally designed to reflect the needs of publicly held corporations where the public market for shares provides shareholders with an escape route. The absence of a liquid market in non-listed companies shares, however, deprives the business parties of an effective exit mechanism. The lock-in effect of the corporate form may help to prevent an abusive use of an exit right, thereby furthering the stability of the firm. This is not to say that parties are prevented from contracting around restrictive company law norms and rules. For example, joint venture partners usually bargain *ex ante* to provide exit provisions that assist in the resolution of any disputes or deadlocked issues. The next session analyzes the contractual arrangements that are common in family-owned, joint venture businesses, and venture capital arrangements.

5.2 Pillar 2: Contractual Arrangements

Because the contractual decisions are made before the actual outcome of the venture is clear, the business parties must engage in an *ex ante* search for the contractual terms that improve their governance structure and maximizes the value of their investment. They tend to bargain over four fundamental elements – risk of losses, return, control and duration – subject to three major constraints: conflict of interest, government regulation and limits on specifying in complete detail all the terms of the relationship *ex ante*.[63] Two questions, which follow the bargaining elements and constraints, are crucial to efficient contracting. First, what is the relationship between the business parties inside the firm? The choice here is a function of the governance structure, break-up provisions and incentive mechanisms. Second, what is the relationship between the firm and outsiders? This question focuses mainly on liability regimes. From an efficiency perspective, business parties will bargain into contractual arrangements that offer an optimal combination of solutions to these problems.

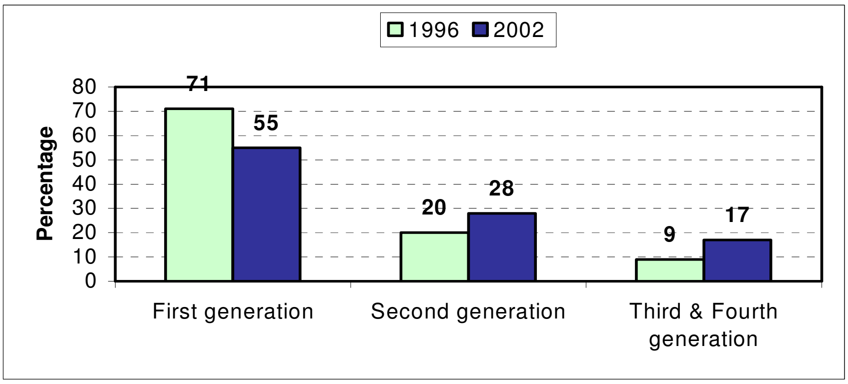
To be sure, company law offers standard form contracts that help to economize on transaction costs such as drafting, information and enforcement costs. It offers models that cover the relationships between the participants inside the firm and the representation of the firm in their dealings with outside participants, such as creditors. The business statutes act as a set of 'off-the-rack' terms upon which business parties can fall back upon when establishing the distribution and allocation of powers and responsibilities for varying levels of control and commitment. That is not to say that company law provides the parties with a set of all-encompassing standard form agreements. Given the large variety of business arrangements, it is simply impossible for lawmakers to provide a set of default terms that deal with every possible contingency. The parties in non-listed companies should therefore also rely on carefully drafted and other customized agreements.

To see this, this section analyzes the contractual relationships in family-owned businesses, joint ventures, and venture capital-backed firms.

5.2.1. Family-owned Businesses

Family-owned businesses are conceived as a nexus of oral and written agreements. Whilst such contracts can be costly and difficult to enforce, reciprocal commitments and penalties bundled together often proves effective in incentivizing parties to invest the necessary resources to achieve an optimal contractual relationship. If the relationship should threaten to breakdown, for instance in family businesses after the third generation (see *Figure 9*), the insertion of provisions that create 'mutual hostage' situations can encourage parties to work through their differences. The evidence shows that the most successful family-owned businesses employ a variety of contractual-based mechanisms to tie family members for generations. Family members who wish to exit usually face serious lock-in provisions making it virtually impossible to liquidate their interest in the company. Common 'penalty' mechanisms include the right of first refusal to family members on tendering shares, below-market valuations in the case of a share buyback, and restrictions on the number of shares that can be sold in a particular period. Conversely, the members will create institutions and privileges that function to foster family interests and minimize conflicts. Empirical evidence reveals that families anchor their members through large charitable organizations that offer employment to members not active currently in the business and include decision-making opportunities for the children of family members.[64]

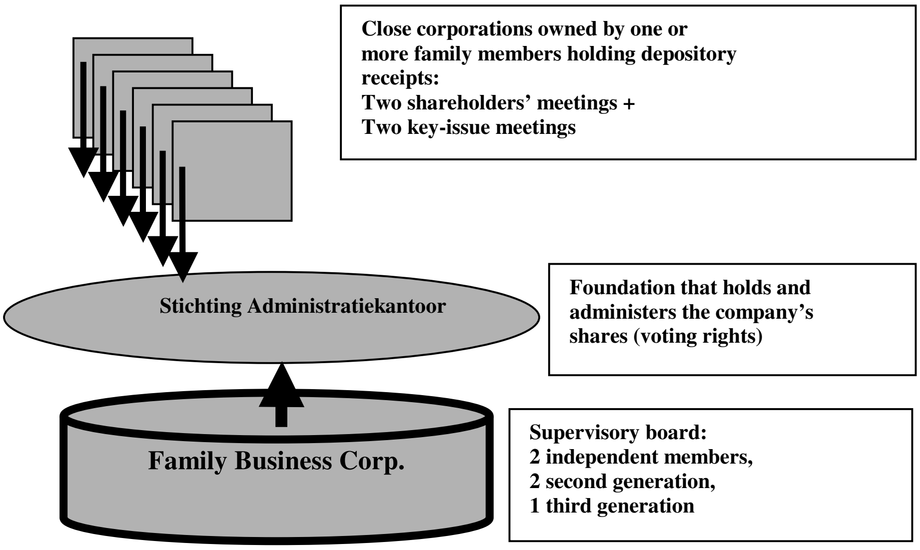
Figure 9: **Proportion of Ownership by Generation**



Source: Australian Institute for Social Research, Centre for Labour Research, Towards an understanding of the significance of family business closures in South Australia, May 2005.

Other contractual mechanisms in family business charters include the design of the board and the composition of its members, the voting rules and appointment procedures, the conditions for family members' participation in firm decision-making, their role in the business and succession planning, and the dissemination of information and dividends. For instance, Dutch incorporated family firms typically will contract around company law defaults by establishing a foundation that issues depository receipts to family members to ensure the continuity of ownership. Moreover, family members in need of more information and communication mechanisms rely on informal key-issue meetings which are convened outside the statutory shareholders meetings (see *Figure 10*).

Figure 10: **Example of Governance Structure Family-Owned Business**



Source: Adapted from 'Derde generatie betrekken voor de toekomst' (*Third generation involvement for the future*), Financieele Dagblad of 23 November 2005.

5.2.2 Joint Ventures

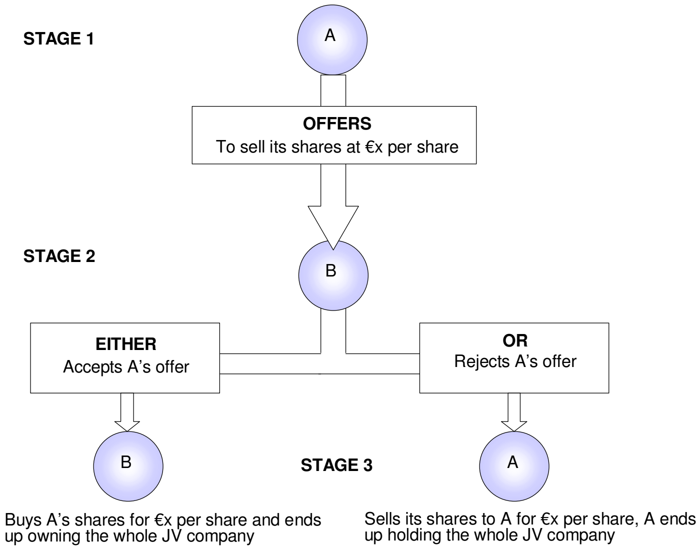
Similar contracting problems arise in the context of strategic alliances and joint-ventures. Joint ventures are owned and actively co-managed by pre-existing independent firms that pool resources for specific objectives. Many of these of structures are prone to excessive opportunism on part of the joint venture partners. First, the independent joint venture partners are often simultaneously competitors outside the scope of the venture. Second, since joint ventures usually involve the development of a particular product, the average lifespan is usually not very long (see *Figure 6*). Third, joint venture partners mainly rely on renegotiation and reputational incentives to worst effects of moral hazard.

In their effort to align interests, joint venturers will employ contractual defaults and remedies. Indeed, joint venture parties routinely pay for costs to specify their rights and duties so as to avoid excessive reliance on *ex post* adjudication of end game and other contractual problems. Specific legal terms are needed for the control and management, contribution and distribution of assets and cash, and the valuation of human capital, intellectual property and other contributed assets. Parties to a joint venture must also address the allocation and control of confidential information, trade secrets and corporate opportunities. Generally, joint venture agreements contain provisions on reporting and disclosure of financial and non-financial statements. Should parties rely on continuing finance, the agreement must include the terms of the investment, finance contributed, priority rights, and milestones.

The most important contractual mechanisms are directed to resolving deadlocks and other disputes. Like family businesses, joint venture parties are usually locked-in to their investment. The nature of the relationship and the specificity of the assets necessitates the provision of contractual 'divorce' mechanisms. *Ex ante* the parties will design a number of triggers to protect their investment when the relationship comes under strain. Voluntary-winding up provisions are intended, when a deadlock arises, to induce parties to negotiate since failure to arrive at a resolution will result in the liquidation of the venture. Buyout provisions are inherently difficult to contract for *ex ante* due to the information asymmetries regarding the assets contributed to the joint venture. When provisions are agreed, it prevents the dissenting party from frustrating the decision-making process. A continuing veto will trigger either a call or put option under which a party will have the right to exercise its buyout or expulsion rights. To be sure, buy-out provisions are not entirely without difficulties. Thorny calculation issues, particularly concerning the valuation of shares and whether payment should be deferred, abound in endgame settings, since the fair value of interests is likely to be non-verifiable by courts. Parties to joint venture agreements can alternatively choose to adopt 'shotgun' or 'auction' provisions in which one party proposes a price that can be accepted as either the selling or buying price of the dissolving stake. *Figure 11* displays the *Russian roulette* mechanism which is often viewed as a fair solution to resolve deadlocked conflicts. Either party can offer to buy the shares of the other party or to sell its own shares, thereby forcing the other party to accept or reverse the offer. The risk of reversal usually induces parties to value fairly the interests in the joint venture. However, a business party who has information about the other party's financial situation could act opportunistically by offering a too-low price. The *Texas shoot-out* mechanism (see *Figure 12*) is a variation on the *Russian roulette* provision with a built-in auction system.

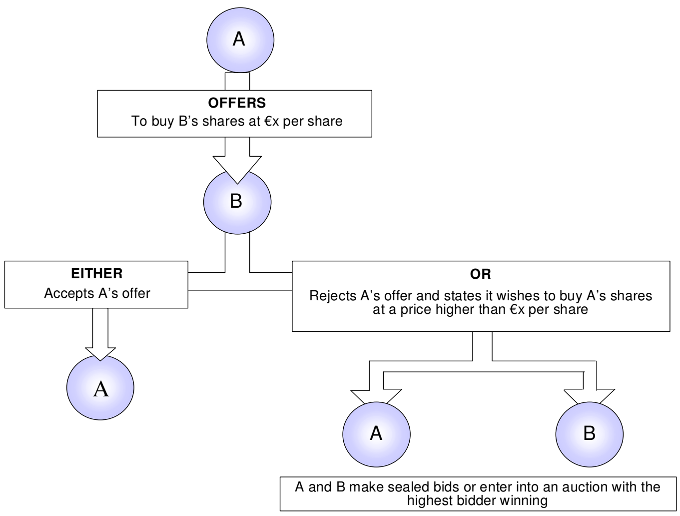
A review of the above-discussed measures suggests that family-owned firms and joint venturers can provide effective contractual arrangements that limit opportunism and encourage long-term commitments. Many of the defaults and remedies mechanisms that address the governance problems of these types of firms clearly specify the rights and duties of the parties involved. Still the evidence suggests that unsophisticated parties or businessmen that complete agreements without legal advice may be less inclined to consider such contractual obligations and remedies in the context of creating their business obligations. Moreover, despite the commitment-enhancing effects of these provisions, contracting infirmities may persist as these mechanisms appear to favour the party with the greatest bargaining power. Finally, overconfidence, over-optimism and excitement about the prospects of the venture prevent business parties from engaging in contractual planning and contemplating methods for addressing future conflicts of interest. Because parties must either trust each other or forgo the deal, they often shun tailoring their business arrangement thereby intentionally leaving gaps in their contracts. Bargaining theory in law and economics recognizes that even if the parties are willing to accept the challenge of drafting an agreement and transactions are marginal, information asymmetries and strategic conduct may prevent them from bargaining toward an optimal governance structure.

Figure 11: **Russian roulette**



Source: www.practicallaw.com - Deadlock and termination: international joint ventures

Figure 12**: Texas shoot-out**



Source: www.practicallaw.com - Deadlock and termination: international joint ventures

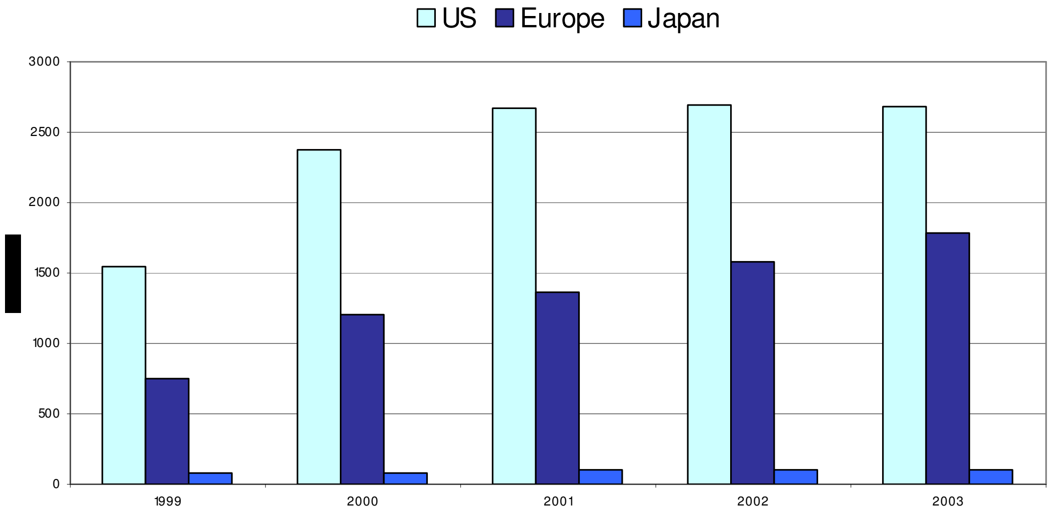
5.2.3. Venture Capital

Venture capitalists are specialized intermediaries that direct capital to firms and professional services to companies that might otherwise be excluded from the corporate debt market and other sources of private finance. Venture capital financing is used to invest mainly in small-and medium-size firms with good growth and exit potential. Typically, venture capital firms concentrate in industries with a great deal of uncertainty, where information gaps among entrepreneurs and venture capitalist are commonplace. These ventures are identified as financially constrained. Start-up firms rely on venture capital as one of their main sources of funding. Recent empirical research has found that the effect of venture capital on the success of these ventures is considerable. The value of venture capital investment is borne out by the figures which show that venture capital-backed firms grow on average twice as fast as those not backed by venture capital firms.

Venture capital has been a critical component in the innovation process in the United States over the last two decades. Venture capital disbursements are more productive in generating patents, compared to corporate R&D. The strong link between venture capital and innovation is reflected in recent research that discovered that venture-backed firms in the United States accounted for 8 per cent of US industrial innovation during the decade ending in 1992.[65] Furthermore, venture funding accounted for approximately 14% of US innovations for the period ending in 1998. Not surprisingly, the rapid increase in venture capital funding in continental Europe has also led to a significant rise in patent applications, particularly in Germany. The importance of venture capital for economic growth is now widely accepted. Empirical evidence from OECD countries over different time periods suggests moreover that an increase in entrepreneurial activity tends to result in subsequent higher growth rates and a reduction in unemployment.[66]

In the United States, the depth of venture capital finance and equity financing for innovative firms is large. It is commonplace that banks, insurance companies, and other investors contribute almost 50 per cent of venture capital funding. Until 2000, European pension funds contributed less than a quarter of total funding. However, that European venture capitalists are now receiving an increased portion of funds from institutional investors. As in the case of Germany, 25 per cent of new capital raised is from pension funds. Moreover, European pension funds increased the level of funding to 27 per cent in 2001 (EVCA 2001). Notwithstanding the increasing amounts of institutional investment, the European market is still lagging considerably behind the US venture capital industry, as reflected in the striking difference between the United States and Europe in terms of capital invested into venture capital (see *Figure 13*). The growth in venture capital investment has been accompanied by a shift in the nature and composition of the US market. Before the 1980s, the venture capital market was dominated by small investment companies, limited partnerships, and some closed-end funds Today, with the growth of funds flowing into the industry, the composition of the sector has been transformed with the investment adviser playing an important role in advising large pension funds and other institutions about their existing and potential investments.

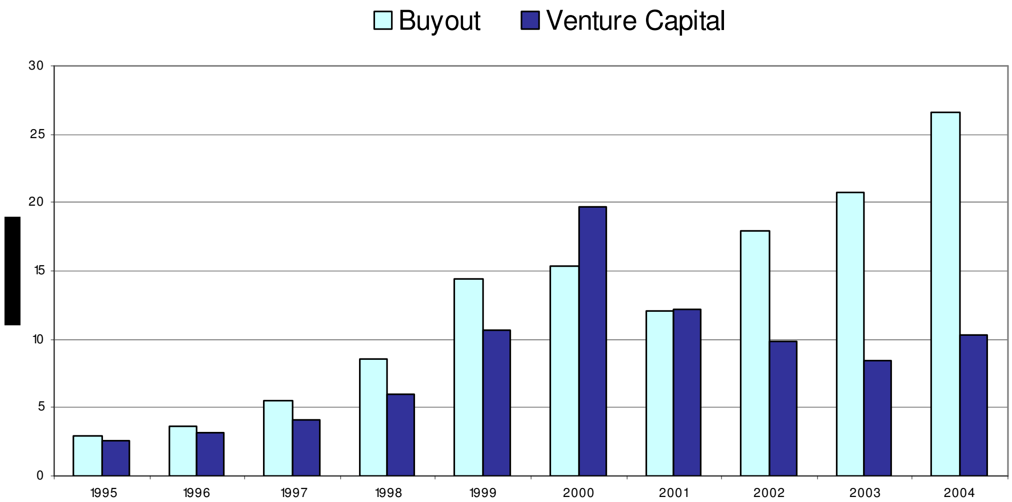
Figure 13: **Venture Capital Investments in Japan, U.S. and Europe**



Source: Graph adapted from Japan External Trade Organization (JETRO), Changing Environment for Japanese Venture Businesses, Japan Economic Monthly, May 2005.

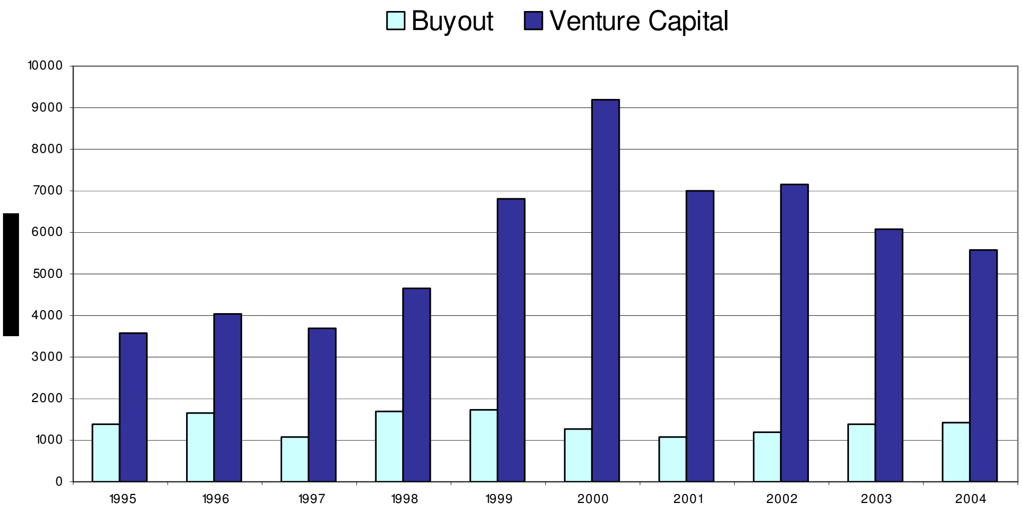
In the last decade or so, venture capital has become more prominent in European countries, with investments increasing more than six times from EUR 5.5bn in 1995 to a record of Eur 36.9bn in 2004. More specifically, two-thirds of this amount was invested in buy-outs and restructurings. Although the remaining amount invested in start-up companies is significantly lower, it is surprising that the number of companies receiving venture-back finance is more than three-quarters of the companies that underwent a buyout (See *Figures 14 and 15* below).

Figure 14: **Amount invested by stage 1995-2004**



Source: CEFS/EVCA – Employment Contribution of Private Equity and Venture Capital in Europe – November 2005.

Figure 15: **Number of companies invested in by stage 1995-2004**



Source: CEFS/EVCA – Employment Contribution of Private Equity and Venture Capital in Europe – November 2005.

5.2.3.1 Governance and Screening of Venture Capital Firms

In contrast to the corporate governance structure of the publicly held firms, where dispersed shareholders have disproportionately less control than equity, the governance arrangements of venture capital backed firms tends to allocate greater control to investors. In this section, we turn to discuss how the screening techniques used by venture capitalists to evaluate business prospects serve to reduce the uncertainty and information problems associated with early stage financing. Some of the success of the portfolio company's returns will be influenced by the effort and skill expended in screening 'good' from 'bad' entrepreneurs. The basic approach to the screening of venture capital investments involves a direct and indirect component. First, direct screening serves to overcome the information problem in two important respects. Direct screening involves selecting the 'good' projects based on the examination of the prospective pool of entrepreneurs' business plans. Because venture capitalists specialize in specific technologies and markets, and evaluate many potentially good investment opportunities, the information asymmetries between portfolio firms and entrepreneurs are reduced. In an recent empirical study of forty-two ventures by ten venture capital firms, portfolio companies tend to use four groups of criteria when evaluating an investment opportunity: (1) attractiveness of the project analyzed in terms of market size and growth, product attractiveness, the strategy, the likelihood of customer adoption, and the competitive position of the venture; (2) the quality of the management team and its performance to date; (3) deal terms; and (4) the financial or exit condition. Based on these analyses, the venture capitalist can make reasonable projections about the project's risks and the likelihood of success.

Venture capitalist firms also specialize by investing in companies at a specific development stages of the venture or in a particular industry (Sahlman 1990). For example, particular skills or expertise, besides financial analysis, will often lead venture capitalists to focus their activities on an industry or sector, such as biotechnology, where the critical factor for success is the optimal allocation of resources to R&D. Second, the contractual terms of venture capitalists' securities, especially in the United States, contribute to the screening process. As in the case of convertible preferred securities, the stock provides for a preference for dividends and liquidation, conversion rights and anti-dilution provisions, pre-emptive rights, go-along rights, and information rights. As a consequence of making this investment, venture capitalists will be induced to make analyses about product market competition, technology, customer and adoption, management team proficiency, financial projections, and exit strategies. The results of these findings will contribute to venture capitalists becoming ever more informed about the valuation of the company and whether to extend further financing.

Staged financing represents one of the most important contractual terms that increase the expected value of the portfolio project and make it possible for venture capitalists to extend financing to early stage projects. In the next section, we show that staged financing provides the necessary incentives to align the interests of the entrepreneur and venture capital fund.

5.2.3.2 Staged Financing of Venture Capital Investment

Thus far we have argued that the venture capitalist fund's screening techniques tend to limit the problems of adverse selection and ensure that they are in a position to judge accurately the portfolio company's prospects. We address the special development technique – staged financing – which is designed to reduce the uncertainty associated with early stage, high-tech financing and supply high-powered incentives for entrepreneurs by creating performance incentives. An important advantage of staged financing is that it allows venture capitalists the real option to stop financing the venture. In most deals, the venture capitalist provides the entrepreneur with just enough capital to reach specific milestones. Specific milestones are linked to important events such as the completion of a business plan, the production of a prototype, the receipt of a patent, and the marketing of a product. The fact that when a milestone has not been reached venture capitalists can abandon the project limits the downside risk. If the initial funding runs out before the management team of the portfolio company fails satisfactorily to meet a milestone, the venture capitalist has the option either to abandon financing or reduce the level of financing by making a lower valuation of the portfolio company. As such, the staging of investment commitment performs the same function as debt in a leveraged buyout. Even though the entrepreneur can take steps to locate new financing, the first-round backers' unwillingness to fund future rounds of the project is information revealing, and may serve to deter other venture capital funds from taking on the risk. Nor will potential new investors want to extend new finance to projects where the incumbent venture capitalist fund has a contractual right of first refusal to future financing. Second, staged investment tends to limit the asymmetric information and agency problems associated with early stage investment. Accepting a contract that includes staged financing allows the entrepreneur to send a costly signal about the true quality of his project. Thus, only entrepreneurs confident about their skills and the quality of the venture will accept the incentive contract.

Staged investment also helps to attenuate the commitment problem of the entrepreneur. Given that the venture consists mainly of intangible assets at the beginning of the relationship and that the entrepreneur has the unique human capital that is critical to the success of the venture, the entrepreneur has considerable bargaining power over the claims to the venture's returns in the subsequent rounds. As a consequence, the technique of staged investing offers a potential solution to the hold-up problem. Moreover, it creates high-powered incentives for the entrepreneur to exert optimal effort to increase, for example, the speed of product development. In each stage of funding, the investors provide capital in exchange for shares of the venture. Because the entrepreneur is financially constrained, his ownership of the venture will be reduced after each round of financing. The entrepreneur can limit this effect by achieving a high valuation of the firm at each new stage of financing. The valuation determines the number of shares that will be sold. The venture capitalists and the entrepreneur fix the amounts of funds necessary to reach the next milestone. A positive correlation between high valuation and share price reduces the number of shares that must be sold. Thus, the threat of dilution supplies the entrepreneur with a high-powered incentive to exert more effort.

So far we have focused on the positive benefits of staged financing. There are, however, a number of recent articles in the literature showing how staged financing can give rise to opportunistic behaviour by both parties. First, staging creates incentives for the entrepreneur to focus on increasing the likelihood of the short-term positive performance of the venture ('window-dressing'). In order to increase the probability of gaining another round of financing, the entrepreneur will have an incentive to manipulate short-term performance either by emphasizing the conditions that affect the valuation more favourably or by focusing on short-term goals. Staging shifts the entrepreneur's focus from long-term goals to short-term signal manipulation, which consists of making a positive news more likely to appear. Signal manipulation reduces the probability that the venture will be terminated. However, as this reduces the value of the option to abandon the project, it may become less likely that the venture capitalist will provide finance in the first place. Second, staging also puts the venture capitalist in a position to behave opportunistically. Both the initial venture capitalist and the entrepreneur know that by not investing in a future round, the initial venture capitalist sends a negative signal to other potential investors about the quality of the venture. As the signal is particularly important for early stage companies, the initial venture capitalist can misuse his bargaining power by extracting additional returns at the expense of the entrepreneur. Moreover, if the expected return is not sufficient to cover the opportunity costs of time, knowledge, and capital, the venture capitalist can choose to prematurely liquidate a venture that has economic value. Convertible preferred stock, discussed in the next section, can attenuate the window-dressing problem caused by staging. Additionally, syndicating investments can serve to alleviate the hold-up problem of the venture capitalist.

5.2.3.3 The Monitoring Process

In exchange for their investments, monitoring, and advice, venture capitalists usually demand control rights that are disproportionate to their shareholdings. From the perspective of the venture capitalist, monitoring of the entrepreneur and the interim performance of the venture is crucial to making the optimal continuation decision. During the postcontracting stage, the venture capitalist combines monitoring with advising activities, which are typically arranged by contract. The venture capitalist's control extends to advising management on strategic decisions, assisting in recruiting key personnel, replacing management, and providing assistance on other issues such as investment banking and legal advice. Lerner (1995) finds that venture capitalists are more likely to join or be added to the board of ventures in periods when there is a change in chief executive officer (CEO). Therefore, one would expect venture capitalists to intensify their monitoring activities at times when it is more necessary. The board mechanism also allows the venture capitalist to have access to key information about the potential profitability of the venture. In addition, most venture capitalists demand timely access to information, including detailed monthly financial statements and other operating statements. They can demand to inspect the venture's financial accounts at will. Venture capitalists spend approximately half of their time monitoring an average of nine ventures. Furthermore, one of their most frequent activities is to assist management in raising additional funds. The frequency of interaction between the entrepreneur and the venture capitalist depends on a number of factors: (*a*) the extent of the CEO's new venture experience; (*b*) the venture's stage of development; (*c*) the degree of technological innovation pursued by the venture; and (*d*) the extent of the congruence between the CEO and the venture capitalist. The result shows that the degree of management ownership has no impact on the frequency of interaction. These findings are important since they show that, even with a high degree of goal congruence, extreme levels of uncertainty may weaken signals about the appropriate course of action, therefore requiring actions to generate extra information.

5.2.3.4 Convertible Preferred Stock

Some commentators suggest that the most suitable type of security to use in early stage ventures is convertible preferred stock. Convertible preferred equity is considered optimal because it secures downside protection for venture capitalists by providing seniority over straight equity, while it supplies entrepreneurs with sufficient incentives to take risks in order to create higher final firm value. Convertible preferred stock gives the venture capitalist a fixed claim on the returns of the venture in the form of a dividend. The unpaid dividends accrue and must be paid to the convertible preferred equity holders before the dividend is paid out to common stock holders. Common shares provide incentives to the entrepreneur as compensation is thus based on the performance of the venture. Using convertible preferred stock also gives venture capitalists a senior claim on cash flow and distributions in the case where the venture is liquidated. There are a number of explanations for the popularity of convertible preferred equity. One possible explanation for this pattern is that convertible preferred stock—which confers a voting right—ensured venture capitalists protection against burdensome amendments that favour other classes. Furthermore, this class voting mechanism allows holders of preferred stock to elect half or more of the board of directors, which gives the venture capitalist substantial control over the board. Recall that if the venture capitalist gains control through the board of directors, he can thus opt to replace the management team. Next, we note that with convertible preferred stock investors have the option to convert their preferred shares into common shares, which allows them to capture part of the firm's upside gains.

The conversion price is usually set equal to the purchase price of the security, insuring a one-to-one conversion. In addition, the contract contains anti-dilution protections that limit opportunistic behaviour of entrepreneurs. Another often cited reason is that convertible preferred stock is made redeemable at the option of the venture capitalist, which ensures that they will secure some compensation for their investment.[67] (Sahlman 1990).

From a theoretical perspective, some economists argue that convertible preferred stock provides an efficient means for dealing with the double-sided moral hazard problem. Such a double-sided moral hazard problem exists when two principal–agent relationships arise between two parties. This is very common in venture capital contracting since both the entrepreneur and the venture capitalist are agents as well as principals. Convertible securities can also be used to allocate cash flow rights contingent on the state of nature and the entrepreneur's efforts. As such, this contract reduces the double-sided moral hazard problem by inducing both the venture capitalist and the entrepreneur to invest optimally in the project. A critical assumption is that a positive relationship exists between the ultimate success of the project, project quality, the efforts of the entrepreneur, and the commitment of the venture capitalist. It is argued that convertible preferred stock outperforms all other mixtures of debt and equity.

The model assumes that convertible preferred stock is used only by active investors, as the venture's success is highly dependent upon their final efforts. The critical component of the convertible debt contract is the conversion ratio. It must be set at such a level that it induces the venture capitalist to invest and convert only if the entrepreneur chooses at least the efficient effort level. This in turn induces the venture capitalist to choose the right level of effort even though he loses some portion of ownership. In the event of a bad state, the venture capitalist chooses not to convert, the entrepreneur defaults on the debt, and the venture capitalist, as the holder of the debt claims, would accordingly liquidate the venture. It is widely acknowledged that convertible preferred stock is the dominant form of security used by venture capitalists in the United States. This may be due to the standardization of purchase agreements. Recently a number of empirical studies have confirmed the importance of convertible preferred stock in the United States.

5.2.3.5 The Exit Strategy of Venture Capital Firms

The exiting of the portfolio company investment is the final stage in the venture capital process. Venture capital firms have several options when considering exiting a venture. There are six ways in which a venture capital firm can exit a venture, namely: (1) the sale of a company's shares through an initial public offering; (2) the sale of shares to another company or a trade sale; (3) the repurchase of the shares by the company by leveraging the company or by buy-backs; (4) the sale of shares to another investor; (5) the reorganization of the company; and (6) corporate liquidation. The first two techniques are the most popular exit routes for US venture capitalists. Unsurprisingly, the pattern in Europe presents a different picture, as data from most countries show that the most common exit strategy is the sale of shares to another company and liquidation. Yet, there has been a marked increase in IPO activity in recent years (but prior to 2001). The growth in listings can be largely explained by the rapid development of the new market segments created in continental Europe and the United Kingdom. It is claimed that the possibility of an exit through an IPO allows the venture capitalist to enter into an implicit contract with the entrepreneur concerning future control of the company. Clearly, this creates a strong incentive for the entrepreneur to refrain from behaving opportunistically. However, it appears that 'younger', as compared with 'older', venture capital firms have strong incentives to behave opportunistically by taking companies quicker to exit through an IPO. The reason is that a successful IPO allows the young venture capitalists to send a quality signal about their ability to potential investors. Moreover, experienced venture capital firms, with solid reputations, appear to be very good at taking companies public close to market peaks. It is worth pointing out that venture capital backed companies have less of a positive return on their first day of trading compared with non-venture backed IPOs. This finding supports the view that capital markets recognize the monitoring quality of venture capital firms. In other words, venture capital firms' reputational capital enables them to credibly certify the quality of the companies they take to the stock market. This section argued that there is a positive relationship between the venture capital market and the contractual arrangements that facilitate investment in entrepreneurial enterprises. The next section will explain the crucial function of soft law principles and guidelines in assisting firms to overcome contractual bargaining problems and the uncertainties connected with formation and operation of the business.

5.3 Pillar 3: Optional Guidelines

Pillar three examines the optional guidelines needed to foster good governance and the management of non-listed firms. The challenge for legal professionals is to address the bargaining problems identified so as to facilitate optimal business arrangements and governance structures. As follows from the above discussion, even if business parties lack the skills and knowledge necessary to enable the negotiation and composition of contract terms *ex ante*, they are likely to eventually seek the advice of a sophisticated legal practitioner, who would force them to engage in business planning strategies.

From the perspective of the legal professional, a lawyer's performance, however, does not necessarily have to create higher expected firm value. Even if lawyers are willing to draft a comprehensive agreement, the hope of a fruitful relationship might be frustrated. The concern to protect clients from all future contingencies may very well result in lawyers creating undue delay and introducing complexity into agreements, thereby undermining prospects of reaching an optional contractual arrangement. That said, it is clear that this situation, which limits welfare, employment growth and other society values, will persist unless responsible parties step in to create well-considered guidelines for practical use by business parties and legal professionals respectively to develop governance structures that offer a workable set of beneficial provisions attractive enough to serve as focal point.

This raises the following questions: Is there a credible role for best practice guidelines in improving the contractual governance arrangements of non-listed firms? Why are guidelines drafted for the benefit of listed companies not sufficiently robust or even remotely appropriate for advising legal practitioners when serving the needs of their non-listed sector clients? Does each industry segment require the introduction of governance guidelines specific to the industry and its business model? Which institution or group is best placed to develop the right set of principles? Do national corporate governance committees or industry-based associations ensure the creation of optimal guidelines? Having seen that the procedures involved for the creation of best practice guidelines creates integrity and awareness for the business parties and stakeholders, the question is whether what matters most is the substantive variation in guidelines across industry sector or the standardization achieved by a general code that focuses on non-listed companies across the board.

It might be argued that a properly designed single set of standards for listed companies are sufficient to evaluate and improve the governance structure of non-listed companies. Given the flexibility and non-binding nature of the codes and the feedback mechanisms which guarantees that firms will have the best standards available, there is little risk of negative externalities affecting either class of firms unduly. A compelling argument is advanced by policymakers and practitioners who have indicated that the key drivers of effective corporate governance in publicly held companies also serve a similar function in their non-listed counterparts.

Indeed, *Figure 11* shows that greater transparency, enhanced shareholder rights and more effective board practices are conceived to be equally important in the area of non-listed companies. However, because it is unclear when and to what extent the corporate governance principles drafted with publicly held corporations in mind should be applied to non-listed firms, a 'one-size-fits-all' approach may be inappropriate for specific types of non-listed companies. At the same time, strict corporate governance codes are potentially disruptive to the internal affairs of non-listed companies leading to costly deficiencies and inconsistencies which reduces certainty and value for business. Clearly, the magnitude of the disruption and the negative spill-over effects calls into question the salience of this approach. The institutions established to counter and limit the managerial agency problem, such as fully independent boards as a monitoring technique, are not a priority in family-owned businesses and joint ventures. Another problem is that the code provisions that apply to listed companies are often silent when it comes to conflicts between members of private firms. As *Table 2* shows, there are divergent governance strategies for non-listed and listed firms which calls out for significant adjustments of a one-size-fits-all code.

Figure 16: **Reforms within a firm's control, ranked by order of importance**

Source: 'McKinsey Emerging Market Investor Opinion Survey 2001' (published in Paul Coombes and Mark Watson, Corporate reform in the developing world, The McKinsey Quaterly 2001 Number 4: Emerging Markets).

To be sure, legal professionals can strive to adapt a code's provisions to the relationship at hand. However, it appears that once the wrong governance doctrines are accepted, these norms are difficult to opt out of. Network theory indicates that legal professionals contribute significantly to the 'lock-in' effect. If a lawyer drafts a customized term that will benefit other lawyers generally, a potential free-rider problem can emerge. Tinkering with the codes provisions no matter how flexible does not always result in cost-effective adjustments. The possible failure of the newly created term ends to confine the individual lawyer to a more traditional role.

Table 2: **The Anatomy of Corporate Governance – Listed versus Joint Venture Companies**
Note: Adapted from a Table published in Bamford, J. and Ernst, D. (2005), Governing joint ventures, The McKinsey Quaterly 2005 special edition: Value and performance.

Governance in typical public company	Additional governance challenges for joint venture
Board composition	
Board members are not employed by shareholders; represent interest of all shareholders equally. Independent directors are key to proper governance.	Board members are typically employed by one or more of the shareholders, creating potential conflicts of interest. Better model: appoint at least one outsider director who promotes the interest of the JV business.
Board roles	
Board focuses on approval of major strategic decisions, CEO succession, risk management.	Board must manage conflicts between shareholders, secure resources from shareholders, monitor transfer prices/parent transactions, manage career path of management team.
Decision making	
Investors unite in desire to maximize shareholder returns, manage risks.	Key decisions (e.g. strategy setting, capital planning) require agreement among a few large shareholders, which may have very different interests, financial constraints, view of market.
Management team	
Management team members are accountable to CEO and board.	Key members of venture's management team (e.g. CEO, COO) are former employees of one parent; many likely to see future career tied to returning to that parent.
Resource flows	
Venture does not depend on shareholders for any operational inputs	Venture depends (at times extensively) on one or both parents for key inputs, services, business functions (e.g. raw materials, administrative support, sales force)
Ownership structure	
Market model of corporate governance: widely-dispersed shareholders.	Multi-ownership. Joint venture partners own the shares in the company.
Control model of corporate governance: concentrated ownership.[68]	The equity structure is the most important and difficult negotiating issue in joint venture agreements.[69]
Shareholders can dispose of their shares in the stock market.	Legal professionals are typically against 50-50 joint ventures, while business parties are in favour of equal joint ventures (cf. Figure 5)
Shareholder activism	
Measures are advanced to encourage shareholder activism – electronic voting, proxy voting, active institutional investors.	Participants start as active shareholders. Improved governance arrangements should enable shareholders to effectively change the strategy, scope, financial arrangements and operations of the joint venture.
Deadlock and other conflicts	
Board members owe fiduciary duties. Derivative and class actions.	A bundle of reciprocal commitments and penalties could prevent deadlocks and disputes. Contractual mechanisms, such as 'shotgun' and 'auction' provisions, are last resort options to resolve conflicts and deadlocked issues.

The upshot is that we already can see in practice the emergence of distinctive guidelines for privately held companies. For instance, a separate corporate governance code for non-listed companies was introduced in Belgium in 2005. Experts have already praised the code for its fresh perspective and educative value to firms. It is only to be expected that many family-owned companies are considering incorporating these recommendations in their organizational structure. While there are no studies available yet to demonstrate the beneficial effects of the code, the core recommendations were created by a well-seasoned governance committee represented by top business leaders and legal practitioners, under the chairmanship of Baron Buysse, which were sensitive to the dynamics of the environment in which these firms compete.

Another example is the recent launch of the European Venture Capital Association (EVCA) Corporate Governance Guidelines for the Management of Privately Held Companies. Designed in consultation with industry experts, the EVCA guidelines provide a set of optional measures that focus on the staged investment decisions of venture capital and private equity funds and the contractual circumstances surrounding these investments. In contrast to family-owned firms, these guidelines focus on meeting the governance concerns of venture capital-backed firms. For example provisions that enunciate the duties and responsibilities in relation to the design and execution of corporate strategy are a core feature of the recommendations. Indeed, while these guidelines address the responsibilities of boards and shareholders, there is no mention of the important role of succession planning which illustrates the need to provide standards that are relevant and tailored to the organizational features of family-owned firms. *Table 3* shows the different principles and recommendations in the national-oriented Buysse-code and the EVCA's industry-based guidelines.

Having examined two types of recommendations (industry-based versus national-oriented) for non-listed companies, the question naturally arises: Which approach is the best alternative? Although industry-based guidelines are theoretically better able to address some industry specific problems and issues, thereby promoting performance and professionalism in firms, national-oriented codes can ensure that the principles are more suitably designed to interact with the economic and social environment as well as the legal rules and institutions in a particular jurisdiction. We can, therefore, not assess with certainty the effect of the different alternatives on most firms at this juncture. To be sure, given the diversity of non-listed companies, private-ordering and market-based measures (without the influence of specially drafted norms) are more likely to provide the sort of mechanisms that are beneficial to non-listed companies. However, both sets of guidelines contain provisions – on the different ownership and control structures of non-listed companies, the composition of the board of management, transparency requirements, accessing outside capital, and strategies for succession planning and conflict resolution – that arguably educate and train board members and shareholders on becoming competent and reliable business parties in both growing and mature non-listed companies. It goes without saying that a special set of guidelines induces companies to pay increasing attention to the importance of strong and professional governance structures in thriving and surviving in a rapidly changing and internationalized world.

Table 3: **National-oriented and industry-based corporate governance recommendation for non-listed companies**

Role and Composition of:	*Buysse Code*	*EVCA*
Shareholders	Must be active and involved Defining the values and vision of the company Appoint the board of directors Establish financial objectives Establish the rules of the game (e.g. shareholders' agreement) Family forum and charter to ensure the family interests	Shareholder rights should be clear for other shareholders in the same or other classes of shares and to bondholders Active role in strategy-setting Bargain for non-legislative information requirements Ensure that board members are skilled, experienced, responsible, trained, and informed Act openly, honestly and with integrity towards stakeholders
Board	Promoting shareholder involvement Decide on strategic matters Monitor the tasks of management and shareholders Appoint managers Advise management Internal control systems Dividend policy Protect the interest of the company Composition should be balanced and independent Meet on regular basis Consider committees – audit, appointment, remuneration, strategic	Understand and support the business strategy Participate in identification and assessment of risk Determine appropriate levels of remuneration Management agreements to govern the relationships among the Private Equity and Venture Capital Investor, board and management
Management	Execution of corporate strategy	Identify, select and adopt an appropriate control framework Procedures for risk assessment Conduct a review of control activities Assess the security, relevance and reliability of business information systems Ensure accurate, clear and timely communication Review the corporate governance framework

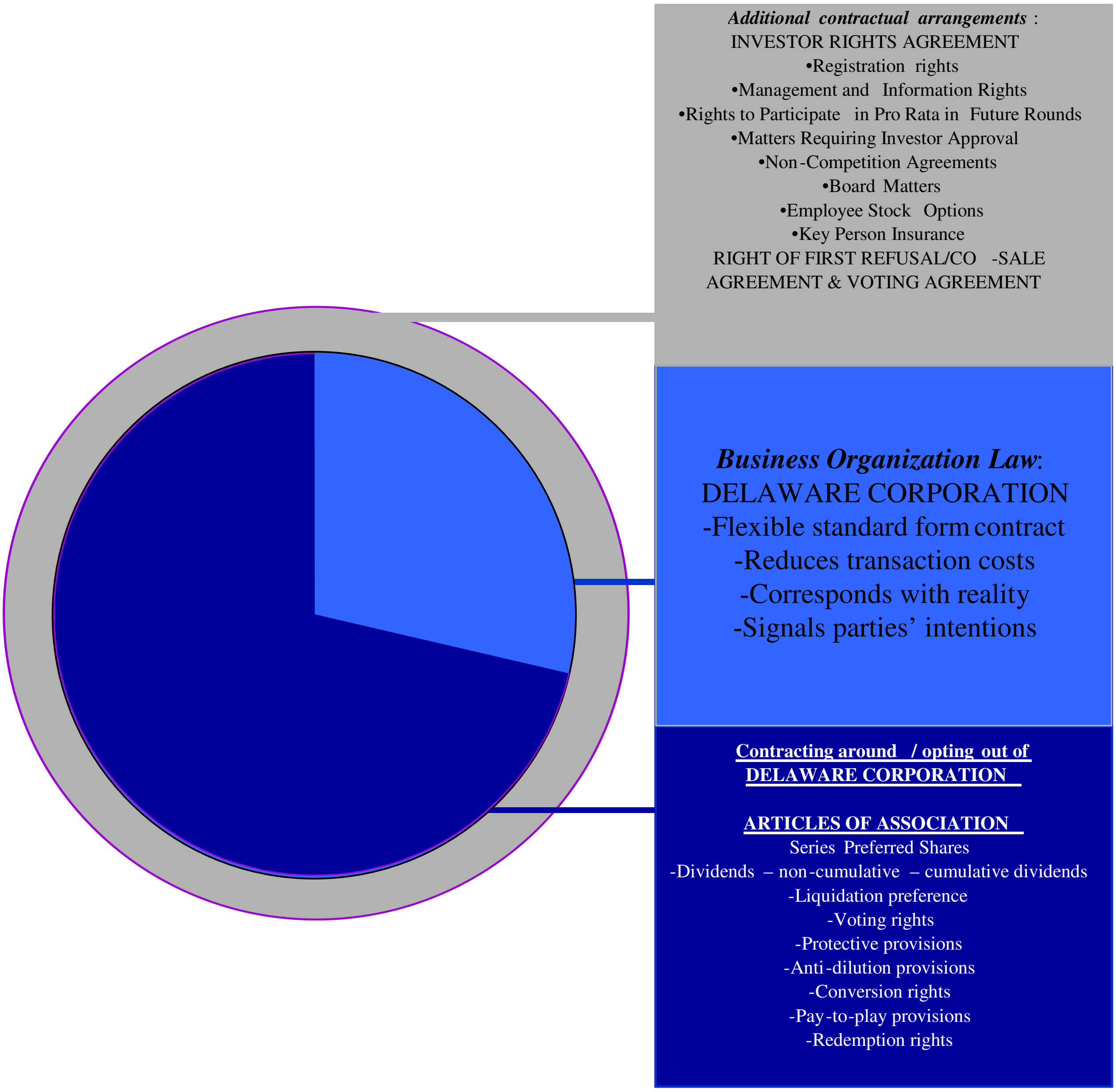
If we accept the idea that corporate governance guidelines for non-listed companies could create awareness and provide for stronger governance structures, then a proliferation of codes, whether industry-based or national-oriented, is likely to further stimulate discussion and feedback leading to the cross-fertilization and refinement in the code-making processes. Parallel work by standard-setting institutions, such as corporate governance committees and industry associations, could be viewed as effective and appropriate because they arguably produce clearer and more defined norms that allow a firm to be better able to identify and address key factors for its long-term success on the one hand, while introducing standards that reflect the ever-changing conditions of the business environment on the other.[70] Moreover, this process serves to limit the effects of lock-in obsolescence when codes-producing institutions are engaged in the continuous revision of the governance guidelines against the background of economic and social change so as to draft up-to-date and successful recommendations.

There are a number of factors that determine the success of industry-based guidelines and national-oriented codes. First, can the recommendations serve as ready-made gap-fillers for structuring the relations between members inside the firm and external relations? Second, does the application of the code provide a credible signal of trustworthiness and creditworthiness, thereby encouraging investment in the firm? Third, can investors use the code profitability to screen for moral hazard problems? Fourth, does the code serve to bond business parties to a long-term relationship with the firm? Fifth, can the code act as a supplement to the monitoring devices to verify the financial and non-financial disclosure of firm performance? Thus, while this list of factors is not an exhaustive enumeration, it can be seen as the first step in the process of creating a robust set of benchmarks to assess the impact of these optional measures. It offers an analytical framework that responsive policymakers, lawmakers and other standard-setting institutions could rely on when devising well-designed and theoretically efficient corporate governance mechanisms that meet the contracting preferences of several types of non-listed companies.

Table 4: **Corporate Governance Progression Matrix for Founder/Family-Owned (Unlisted) Companies**
Source: International Finance Corporation (2005)

ATTRIBUTES	LEVEL 1 Understanding the need to professionalize the Company	LEVEL 2 First concrete steps toward best practices	LEVEL 3 Implementation of best practices	LEVEL 4 Leadership
A. COMMITMENT TO CORPORATE GOVERNANCE	- The basic formalities of corporate governance are in place including: o Board of Directors; o Annual Shareholders' meeting; o Shareholders and shareowners identified and recorded. - Board member or high-level company executive explicitly charged with responsibility for improving corporate governance practices.	- Written policies established addressing key elements in family firm governance: o Succession planning; o Human resources and family member employment; o Non family member ownership. - Management/Board approves annual calendar of corporate events.	- Corporate Governance policy covers: o Role of Board vis-à-vis management; o Long-term planning for corporate governance of company commensurate with business plan.	- Applicable corporate governance, accounting, auditing and internal controls, and shareholder information practices are equivalent to those in place at best practice public companies (i.e., little would need to be done to qualify to make a public offering). - Company fully complies or explains any deviations from all applicable provisions of voluntary code of best practices of the country (some elements of which may be applicable only to public companies).
B. STRUCTURE AND FUNCTIONING OF THE BOARD OF DIRECTORS	- Board of Directors constituted and meet periodically.	- Board meetings held according to a regular schedule, agenda prepared in advance, minutes prepared and approved. - Non family members (probably company executives or ex-executives) appointed the Board and core competency (skill mix) review of Board conducted, or advisory Board of independent professionals established and consulted on a regular basis.	- Board composition (competencies/skill mix) adequate to oversight duties. - Annual evaluation conducted. - Audit Committee of non – Executive Directors established. - Directors independent of management and owners appointed to the Board (perhaps "graduated" from the advisory Board).	- Audit committee composed entirely of independent directors. - Nominating Committee established. - Compensation Committee established.
C. INTERNAL CONTROL ENVIRONMENT; TRANSPARENCY AND DISCLOSURE	- Adequate accounting and auditing systems in place including: o Adequate internal accounting and control system periodically reviewed by independent external auditors and quarterly financial reports prepared by internal accounting and approved by the Board; o Annual financial statements audited by independent external auditors and approved by Shareholders' Meeting.	- Accounting and auditing performed in accordance with highest national standards and audit performed by recognized accounting firm.	- Accounting, auditing and internal control systems up to international standards.	
D. SHAREHOLDERS	- All shareholders kept informed of company policy, strategy and results of operations. - Annual shareholders' meetings held.	- Shareholders provided with all material information and detailed agenda in advance of shareholders' meetings.	- Family council established (if number of family members large or substantial portion are not working in the business).	- Company in position to quickly implement all aspects of best practice code with respect to shareholders when company to go public.

Figure 17: **The Model Venture Capital Contractual Arrangements**
Source: Adapted from National Venture Capital Association (www.nvca.com)



6. Summary and Conclusions

As we have seen, the corporate governance movement has again captured the imagination of policymakers, lawmakers, and company executives worldwide. Skeptics might argue that it all started as merely a fashion trend among company law professors who were inspired by Berle and Means' book on the *Modern Corporation and Private Property* (1933). In the modern corporation, characterized by the separation of ownership and control, the shareholders have lost their direct influence and involvement in the firm. As a consequence, managers and insider control groups are encouraged to pursue their own personal goals without taking the interests of the shareholders, other stakeholders, and society into account. Scholars have written extensively on the managerial agency problem, and have recommended the introduction of both market mechanisms and legal strategies that mitigate opportunism and shirking in listed companies.

The finance-ridden scandals in Europe and the US further brought attention to the importance of governance and provided new momentum for introducing important legal and regulatory reforms. Certainly the scandals were not only instrumental in moving corporate governance up the policy-making agenda, but also in making corporate governance an integral part of the day-to-day decision-making process of public firms. Corporate governance is a major political issue, attracting considerable attention from policymakers, lawmakers, company executives, shareholders, banks and other investors, the media, and legal and financial professionals. To be sure, managerial abuses have been around for as long as widely-dispersed investors poured their money into risky ventures (such as the Dutch East India Company), and, as always, policymakers and lawmakers have attempted to mitigate the underlying governance failures and errors. However, the current corporate governance movement has tended to overreact by creating too many rules and attempt to overprotect (minority) shareholders and other stakeholders. Unchecked, this trend could jeopardize entrepreneurship and longer term economic growth. This prompts questions about the 'one-size-fits-all' mentality of policymakers, lawmakers and gatekeeper institutions and the success of ready-made strategies that can be detrimental to the operation and development of non-listed companies.

In this study, four developments were described which could usher in a new movement towards corporate governance initiatives focused on non-listed companies. First, the 'one-size-fits-all' and over-regulatory mentality arguably led to some undesired spill-over effects to non-listed companies. Separate reform projects could mitigate the ambiguity and spill-over effects related to corporate governance issues. Second, since firms cannot afford to ignore the rewards of joint venturing any longer, it is important that business parties be made aware of the benefits of improved and stronger corporate governance structures. The refocusing of corporate governance on typical problems in non-listed companies, including family-owned firms, joint ventures and high-potential start-ups, could help promote the economic performance of countries. Third, it is widely acknowledged that family-owned businesses and start-ups are the backbone of a country's economy. The typical life cycle of family-owned firms, however, indicates that where the first generation establishes the business, the second generation develops it and the third generation destroys it. Only companies with strong and professional governance structures are able to survive beyond the third generation. It is submitted that education and training of family-owned firms is of utmost importance to assure the steady and healthy growth of these businesses. Finally, it is only to be expected that non-listed firms, which rely heavily on bank finance and venture capital, would be required to have a professional governance structure in place. Separate corporate governance discussions could well contribute to the awareness creation regarding the beneficial effects of such measures.

We then turned to the three pillars that constitute the corporate governance framework of non-listed companies. One of the key pillars, of course, is company law which could be viewed as the most important source of corporate governance techniques in the context of non-listed companies. If we look at *Table 4*, for example, which shows that the level 1 requirments are ideally covered by countries company law measures in the area management control and rules on disclosure and transparency that enable shareholders to employ legal techniques that secure accurate and timely information on the financial affairs and performance of the company. The level 1 measues also provide for basic techniques that protect minority shareholders' interests through participation rights and legal restrictions on managers' power to act in response to directions given by controlling shareholders.

More effective lock-in rules, moreover, should ensure both continued investment and minority protection. Fiduciary duties, for instance, should play an important role in preventing *non pro rata* distributions. The open-ended duty of loyalty arguably provides a safety mechanism to protect investors against the abusive tactics of controlling shareholders. In this view, courts and other conflict resolution bodies are crucial to fill the gaps in the corporate governance framework *ex post*. However, it was argued that due to the difficulty in predicting the judicial outcome, business parties often prefer to bargain for contractual provisions that deal with possible dissension and deadlocks *ex ante*. Examples from the area of family businesses and joint ventures portrayed a range of contractual arrangements through which business parties could be encouraged to resolve their differences and conflicts before resorting to the more costly and uncertain judicial process.

It follows from the above discussion, that if policymakers and lawmakers were to introduce reforms designed to provide a menu of optional substative rules, the resulting legislative outcome could increase the incentives to reduce transactions costs thereby increasing firm performance. Given the ever-chaning nature of the business environment, an effective enabling approach ideally should also include both opt-in and opt-out provisions. *Figure 17* evinces this point by showing the imporance of flexible provisions giving parties the opportunity not only to contract around the company law default rules, but also permitting them to contract into additional protective measures that reflect their preferences.

Yet even when company law rules are sufficiently flexible to enable business parties to contract into the desired organizational structure, transaction costs and information asymmetries may prevent the emergence of effective and optimal governance solutions. While there could be a great appeal to the utilization of existing corporate governance mechanisms (designed for listed companies) to address, among other thing, the ownership and control structures, the composition and operation of the board of management, transparency requirements, accessing outside capital, and strategies for succession planning and conflict resolution, this study advocated the introduction of a separate approach to the creation of corporate governance guidelines. It is important, particularly in view of the need for more professionally managed non-listed businesses, to produce measures that are sufficiently attractive and coherent from a cost-benefit perspective to persuade non-listed companies to opt into a well-tailored framework of legal mechanisms and norms.

Thus, such an optional set of recommendations could not only play a pivotal role in the awareness creation of the importance of good corporate governance practices, but also contain provisions about the benefits of educating and training board members and shareholders to become competent and reliable players in non-listed companies. Such measures are reflected in levels 2 to 4 in the *Table 4*. Despite the prospective benefits of these guidelines, empirical research is needed to confirm the anticipated productivity effects, discussed earlier in this study, for non-listed companies overall. In this regard, an important starting point for such work would be to analyze the implementation of the recent recommendations introduced by standard-setting institutions, such as the Belgian Buysse committee and the European Venture Capital Association. Clearly, non-listed companies that operate under a well-designed and effective governance structure are likely to perform better and consequently will be more attractive to external investors.

Endnotes

1 During the internet bubble, important ingredients for market failure were present: (1) corporate malfeasance, (2) conflict of interests, (3) lack of oversight and (4) inconsistent controls. Many financial crises followed – for instance, Enron, Adelphia Comm., HealthSouth, Worldcom, Parmalat, Ahold, Shell, and Vivendi. New internet opportunities combined with opportunism, abundant capital investments and reduced transaction costs through online trading caused unrealistic investor expectations. The use of off-balance sheet transactions with special purpose vehicles made effective supervision almost impossible.

2 Cf. OECD Principles of Corporate Governance (2004).

3 Shareholders who are prepared to undertake the financial risk are not necessarily equally suited and talented to make the appropriate management decisions about the allocation of the firm's resources.

4 Rational shareholders have incentives to free-ride on the costly monitoring efforts of other shareholders. Attempts to engage in collective monitoring will therefore fail if a few shareholders bear the entire cost, but receive only a portion of the benefits.

5 This figure can be downloaded by using the following link:
http://www.encycogov.com/A0BigPicture/1CorpGovProblem/Exhi_1CorpGovProblem.asp

6 Cf. Milgrom, P.R., North, D.C., and Weingast, B.R. (1990), The Role of Institutions in the Revival of Trade: the Law Merchant, Private Judges, and the Champagne Fairs, Economics and Politics 2: 1-23.

7 See Berman, H.J. (1983), Law and Revolution, The Formation of the Western Legal Tradition, Cambridge: Harvard University Press.

8 Initially, the Vereenigde Oostindische Compagnie would have a limited lifespan of 20 years – upon which the proceeds of the VOC would be distributed back to the shareholders. However, this proved impractical and its directors continued the duration of the venture until the end of the VOC in 1799.

9 See De Jong, A. and Röell, A. (2004), Financing and control in The Netherlands: an historical perspective, Paper prepared for NBER History of Corporate Ownership conference.

10 The seventeen seats of the Board were held by representatives of the six cities with a VOC Chamber: Amsterdam, Middelburg (Zeeland), Rotterdam, Delft, Enkhuizen and Hoorn. As Amsterdam's Chamber held 8 seats, it 'controlled' the agenda-setting and decision-making process in the meetings.

11 'Chief participants' were investors with a significant stake in the venture – more than 6,000 Dutch Florins.

12 Of course, the governance structure was exacerbated by the fact that long distance and limited communication means hampered the conceyance of decisions and information.

13 This figure can be downloaded by using the following link:
http://www.tanap.net/content/voc/appendices/voc_general.htm

[14] The Mississippi Company and South Sea Company were devised by financial geniuses and promoted by the British and French governments to buy the national debt of the respective countries. The governments granted a charter to the Companies so as to facilitate the issuance of shares to the public in exchange for government bonds. The companies held all the debt with reduced interest rates (which the governments procured in exchange for generous monopoly grants).

[15] Economic theories show that integration of ownership and control limits the benefits of specialization in the firm's decision-making and induces free-riding behaviour among the business parties. See, e.g., Alchian, A.A. and Demsetz, H. (1972), Production, Information, and Economic Organization, American Economic Review 62: 777-785; Fama, E.F. and Jensen, M.C. (1983), Separation of Ownership and Control, Journal of Law & Economics 26: 301-325.

[16] Limited liability was not an automatic consequence of the concept of the corporation as a separate legal person. Substantial industrial developments took place under a legal regime imposing liability on business parties for corporate debts and obligations. Limited liability emerged in the United States around 1825 and in England in 1855 and is a result from lobbying activities by high-powered industrial and political interest groups. Before that time firms attempted to obtain limited liability protection by employing a variety of devices, such as contractual clauses and insertion of the term 'limited' after the firm's name.

[17] See Blumberg, P.I. (1986), Limited Liability and Corporate Groups, Journal of Corporation Law 11: 573-631.

[18] See Rock, E.B. and Wachter, M.L. (2000), Corporate Law as a Facilitator of Self Governance, Georgia Law Review 34: 529-545.

[19] Initially, shareholders could remove board members only for cause. Law has evolved since, and most corporate laws around the world permit the shareholders to remove a board member without cause. Cf. Cary, W.L. and Eisenberg, M.A. (1988), Corporations, Cases and Materials, University Casebook Series, Westbury NY: The Foundation Press.

[20] See Berle, A.A. and Means, G.C. (1933), The Modern Corporation and Private Property (rev. ed. 1991).

[21] The Securities Exchange Act of 1934 extended the "disclosure" requirements to securities listed and registered for public trading on the U.S. securities exchanges. In 1964, the Securities Act Amendments extended disclosure and reporting provisions to equity securities in the over-the-counter market.

[22] For instance, it is argued that the 'market-for-corporate-control' adequately aligns the interest of managers and shareholders. By providing a constant and credible risk of hostile acquisitions, the takeover market creates a powerful incentive for managers to restrain from managerial self-dealing, thereby creating shareholder value. A high share price prevents hostile takeovers and the subsequent dismissal of the management board members.

[23] See Romano, R. (2005), The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, Yale Law Journal 114: 1521-1606.

[24] Congress introduced the Sarbanes-Oxley Act of 2002 (the Act) in response to the deficiencies in the US corporate governance system exposed by Enron. The Act mandates changes in the oversight of the accounting profession and requires CEOs and CFOs to certify, on pain of criminal penalties, their firm's periodic reports and the effectiveness of internal controls, the prohibition of corporate loans to officers or directors, restrictions on stock sales by executives during certain blackout periods, and requiring firms to establish an independent audit committee, of which at least one member must be a financial expert. Many of the measures are meant to deter earnings management and other forms of opportunism. For example, the certification requirement and restrictions on insider trading will certainly strengthen corporate governance, but may also create some unintended effects (diminished liquidity in company shares). Other requirements on off balance sheet financing and special purpose entities are crucial to limiting balance sheet manipulation. The most important changes concern independent audit committees and limitations on the provision of non-audit services.

[25] Davies, P.J. (forthcoming 2006), 'Enron and Corporate Law Reform in the UK and the European Community in Armour' in J. Armour and J.A. McCahery (eds.) After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US, Oxford: Hart Publishing.

[26] Communication from the Commission to the Council and the European Parliament, Reinforcing the statutory audit in the EU COM(2003) 286 final [2003] OJ C236/2.

[27] Communication from the Commission to the Council and European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward COM(2003) 284 final 21 May 2003.

[28] Communication from the Commission to the Council and European Parliament, On Preventing and Combating Corporate and Financial Malpractice COM(2004) 611 final 27 September 2004.

[29] See Enriques, L. (2005), Bad Apples, Bad Oranges: A Comment From Old Europe on Post-Enron Corporate Governance Reforms, Wake Forest Law Review 38: 911-934.

[30] Report on the proposal for a European Parliament and Council regulation on the application of international accounting standards (COM(2001) 80 – C5-0061/2001 –2001/0044 (COD)); Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC, 83/349/EEC and 91/674/EEC on the annual and consolidated accounts of a certain type of companies and insurance undertakings COM(2002) 259 final 2002/0112 (COD).

[31] Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC concerning the annual accounts of certain types of companies and consolidated accounts.

[32] It appears that many jurisdictions attempt to encourage good governance not only via changes in their corporation and securities laws, but also through the introduction of more enabling corporate governance codes. Nevertheless, the enabling legal mechanisms that could discipline opportunistic behaviour and provide minority shareholders with greater protections might not always be sufficient. To be sure, it is submitted that these codes could create awareness around corporate governance issues. However, since application of corporate governance codes in practice rather

than in books is important, it is argued here that a set of principles will not always sort the coveted effect of protection. For instance, the judiciary might, for several reasons, be unable to monitor and enforce good governance. Because the judiciary is not able to observe and verify opportunistic behaviour by shareholders, due to time constraints and the lack of precedents, the legislators must occasionally provide an update in order to satisfy demand-side pressures from firms. Professors Black and Kraakman – Black, B. and Kraakman, R. (1996), A Self-Enforcing Model of Corporate Law, Harvard Law Review 109: 1911-1982 – have developed a 'self-enforcing' approach to drafting corporation law. They propose a rule requiring shareholder approval for self-interested transactions. By offering clear and bright-line rules for an internal approval procedure, company law would 1) increase the available information for shareholders, and 2) prevent the need for judicial interpretation, which is often unavailable and unreliable. In order to be effective and efficient in the long run, the corporation law statute should not only describe and classify precisely the transactions that need approval, but also the formal legal procedure that has to be followed. In this way, corporation law would be brought into step with prevailing corporate governance values. The supply of clear and simple rules will arguable be regarded as value-enhancing (Easterbrook, F.H. and Fischel D.R. (1991), The Economic Structure of Corporate Law, Cambridge: Harvard University Press).

[33] See Coombes, P. and Chiu-Yin Wong, S. (2004), Why codes of governance work, The McKinsey Quaterly 2004 Number 2).

[34] Illustrative for this is the report of the Dutch Monitoring Committee Corporate Governance Code, which monitored the operation of the Dutch Corporate Governance Code and its implementation by listed companies and shareholders. The Monitoring Committee Corporate Governance Code was installed by the Ministry of Finance on 6 December 2004 – approximately one year after the introduction of the Code. In its report of 20 December 2005 the Committee concludes that listed companies conform largely to the Code's provisions. However, some argue that the Committee conducted its survey by mere "box-ticking" which resulted in a too positive view.

[35] Cf. McCahery, J.A. and Vermeulen, E.P.M. (with Hisatake, M. and Saito, J.) (2006), Path Dependence versus Innovation: New Business Organization Law in Japan, working paper.

[36] In emerging markets and transition economies, corporate governance is still very much orphaned as a research topic. What little research there is has a blueprint-oriented approach to devising corporate governance codes. The haphazard transplantation of foreign corporate governance mechanisms without first assessing the conditions required for their effective functioning is a futile attempt to improve a country's investment climate. In order to be effective, a borrowed legal rule or standard must be understood and appreciated by domestic lawmakers, law enforcers and other legal and economic actors. See also infra note 40.

[37] See Bebchuk, L.A. and Roe, M.J. (1999), A Theory of Path Dependency in Corporate Ownership and Governance, Stanford Law Review 52: 127-170.

[38] See Bratton, W.W. and McCahery, J.A. (1999), Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference, Columbia Journal of Transnational Law 38: 213-297.

[39] Another example of 'inefficient convergence' is the worldwide prominence given to the independent members of the management board. However, independence of boards is less relevant for emerging and transition markets due to the presence of controlling shareholders desiring to run the firms. It is argued that best practice principles in these countries should focus on more basic norms that help improve the timely dissemination of information and minimize opportunistic behaviour by the controlling shareholder. See Coombes, P. and Chiu-Yin Wong, S. (2004), Why codes of governance work, The McKinsey Quaterly 2004 Number 2).

[40] See Bamford, J. and Ernst, D. (2005), Governing joint ventures, The McKinsey Quaterly 2005 special edition: Value and performance.

[41] See Williamson, O.E. (1985), The Economic Institutions of Capitalism, New York: The Free Press.

[42] Lawyers and legal counsel are usually focused on limiting risks and creating future options for their clients. This scope is considered to be too narrow in the process of crafting joint venture and strategic alliance agreements. Managers argue that lawyers' concerns about, for instance, (1) a broadly defined scope and (2) a 50-50 joint venture are exaggerated. In the managers' view, these elements are needed so as to encourage the necessary trust and independence of the joint venture. See Ernst, D. et al (2003), Crafting the Agreement – Lawyers and Managers, in Bamford, J.D. et al, Mastering Alliance Strategy, A Comprehensive Guide to Design, Management, and Organization, San Francisco: Jossey-Bass: 88-106. See also Lewis, J.D. (1999), Trusted Partners: How Companies Build Mutual Trust and Win Together, New York: The Free Press.

[43] People intend to act rationally, but they are simply not able to foresee and describe all future contingencies in a contract. As a consequence, economists claim that people are 'boundedly rational'.

[44] Typically 'non-law-and-economics' scholars make the routine mistake of assuming that business parties are only influenced by distorted tax measures provided by rent-seeking jurisdictions. While this often occurs in practice, it nevertheless provides no basis for the efficient selection of corporate forms. Tax reforms aiming at the neutralization of legal business forms by pursuing equality of tax treatment, independent of the business form, may stimulate the creation and introduction of more efficient legislation. For instance, the federal 'check-the-box' tax regulations (Treas. Reg. §§ 301.7701-1 to 3, 61 Fed. Reg. 66,584 (1996)), under which unincorporated associations are taxed as partnerships unless they affirmatively elect to be taxed as corporations, appear to be responsible for the rapid development of more flexible and innovative legal business forms in the United States.

[45] See Doing Business in 2004, Understanding Regulation, A copublication of the World Bank, the International Finance Corporation and Oxford University Press.

[46] See Lutter, M (1998), Limited Liability Companies and Private Companies, in D. Vagts (ed.), Business and Private Organizations, International Encyclopedia of Comparative Law Vol. XIII Chapter 2, Tübingen: Mohr Siebeck.

[47] For instance, in the United States and Germany, the judiciary has viewed the close corporation as a 'quasi-partnership'. See Donahue v Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975) and, to a lesser extent, Wilkes v Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976). In Germany, the German Supreme Court imposed a broad fiduciary duty on controlling shareholders of the German close corporation – Gesellschaft mit beschränkter Haftung (GmbH) – in the ITT case (BGH 5 June 1975, BGHZ 65, 15 (ITT).

[48] See Case C-212/97 Centros Ltd v Erhvervs- og Selskabsstryelsen [1999] ECR I-1459; Case C-208/00 Überseering BV v Nordic Construction Co Baumanagement GmbH; Case C-167/01 Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd.

[49] See Bankman, J. (1994), The Structure of Silicon Valley Start-ups, UCLA Law Review 41: 1737-1768.

[50] In contrast, a US non-listed company which has total assets exceeding $10,000,000 and more than five hundred shareholders must publish its accounts (Securities Exchange Act of 1934 §12(g)).

[51] Some smaller enterprises are exempted from the publication of certain information.

[52] International Accounting Standards (IASs) are developed by the International Accounting Standards Committee (IASC), whose purpose is to develop a single set of global accounting standards. Further to the restructuring of the IASC, the new Board on 1 April 2001, as one of its first decisions, renamed the IASC as the International Accounting Standards Board (IASB) and, as far as future international accounting standards are concerned, renamed IAS as International Financial Reporting Standards (IFRS). These standards should, wherever possible and provided that they ensure a high degree of transparency and comparability for financial reporting in the Community, be made obligatory for use by all publicly traded Community companies.

[53] IAS 24.22.

[54] The recent proposal to amend the Fourth and Seventh Directives in relation to related parties proposes an extension of IAS 24 to smaller non-listed companies. EC regulators defend the requirement on the grounds that: 1) related party transactions are very often material for non-listed companies; and 2) disclosure would not be too cumbersome, as these firms usually do not have complicated off-balance sheet arrangements.

[55] For example, Delaware company law provides (Del. Code Ann. Tit 8 §220(b) (1998): 'Any stockholder, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose the corporation's stock ledger, a list of its stockholders, and its other books and records, and to make copies or extracts therefrom.' A proper purpose shall mean a purpose reasonably related to such person's interest as a stockholder.' Engaging in information gathering about opportunistic transactions influenced by the controlling shareholder are obviously 'proper purposes' under Delaware law.

[56] See Charkham, J. (2005), The 8P's of Reporting, in International Corporate Governance Network (ICGN), 2005 Yearbook: 26-27.

[57] See, for instance, Sang-Woo Nam and Il Chong Nam (2004) (noting that in Thailand, Indonesia and the Republic of Korea, only a few firms adopted this mechanism after it had been enacted). Cumulative voting allows shareholders to multiply the number of share owned by the number of board of director positions to be voted on, and then cast that number for one or more directors.

[58] See Rock, E.B. and Wachter, M.L. (1999), Waiting for the Omelet to Set: Match-specific Assets and Minority Oppression in Close Corporations, Journal of Corporation Law 24: 913-948; Rock E.B. and Wachter, M.L. (2000), Corporate Law as a Facilitator of Self Governance, Georgia Law Review 34: 529-545.

[59] Dominant shareholders may use the issuance of new shares to expropriate private benefits from the minority shareholders. See Sang-Woo Nam and Il Chong Nam (2004) (stating that the pre-emptive rights were not well protected in the East Asian countries until very recently).

[60] See Paredes, T.A. (2004), A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't The Answer, Washington University in St. Louis, School of Law, Faculty Working Papers Series, Paper No, 04-02-01.

[61] Derivative suits are brought by one or more shareholders in the name of the company and for the benefit of the company as a whole, and are an exception to the usual rule that a company's board of directors manages the company affairs.

[62] See, e.g., sections 335-343 of Book 2 of the Dutch Civil Code (providing rules of disputes in closely corporations); section 459 of the UK Companies Act (stating that a member of a company may file a petition for a buyout remedy 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 some part of the members or that any actual or proposed act or omission of the company is or would be so prejudicial); Model Business Corporation Act §14.30(2) (stating that a court may dissolve a corporation in a proceeding by a shareholder in the event of a corporation being deadlocked in decision-making issues regarding the corporate affairs).

[63] See Klein, W.A. and Coffee, J.C. jr. (1996), Business Organization and Finance, Legal and Economic Principles, Westbury: The Foundation Press.

[64] See Elstrod, H-P (2003), Keeping the family in business, The McKinsey Quaterly 2003 Number 4.

[65] See Kortum, S., and Lerner, J. (2000), Assessing the Impact of Venture Capital on Innovation, Rand Journal of Economics 31: 674-692.

[66] See Audretsch, D.B., and Thurik, R., 2001 Linking Entrepreneurship to Growth, Organization for Economic Cooperation and Development, STI Working Paper.

[67] See Sahlman, W.A. (1990), The Structure and Governance of Venture-capital Organizations, Journal of Financial Economics 27: 473-521

[68] The market model of corporate governance is found in the United States and the United Kingdom. The control model prevails in Asia, Latin America and much of continental Europe. See Coombes, P. and Watson, M. (2001), Corporate reform in the developing world, The McKinsey Quaterly 2001 Number 4: Emerging Markets.

[69] Cf. Miller, R. et al (1997), International Joint Ventures in Developing Countries, Finance & Development, March 1997.

[70] For instance, the Buysse Code contains a general recommendation on succession planning in family firms by stating that '[t]he timely organization, proper preparation and careful accompaniment of a succession is one of the most crucial processes in the family business' which must be addressed in a professional matter. It does not provide more concrete guidelines that could be considered to safeguard the family's interests in the long term.