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**THE US LIMITED LIABILITY COMPANY:
A ROLE MODEL
FOR GERMAN COMPANY LAW**

LLM RESEARCH PAPER

ADVANCED LEGAL WRITING (LAWS 582)

**LAW FACULTY
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2003

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ABSTRACT

German company law is said to offer small and medium-sized businesses that strive for limited liability a burdensome and inflexible business form: the *Gesellschaft mit beschränkter Haftung* (GmbH). Critics point to the success of the US Limited Liability Company (LLC), which combines corporate-like limited liability protection and the tax treatment and flexible entity-governance of a partnership. This paper argues that an LLC-like business form is urgently needed in Germany.

First, the historical roots of the US LLC will be illustrated as well as the role of the new entity in the context of US and German company law. The focal point of the paper is a comparative analysis of GmbH and LLC. This will include a discussion of powers, liability, taxation, formation procedures, management and member issues, and a detailed analysis of capital requirements revealing that the LLC offers a far more convenient regime for small and medium-sized businesses.

Consequently, this paper concludes that an LLC-like business form should be available to German businesses. As reforms at the European level would take too long to be realised, a new company form needs to be implemented in Germany.

STATEMENT ON WORD LENGTH

The text of this paper - excluding table of contents, abstract, footnotes, bibliography and appendices - comprises approximately 12,478 words.

I INTRODUCTION

The *Gesellschaft mit beschränkter Haftung* (GmbH) has turned out to be the preferred business form for small and medium-sized firms in Germany that strive for limited liability. However, the GmbH burdens small and medium businesses with a variety of regulatory requirements, which inevitably cause them to incur substantial costs in carrying out their normal business activities.

A Recent Developments In Company Law

Some scholars have already pointed to the success of the Limited Liability Company (LLC) in the US as a role model for German reform.¹ The idea of coupling limited liability protection with preferential tax treatment and flexible entity governance compelled States in the US to enact new legislation leading to fundamental changes in company law. The LLC emerged as a new business form combining the best of both worlds, meaning the advantages of a corporation (limited liability) and the advantages of a partnership (taxation, flexibility).

In addition to creating the LLC as a completely new business form, US States have also modified traditional partnerships by mutating them to Limited Liability Partnerships (LLPs). Once registered as an LLP, limited liability protection is granted to owners that have historically faced unlimited liability. Only recently, the UK followed the US lead and enacted the Limited Liability Partnerships Act.²

¹ Joseph A McCahery and Eric P M Vermeulen "Unincorporated Business Entities: The Evolution of Closely Held Business Forms in Europe" (2001) 26 Iowa J Corp L 855; Stephen L Wright and Eva M Holland "Neue Wege im Gesellschaftsrecht der USA: Die Limited Liability - Company (LLC) am Beispiel des Bundesstaates Georgia" (1996) 1996 NJW 95.

² The Limited Liability Partnerships Act 2000 (UK) is available online at <http://www.legislation.hmso.gov.uk/acts/acts2000/20000012.htm> (last accessed 25 September 2003). Although in its origins the UK LLP is similar to the US LLP, the actual legal form rather resembles the US LLC: Judith Freedman "Limited Liability Partnerships in the United Kingdom - Do They Have a Role for Small Firms?" (2001) 26 Iowa J Corp L 897, 899; Matthias Kilian "Die limited liability partnership - Eine neue Gesellschaftsform im britischen Recht" (2000) 2000 NZG 1008, fn 18.

These developments in the US and the UK eliminated the traditional choice that businesses had to make between limited liability and the tax treatment of a partnership. As a Delaware court stated: "Long gone are the days when business planners were confined to corporate and partnership structures."³

Measured by popular acceptance, all these reform efforts have been extremely successful.⁴ Practitioners are using the new business forms without any apparent hesitation. The reforms have similarly found great support in legal scholarship. Both the LLC and LLP are widely regarded as the product of a selective process, in which new business forms are created and traditional forms are modified as part of a movement towards wider availability of limited liability. It is maintained that competition between legal jurisdictions has led to a "race to the top" in the production of efficient business forms.⁵ However, this view is not unchallenged. In opposition to the prevailing opinion in academia, some legal scholars argue that interfusing corporate and partnership law principles does not create new coherent entities but business forms burdened with many disadvantages. Consequently, the new business forms might result from a "race to the bottom".⁶

B Reform Need In German Company Law

The evaluation of the aforementioned reforms leads back to the starting point, the burdensome complexity of German company law. Large companies have the resources to cope with inconvenient statutory provisions. However, for small and medium-sized enterprises it is of the utmost importance that German law provides the GmbH as a highly developed business form, but at present limited liability is cumbersome and expensive to achieve. Therefore, creating a new simplified regime could satisfy the needs of a range of small and medium-sized firms and also lead to an increase in the number of start-up firms.

³ The cited phrase can be found in the obiter dicta of *ELF Atochem North America, Inc v Jaffari and Malek LLC* (1999) 727 A2d 286, 290 (Del). In this case, a member had brought a derivative suit against an LLC and its manager, alleging, inter alia, breach of fiduciary duty. However, the suit was dismissed for lack of subject matter jurisdiction.

⁴ Charles W Murdock "Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future" (2001) 56 Bus Law 499; Joseph A McCahery and Eric P M Vermeulen "Unincorporated Business Entities: The Evolution of Closely Held Business Forms in Europe" (2001) 26 Iowa J Corp L 855, 856.

⁵ Joseph A McCahery and Eric P M Vermeulen "Unincorporated Business Entities: The Evolution of Closely Held Business Forms in Europe" (2001) 26 Iowa J Corp L 855, 856.

⁶ "Unincorporated Business Entities: The Evolution of Closely Held Business Forms in Europe" (2001) 26 Iowa J Corp L 855, 856.

The emerging question is whether Germany should follow the US and UK lead and implement a new business form, thus extending the menu of available business forms. This research paper focuses on the US LLC as a possible role model. Nevertheless, where appropriate the US LLP as well as the UK LLP will be considered. As far as the US LLC is concerned, this paper will mainly deal with the state legislation in Wyoming. As far as case law is concerned, other LLC statutes and the Uniform Limited Liability Company Act (ULCCA) will also be considered.

The paper briefly outlines the history of LLC legislation in the US (II). The LLC will then be distinguished from other US business forms in order to categorise this new company form (III). Next, German law is introduced by asking whether there is a German business form that resembles the US LLC (IV). As there is no business form completely identical, it will be discussed whether Germany should adopt the US approach. Here, a comparison is drawn between the US LLC and the most appropriate German counterpart, the GmbH (V). This comparison will point out similarities and differences with regard to powers, liability, taxation, formation, and capital requirements. Furthermore, management- and member-related issues come up for discussion. Finally, this paper concludes that a new business form in Germany is urgently needed. This conclusion is based upon the aforementioned comparison, which proves that the LLC provides a far more flexible and convenient business form for small and medium-sized businesses (VI).

⁶ Allan Vestal and William Callison „They’ve Created a Lamb with Mandibles of Death: Secrecy, Disclosure, and Fiduciary Duties in Limited Liability Firms“ (2001) 76 Ind L J 271, 274.

II HISTORY OF LLC LEGISLATION IN THE US

The term "limited liability company" first appeared in a US Supreme Court decision in 1891.⁷ While today's LLC may not be the same business entity as the limited liability company described in this decision, the concept of limited liability remains the same. Nevertheless, the advantage of limited liability protection was soon depreciated by disadvantages in tax law as the Revenue Act 1913⁸ started to tax the income of corporations, but not the income of partnerships. The system of double taxation for corporations introduced by this Act can be seen as one of the dominant factors for the emergence of the LLC more than 60 years later.

Regarding today's LLC, everything started with Hamilton Brothers Oil. This Denver-based but internationally operating company mainly used the Panamanian Limitada for its business activities. The Panamanian Limitada offered limited liability and partnership classification for US income tax purposes. However, it had the disadvantage of a complex administrative structure. Furthermore, it was not ensured that US courts would acknowledge the liability protection.⁹ On account thereof, the legal advisers of Hamilton Brothers Oil invented the concept of the LLC and first presented it to the Alaska legislature in 1975. After Alaska refused to implement new legislation, Hamilton Brothers Oil approached Wyoming. Here the lobbying was successful.¹⁰ In 1977, Wyoming enacted the new concept, thus becoming the first state in the US providing the LLC form.¹¹

Florida followed in 1982,¹² but the LLC did not attract much attention, as the Internal Revenue Service (IRS) first was reluctant to acknowledge partnership status. For the IRS, limited liability seemed to be inevitably bound to the classification as a corporation. Eventually in 1988, the IRS issued a ruling stating that limited liability

⁷ *Case Manufacturing Co v Soxman* (1891) 138 US 431, 435. Here, the US Supreme Court upheld the statutory liability limitations of a Pennsylvanian entity known as Latrobe Milling Company, Ltd.

⁸ For details regarding the Revenue Act 1913, see Susan Pace Hamill "The Origins Behind the Limited Liability Company" (1998) 59 Ohio St LJ 1459, 1501, 1502.

⁹ Very detailed on the Latin Limitada, Susan Pace Hamill "The Origins Behind the Limited Liability Company" (1998) 59 Ohio St LJ 1459, 1464.

¹⁰ For more details see Warren H Johnson, "Limited Liability Companies (LLC): Is the LLC Liability Shield Holding Up Under Judicial Scrutiny?" (2000) 35 New Eng L Rev 177, FN 50.

¹¹ Wyoming Limited Liability Act, ch 158, 1977; codified at Wyo Stat Ann, ss 17-15-101 to -143.

¹² Florida Limited Liability Company Act, ch 82, 1982; codified at Fla Stat Ann, ss 608.401-471.

protection by itself would not lead to corporate taxation.¹³ The IRS referred to the four corporate characteristics as mentioned by the US Supreme Court in the *Morrissey Case*,¹⁴ these being continuity of life, centralised management, free transferability of interests, and limited liability. The IRS pointed out that each of the four characteristics had equal weight. Consequently, the absence of at least two of the four corporate attributes would ensure taxation of the LLC as a partnership.

The Wyoming LLC lacked continuity of life and free transferability of interests. Thus, a Wyoming LLC would always be treated as a partnership for tax purposes. However, such a bulletproof LLC statute limited the member's flexibility. To ensure the characteristics important for partnership taxation, many of the statute's provisions needed to be mandatory, thus reducing flexibility. For instance, members were not able to depart from partnership-like shares in order to establish shares as easily transferable as corporate shares.

Nevertheless, after the 1988 IRS ruling the number of LLC filings in Wyoming and Florida increased. In addition, more and more states decided to join the LLC movement. In 1994, the National Conference of Commissioners approved the Uniform Limited Liability Company Act (ULLCA).¹⁵ This Act served as a model law for some states. By 1995, every US State had enacted its own LLC statute.¹⁶ Some States followed the Wyoming and Florida lead in enacting bulletproof LLC statutes. Others decided to start the second generation of LLC statutes. These more flexible statutes provided members with options concerning continuity of life, management and transferability of interests. However, they had the disadvantage that an LLC making use of these options might not have been taxed as a partnership.

¹³ Rev Rul 88-76, 1988-2 CB 360.

¹⁴ *Morrissey et al v Commissioner* (1935) 296 US 344. This case primarily deals with trust issues. It was held that a business profit objective is not characteristic of an ordinary trust.

¹⁵ The ULLCA is based on a combination of provisions relating to characteristics of other uniform acts, in particular the general partnership models, the limited partnership model, and the corporate models. Furthermore, it combines features of the Wyoming statute, the Delaware model and the "Prototype" LLC Act developed in 1992 by a working group of the American Bar Association.

¹⁶ Robert W Hamilton *Cases and Materials on Corporations Including Partnerships and Limited Liability Companies* (7 ed, St Paul, Minnesota, 2001) 188. See Appendix 1.

Taking effect on 1 January 1997, the IRS introduced the "check-the-box" regulations. These new rules eliminated the traditional corporate attribute analysis as outlined above. It was no longer necessary to negate such corporate characteristics as continuity of life, centralised management or transferability of interests in order to be treated as a partnership for federal tax purposes. At the time of filing or shortly afterwards, the LLC could now simply elect to be classified as a corporation or a partnership for tax purposes. Even if no choice is made at all, the LLC will be automatically treated as a partnership in most cases. The "check-the-box" regulations thus have expanded the options and led to the third generation of LLC statutes being able to provide even more flexible rules.

III THE LLC IN THE CONTEXT OF US COMPANY LAW

It has already been implied that the US LLC is not a modification of traditional business forms, but represents the creation of a new company form. There is a need to distinguish this new form from other traditional US business forms, and consider the similarities and differences.¹⁷ However, the precise legal classification of the LLC is highly controversial.

A US Corporate Law

For various purposes, courts have held the LLC to be a corporation.¹⁸ At first sight, this might be appealing, as both the LLC and all forms of corporations enjoy limited liability protection. However, corporations are generally taxable at the entity-level, thus not benefiting from pass-through taxation as the LLC.¹⁹ The Close Corporation may allow shareholders to dispense from various corporate formalities, but is still subject to double taxation.²⁰ Though double taxation can be

¹⁷ See Appendix 2.

¹⁸ In *Fraser v Major League Soccer, LLC* (2000) 97 F Supp 2d 130, 135 (Mass), an LLC was treated as a corporation with regard to antitrust law: "The cases do illustrate how courts generally understand the LLC structure to be like that of a corporation and generally apply legal rules applicable to corporations to LLCs...In the present context, there is little reason to treat an LLC differently from a corporation." In addition, some courts have held that LLCs more closely resemble corporations than partnerships in non-antitrust contexts as well. For instance, in *Exchange Point LLC v US SEC* (10 June 1999) WL 386736 at 3 (NY) the court held that an LLC is more similar to a corporation than a partnership and thus not a person for the purposes of the Right to Financial Privacy Act of 1978.

¹⁹ For a more extensive look at US tax law, see part V B 2 of this paper.

²⁰ Robert W Hamilton *Cases and Materials on Corporations Including Partnerships and Limited Liability Companies* (7 ed, St Paul, Minnesota, 2001) 163.

avoided if incorporating as an S Chapter Corporation, contrary to the LLC, the S Chapter Corporation features a broad range of restrictions. For instance, the number of shareholders is limited to 75 and shareholders must either be US citizens or permanent residents.²¹ Therefore, no type of corporation can claim to resemble the LLC in general terms.

B US Partnership Law

For some purposes, courts have also held the LLC to be a partnership.²² It is emphasised that both the LLC and all partnerships enjoy pass-through taxation. However, all forms of partnership have at least one, but mostly more distinguishing features.

In contrast to a general partnership, an LLC cannot be implied at law or exist by estoppel.²³ Furthermore, unlike LLC members all partners are personally liable for the entity's debts. Liability also differentiates the limited partnership. In a limited partnership, at least one partner, the general partner, is personally liable. In comparison, all LLC members and managers enjoy limited liability protection. Finally, the LLC features various differences with regard to the LLP.²⁴ The LLP is a modified traditional partnership form, where a general partnership can register to provide all partners with limited liability protection. Traditionally, the LLP form was reserved for professionals, whereas today most states have opened it up to all kinds of businesses. The LLP is not only bound to partnership law, but there is also an abundance of technical differences compared to the LLC.

²¹ Robert W Hamilton *Cases and Materials on Corporations Including Partnerships and Limited Liability Companies* (7 ed, St Paul, Minnesota, 2001) 163.

²² In *Cosgrove v Bartolotta* (1998) 150 F 3d 729, 731 (Wis), the court had to decide whether an LLC is a citizen of the state. The court held that "given the resemblance between an LLC and a limited partnership...we conclude that the citizenship of an LLC...is the citizenship of its members." This has been confirmed in *JMTR Enterprises, LLC v Duchin* (1999) 42 F Supp 2d 87, 94 (Mass). Here the court held that "there is no justification for treating a limited liability company like a corporation."

²³ Jacob Rabkin et al *Current Legal Forms with Tax Analysis* (New York, 2002) s 18A.01.

²⁴ Texas enacted the first LLP statute in 1991 in response to lawyers being subject to enormous claims because of their involvements in the savings and loan crisis in the 1980s. By 1999, all states had enacted statutes authorising LLP registration. See for example Wyoming Registered Limited Liability Partnership Act, codified at Wyo Stat Ann 1977, ss 17-21-1101 to -1106. For a detailed comparison of LLC and LLP see Fallany O Stover and Susan Pace Hamill "The LLC Versus LLP Conundrum: Advice for Businesses Contemplating the Choice" (1999) 50 Ala L Rev 813.

In conclusion, it has been shown that the LLC combines both corporation and partnership characteristics.²⁵ For some purposes it is held to resemble a corporation, for some purposes it is rather treated as a partnership. Therefore, it is difficult if not impossible to classify this business entity exclusively as a form of corporation or partnership. However, there is no need for such a classification. The LLC is neither a corporation nor a partnership. It has emerged as a new and independent business form. It cannot be slotted to the traditional categories, but creates a new category in US business law.²⁶ In summary: "The allure of the limited liability company is its unique ability to bring together in a single business organization the best features of all other business forms, - properly structured, its owners obtain both a corporate-style liability shield and the pass-through tax benefits of a partnership."²⁷

IV THE LLC IN THE CONTEXT OF GERMAN COMPANY LAW

This paper argues that the US LLC should be used as a role model for German reform. The argument is based on the assumption that an LLC-like business form is currently missing in German company law. This assumption can be proven by comparing the US LLC to existing German business forms.

A German Corporate Law

The striking feature of the LLC is limited liability protection. As this attribute is traditionally linked to corporate law, the corresponding German business form could be a corporation, particularly the GmbH.²⁸

²⁵ In *Great Lakes Chem Corp v Monsanto Co* (2000) 96 F Supp 2d 376, 383 (Del), the purchaser of an LLC alleged securities fraud. It was held that interests in an LLC are not securities for the purposes of the federal securities law. As part of the obiter dicta, the court stated: "LLCs are hybrid entities that combine desirable characteristics of corporations, limited partnerships, and general partnerships."

²⁶ Warren H Johnson "Limited Liability Companies (LLC): Is the LLC Liability Shield Holding Up Under Judicial Scrutiny?" 35 New Eng L Rev 177, 181.

²⁷ *PB Real Estate, Inc V DEM II Properties* (1998) 719 A2d 73, 74 (Conn App Ct). Here, the court held that payments owners made to themselves from the company assets constituted distributions and are, therefore, subject to turnover orders. The above-mentioned citation is part of the obiter dicta.

²⁸ German company law recognises two forms of incorporation, the *Aktiengesellschaft* (AG) and the *Gesellschaft mit beschränkter Haftung* (GmbH). The AG was first regulated in the *Allgemeines Deutsches Handelsgesetzbuch* (ADHGB) of 1861, but outsourced to the *Aktiengesetz* (AktG) in 1937. The GmbH was introduced in 1892 by the *Gesetz betreffend die Gesellschaften mit beschränkter Haftung* (GmbHG). The basic difference is that the AG was designed to be a publicly traded company, whereas the GmbH was designed to be privately held. Both the AktG and the GmbHG can be found at <http://www.bundesregierung.de/-418/Gesetze.htm> (last accessed 25 September 2003).

The GmbH is sometimes even identified as one of the precursors of the US LLC, so it is no surprise that numerous courts and scholars actually see the GmbH as the German counterpart to the LLC.²⁹ However, such a classification evidently puts too much emphasis on liability. Liability protection is a dominant but not the exclusive feature of the LLC. It needs to be considered that the LLC is taxed as a partnership and exhibits a partnership-like governance regime. The GmbH, therefore, is not the corresponding business form in German law - at least from a purely theoretical viewpoint. Nevertheless, besides all theoretical differences the LLC and the GmbH address the same kind of entrepreneurs. Both business forms predominantly approach small and medium-sized businesses that strive for limited liability. Therefore, as far as a practical viewpoint is concerned, LLC and GmbH are comparable business forms.

B German Partnership Law

In particular when looking at tax treatment and flexible entity governance, the LLC may rather resemble a German partnership form. First, the general partnership (*BGB-Gesellschaft*; GbR) could be the corresponding form. A few years ago, this evaluation could be proved incorrect simply because - in contrast to the LLC - the GbR was widely denied legal capacity.³⁰ However, this has changed only recently. The Federal Court of Justice (*Bundesgerichtshof*; BGH) has adjudicated that the GbR, though not being a corporate body, possesses legal capacity for practically any purpose.³¹ Nevertheless, in a second judgment the BGH further decided that there is no way to limit liability in a GbR except by having an explicit agreement with the creditor.³²

²⁹ Karin Schwandt "Limited Liability Companies: Issues in Member Liability" (1997) 44 UCLALR 1541, FN 3. Warren H. Johnson "Limited Liability Companies (LLC): Is the LLC Liability Shield Holding Up Under Judicial Scrutiny?" 35 New Eng L Rev 177, FN 10. In *TMT North Am Inc v Magic Touch GmbH* (1997) 124 F3d 876, 879 (7th Cir), the court characterised a GmbH in the obiter dicta as "somewhat analogous to an American LLC."

³⁰ Peter Ulmer *Münchener Kommentar zum BGB* (3 ed, Beck, Munich, 1997) s 705, para 8; Egon Schneider "Tendenzen und Kontroversen in der Rechtsprechung: Die wachsende Bedeutung der GbR" (1998) 1998 MDR 690, 693.

³¹ BGH (2001) 2001 NJW 1056. The BGH had to decide whether a GbR has the capacity to sue and be sued. The BGH held that a GbR can take almost any legal position. For instance, a GbR can be partner to a contract or hold property. Furthermore, the BGH expressly acknowledged the GbR's capacity to sue and be sued.

³² BGH (1999) 1999 NJW 3483. In this case, the BGH had to decide whether the partners in a GbR are liable for business debts even though they included a clause in the partnership agreement that excludes their liability. The BGH held that such an exclusion clause is without any external effect.

Being a partner in a GbR, therefore, always results in personal liability. While, therefore, the GbR is not the corresponding company form, the counterpart of the US LLC could be the limited partnership (*Kommanditgesellschaft*; KG).³³ The KG is different from the LLC in that at least one partner, the general partner, is personally liable for the entity's debts whereas the LLC provides limited liability for all members. Over the years, however, German practitioners developed a special form of the KG, the GmbH & Co. KG.³⁴ It is possible to have a corporate body, for example the GmbH, as the only general partner. Because the GmbH shareholders all enjoy limited liability protection, there is no personal liability for the KG's debts. By using this legal construction, the benefit of limited liability can be combined with the advantages of pass-through taxation, this being similar to the US LLC. However, the GmbH & Co. KG suffers from a range of disadvantages. At the outset, when forming a GmbH & Co. KG two companies need to be established, a KG and also a GmbH. Furthermore, not only partnership law is to be applied. German courts additionally apply corporate principles and have developed a set of special rules.³⁵ Overall, the GmbH & Co. KG lacks much of the flexibility normally aligned with a partnership form. Therefore, though combining limited liability and pass-through taxation, it does not bear resemblance of the LLC.

Finally, the professional partnership (*Partnerschaftsgesellschaft*; PartG) might be the accurate counterpart of the LLC.³⁶ However, the PartG limits liability only in so far, as a partner is not liable for liability arising out of another partner's professional malpractice.³⁷ Secondly, the PartG exclusively applies to professional persons.³⁸ In respect of all that, the PartG features too many differences to be characterised as the corresponding business form of the LLC.

³³ The KG is governed by ss 161 to 177a *Handelsgesetzbuch* (HGB; Commercial Code). The HGB is available at <http://www.bundesregierung.de/Gesetze> (last accessed 25 September 2003).

³⁴ The GmbH & Co KG was first acknowledged by the *Bayerisches Oberstes Landesgericht*, the highest Bavarian state court, in 1912; federal courts looked at the GmbH & Co. KG as a permissible business form from 1922 on, RGZ 105, 101. For more details see Karlheinz Boujong et al *HGB* (Beck, Munich, 2001) s 16, para 14.

³⁵ Adolf Baumbach und Klaus Hopt *HGB* (3 ed, Beck, Munich, 2000) App s 177a, para 1.

³⁶ By enacting the *Partnerschaftsgesellschaftsgesetz* (PartGG) in 1995, the German legislator has created a new business form for the very first time since 1892, see see Peter Ulmer *Münchener Kommentar zum BGB* (3 ed, Beck, Munich, 1997) PartGG, paras 1 to 29. The PartGG is available at <http://www.bundesregierung.de/Gesetze> (last accessed 25 September 2003).

³⁷ S 8(I), (II) PartGG.

³⁸ S 1(I)(1) PartGG.

In conclusion, there is no German business form that completely corresponds to the US LLC. Similar to the analysis of US company law, the discussion of German law has shown that the LLC combines corporate and partnership attributes and, therefore, cannot be clearly allocated to either side. However, as already mentioned above, this is limited to a purely theoretical viewpoint. From a practical perspective, the GmbH certainly is the most appropriate counterpart. Thus, the following parts of this paper focus on comparing GmbH and LLC.

*V SHOULD GERMANY ADOPT THE US MODEL?*³⁹

The GmbH is Germany's preferred business form for small and medium-sized businesses that strive for limited liability. This paper argues that businesses should have an additional choice, an LLC-like company form. To prove the case for this thesis, a comparison is drawn between the GmbH and the LLC. Within the scope of the comparison, it will be seen that LLC and GmbH feature a number of similarities but predominantly striking differences. Those differences mainly turn out to be advantages of the LLC form. In particular flexible capital rules and the possibility of decentralised management will be identified as such advantages. The comparison of further issues, such as formation procedures, meetings and voting or profit distribution, also illustrates that the LLC form is the more convenient business form for small and medium-sized businesses.

A The Underlying Conflict

Most if not all advantages of the LLC arising within the scope of this analysis are to the benefit of the entrepreneur. However, aspects favouring the entrepreneur are often disadvantageous to the company's creditors. For instance, the absence of a minimum share capital requirement certainly benefits the entrepreneur, as he can set up a company with less capital. On the other hand, creditors face the disadvantage that there may be companies on the market with insufficient capital resources.

³⁹ According to the German Ministry of Justice, there is no need for a new business form. The PartG is supposed to be a suitable form for professionals whereas others can use the GmbH and the GmbH & Co. KG; this information was given in response to an e-mail-request to the Ministry of Justice on 11 April 2003.

Consequently, both sides of each aspect have to be taken into consideration. Only if the advantages for the businesses outweigh the disadvantages for the creditors, a point for law reform is made. The question of new regulations can, therefore, be explained in terms of a tradeoff between the need for creditor protection and the commitment to supply legal rules that enable owners to maximise wealth.⁴⁰

Nevertheless, the following analysis will show that the objective of creditor protection unreasonably prevails over business interests. Moreover, the protection mechanisms for creditors as part of German GmbH law are to a great extent ineffective. Therefore, the *current status* should not be retained. It is urgently necessary to implement a new LLC-like company form.

B Comparative Analysis Of GmbH And LLC

The following analysis comparing GmbH and LLC proves that the LLC provides a far more convenient business form for small and medium-sized businesses. The analysis is divided into six parts. A brief reflection on powers, liability and tax law is followed by an evaluation of formation procedures. Moreover, capital structure and management issues come up for discussion. Finally, member-related issues will be compared.

Supposedly, the extent of statutory regulation is a good starting point. The GmbHG comprises 114 provisions amounting to 12,771 words, whereas the Wyoming LLC statute only consists of 43 provisions totalling 8,462 words.⁴¹ When comparing the regulatory density, it needs to be considered that the LLC provisions contain more detailed language than the rather abstract GmbH provisions. The LLC statute, therefore, covers even less topical areas as suggested by the crude number of words. In contrast, the GmbHG sets up a far more extensive regime consisting of a broad range of mandatory provisions and statutory default rules. In regard to the GmbHG, non-compliance is much more likely to occur.

⁴⁰ Company Law Review Steering Group, Department of Trade and Industry *Modern Company Law for a Competitive Economy: Final Report* (2001), at http://www.dti.gov.uk/cld/final_report/index.htm (last accessed 25 September 2003).

⁴¹ As merger rules are not part of the GmbHG, the merger provisions of the LLC statute have not been included in this comparison. GmbH merger provisions are part of the *Umwandlungsgesetz* (UmwG), available at <http://www.bundesregierung.de/-/418/Gesetze.htm> (last accessed 25 September 2003).

1 Powers and liability

Both GmbH and LLC are separate legal entities that may acquire and hold property and can sue and be sued in their own name.⁴² However, differences as to the entity's powers occur when taking into account the *ultra vires* doctrine. This doctrine restricts the powers of a company. The company statute itself or the company's articles set out those acts that the company has the right and the scope to undertake. According to the *ultra vires* doctrine, any acts that fall outside those limits are void.⁴³ The *ultra vires* rule thus is a regulatory device, which prevents a company from entering into any type of transaction that exceeds the scope of the company's contractual capacity. The doctrine is not part of German corporate law.⁴⁴ It does, however, generally restrict the powers of US companies.⁴⁵ In this regard, the LLC is no exception. The powers of an LLC are subject to the limits established by the *ultra vires* doctrine. This is first indicated by an extensive list of company powers as included in the Wyoming LLC statute.⁴⁶ Such a list points to an active *ultra vires* doctrine, as it would make no sense to itemise specific powers if the company's powers are unrestricted. This finding is confirmed by case law.⁴⁷

The *ultra vires* doctrine has been developed to protect members against undesired business expansions. However, it is disadvantageous regarding the protection of legitimate and reasonable business relationships. Third party protection and contractual freedom argue for potentially unlimited company powers.⁴⁸

⁴² S 13(I) GmbHG; @17-15-104.

⁴³ Robert W Hamilton *Cases and Materials on Corporations Including Partnerships and Limited Liability Companies* (7 ed, St Paul, Minnesota, 2001) 262.

⁴⁴ The *ultra vires* doctrine is not compatible with s 37(II) GmbHG; the aforementioned section provides that a restriction of the manager's authority is without any effect on third parties, see Guenther H Roth and Holger Altmepfen *GmbH-Gesetz* (4 ed, Beck, Munich, 2003), s 3, para 7.

⁴⁵ Nevertheless, Robert W Hamilton speaks of the "decline of (the) doctrine of *ultra vires*". Besides various cases, he cites s 3.04 of the Model Business Corporation Act as amended through 31 December 2001, whereupon the validity of corporate action may not be challenged on the ground that the corporation "lacks or lacked power to act.", Robert W Hamilton *Cases and Materials on Corporations - Including Partnerships and Limited Liability Companies* (7 ed, West Publishing Co, St Paul, 2001) 270.

⁴⁶ @17-15-104.

⁴⁷ *EZ Auto, LLC v H M Jr Auto Sales* (31 July 2002) Lexis 5560 (Tex Ct App). In this case, a car dealer brought action against an LLC to recover a balance due on a car purchased by the manager of the LLC on behalf of the LLC. The court generally acknowledged that the *ultra vires* doctrine applies to LLCs. However, in this case it was held that the manager had actual authority to bind the LLC.

⁴⁸ An *ultra vires* doctrine in German corporate law would breach European law anyway, see First Directive on Company Law, Directive 68/151, OJ, L 65/8, Article 9(1): "Acts done by the organs of the company shall be binding upon it even if those acts are not within the objects of the company...".

Besides the issue of company powers, liability needs to be mentioned. The two statutes briefly state that liability is generally restricted to the entity.⁴⁹ Personal liability of shareholders or members only arises as an exception, first if individual liability is incurred⁵⁰ or, secondly, if the doctrine of piercing the corporate veil applies. It is commonly accepted that the doctrine of piercing the veil applies to LLCs.⁵¹ The doctrine, however, is also a well-established part of GmbH law.⁵² Similar to the situation under US law, piercing the veil in Germany is not regulated by statute, but has been developed by the courts over many years. The governing rules could, therefore, be applied to a German LLC without any problems, and additional statutory regulation would not be necessary. This at least facilitates the implementation of a new limited liability vehicle in Germany.

2 Taxation

At first sight, taxation seems to make a great difference as the GmbH is taxed as a corporation, and the LLC generally as a partnership. The LLC's tax classification in conjunction with the liability protection is one of the major factors for its success.⁵³ Being taxed as a partnership means that the LLC enjoys pass-through taxation, the taxable income, loss, credits and deductions of the entity flowing through to its members. Therefore, the company's profits are taxed just once. There is no taxation of LLC profits at the entity level. Profits are only taxed at the member level, meaning that profits are subject to the member's personal income tax as soon as they are distributed.⁵⁴ It has to be kept in mind that according to the "check-the-box rules", the LLC is not bound to the partnership tax status, but may alternatively elect to be taxed as a corporation.⁵⁵

⁴⁹ S 13(II) GmbHG; @17-15-113.

⁵⁰ Through negligence or guarantees, see Kendal R Hoopes "Liabilities of Members and Managers of Wyoming Limited Liability Companies" (1999) 34 Land & Water L Rev 463.

⁵¹ In *Kaycee Land and Livestock v Roger Flahive* (2002) 43 P 3d 323 (Wyo Supr C), a landowner brought action for damages against an LLC and its managing member. The court held that the remedy of piercing the veil is an available remedy under the LLC legislation; William A Klein and J Mark Ramseyer *Business Associations* (3 ed, Westbury, New York, 1997) 225; Robert R Keating "The Limited Liability Company: A Study of the Emerging Entity" (1992) 47 Bus Law 375, 442.

⁵² The piercing doctrine is known as *Durchgriffshaftung*, see Guenther H Roth and Holger Altmeppen *GmbH-Gesetz* (4 ed, Beck, Munich, 2003), s 13, para 20.

⁵³ Robert W Hamilton *Cases and Materials on Corporations - Including Partnerships and Limited Liability Companies* (7 ed, West Publishing Co, St Paul, 2001) 161.

⁵⁴ William A Klein and J Mark Ramseyer *Business Associations* (3 ed, Westbury, New York, 1997) 96; Joseph A Rodriguez "Wyoming Limited Liability Companies: Limited Liability and Taxation" (1992) 27 Land & Water L Rev 539. However, an annual LLC tax of US\$100 applies, @17-15-132.

⁵⁵ J William Callison "Unincorporated Business Entities: Federalism, Regulatory Competition and the Limited Liability Movement: The Coyote Howled and the Herd Stampeded" (2001) 26 Iowa J Corp L

In contrast, GmbH profits are generally taxed twice, both at the entity and at the shareholder level. First, GmbH profits are subject to a 25 per cent corporate income tax.⁵⁶ Secondly, distributed profits are then taxed at the shareholder level.⁵⁷ However, in order to reduce double taxation, only half of the distributed profits are subject to the shareholders' personal income tax ("*Halbeinkünfteverfahren*").⁵⁸ This procedure practically cuts in half the personal income tax rate. As a result, distributed corporate profits are still subject to two taxes: corporate income tax and personal income tax. However, as shareholders virtually pay a reduced personal income tax rate, the fact of double taxation is compensated.⁵⁹

In conclusion, taxation may have a different starting point. With the German tax law reducing double taxation to the greatest possible extent, however, the practical implications differ only slightly.⁶⁰ In contrast to the US situation, tax law is not the crucial incentive for German reform. Nevertheless, it has and will be shown that various other issues support the argument for a new business form in Germany.

3 Formation

Attention should further be paid to formation procedures. The GmbH, as a corporation, is formed within the context of a highly evolved statute and more than a century of (sophisticated) judicial case law. By contrast, although the LLC formation process is fairly corporate-like, the Wyoming LLC statute resembles partnership law in that it imposes fewer rules. Overall, the formation of an LLC requires fewer efforts than the creation of a GmbH.

951, 961; Tassma A Powers and Deby L Forry "Partnership Taxation & The Limited Liability Company: Check Out the Check-the-Box Entity Classification" (1997) 32 Land & Water L Rev 831.

⁵⁶ See ss 1, 23(I) KStG. Corporate tax law has been subject to recent reforms: *Gesetz zur Fortentwicklung des Unternehmenssteuerrechts* (20 December 2001, BGBl I, 3858); see Dieter Birk *Steuerrecht* (5 ed, CF Müller, Heidelberg, 2002) 318.

⁵⁷ S 20(I) No 1 EStG.

⁵⁸ S 3 No 40 1d EStG.

⁵⁹ Simplified example: Partnership A (partners B and C) and GmbH D (shareholders E and F) both show a profit of €60,000. First: Partnership A. All profits are equally distributed to B and C, each of them being entitled to €30,000. Profits are only subject to the personal income tax, here assumably the top rate of 48.5 per cent. Therefore, both A and B receive €15,450. Second: GmbH D. Profits are first subject to a 25 per cent corporate income tax, leaving €45,000 to be equally distributed to E and F (€22,500 each). According to the *Halbeinkünfteverfahren*, only half of these distributed profits are subject to the personal income tax. Therefore, €11,250 are tax-free, €11,250 are subject to the 48.5 per cent personal income tax. Therefore, both E and F receive €17,043.75.

⁶⁰ Practical differences as to the assessment and collection have not been considered. Nevertheless, the amount of the taxable income and the tax rate are the most important features.

At the outset, both GmbH and LLC may consist of at least one natural or legal person.⁶¹ Only the GmbHG prescribes special rules for single-person-entities. It is claimed that the likelihood of malpractices and fraudulent use of the entity is reduced by having a multitude of shareholders and thus a system of "checks and balances".⁶² The asserted deficiencies in case of a single-person entity are intended to be compensated by special rules, which are mostly designed to increase the standard of creditor protection.⁶³ In the following, not only the aforementioned special rules shall be highlighted, but also the essential steps to bring into existence both GmbH and LLC will be outlined.

(a) Articles of organisation

The first formation step is to draft articles of organisation. Both GmbH and LLC articles must feature some compulsory contents. Beyond these, facultative provisions can be added. Finally, formal requirements have to be considered.

(i) Compulsory contents

The articles' compulsory contents are prescribed by mandatory provisions.⁶⁴ In general, similarities are more apparent than differences. First, the company name must be stated. The German law governing the choice of a company name has been liberalised extensively,⁶⁵ so today similar rules apply for GmbH and LLC. The company name must be distinguishable and not misleading.⁶⁶ It also has to include the term "*Gesellschaft mit beschränkter Haftung*" respectively "limited liability company" or an abbreviation.⁶⁷ The failure to comply with these name requirements attracts personal liability.

⁶¹ S 1 GmbHG; @17-15-144(d). For years, a single-person-GmbH could only be generated if, subsequent to the formation, all interests would be transferred or bequeathed to one person. The initial single-person-GmbH was introduced in 1980, forced by a European directive. The Wyoming statute still requires to have at least two members (@17-15-106), but allows single-person-entities as an exception, if the members choose to be a flexible LLC pursuant to @17-15-144(d).

⁶² Guenther H Roth and Holger Altmeppen *GmbH-Gesetz* (4 ed, Beck, Munich, 2003), s 1, para 6.

⁶³ For instance, s 7(II) GmbHG prescribes that all contribution(s) have to be made prior to the filing of the articles, and not only 25 per cent as generally required.

⁶⁴ For the GmbH see ss 3, 5(IV) GmbHG (132 words), for the LLC see @17-15-107 (424 words).

⁶⁵ See Karlheinz Boujong et al *Handelsgesetzbuch* (Beck, Munich, 2001) s 17, para 4.

⁶⁶ Ss 17, 18, 6(II) HGB, 13(III) GmbHG, @17-15-105.

⁶⁷ S 4 GmbHG; @17-15-105(b).

Only the LLC can reserve a name before actually filing the articles.⁶⁸ German company law lacks a respective provision. However, the desired name can be protected all the same. Prior to the notarisation of the articles, the potential shareholders may form a partnership by stipulating a simple partnership agreement.⁶⁹ The name as used by this partnership is legally protected.⁷⁰ With the notarisation, a so-called *Vor-GmbH* comes into existence, a preform of the later GmbH. As the former partnership ceases to exist, the *Vor-GmbH* may use the partnership's name.⁷¹ After finally registering as a GmbH, the legal form (GmbH) has to be added to the name, and the name can then be used henceforth. In conclusion, German law makes it possible to protect a name, however, in a very complicated manner.

Besides the company name, the GmbH articles must indicate the company's registered office, whereas the LLC articles have to include name and address of a registered agent.⁷² While the LLC requirement provides for the greatest possible flexibility, s 4a(II) GmbHG even restricts the choice of the registered office. It has to be located at the place of production, management or administration.

Thirdly, in both the GmbH and the LLC articles the company's purpose has to be stated. In general, this can be any lawful purpose.⁷³ Whereas for the LLC banking and insurance are excluded, in the case of the GmbH, restrictions for professionals may apply.⁷⁴ Fourthly, the capital structure has to be disclosed. Both GmbH and LLC articles must indicate the amount of share capital and the contributions in kind. However, only the GmbHG calls also for cash contributions to be listed. Furthermore, a limitation of the company's duration has to be included.⁷⁵ Beyond these five requirements, only the LLC statute demands further compulsory contents, for example the admission of new members, names and addresses of managers and the possible choice to be a flexible or a close LLC.⁷⁶

⁶⁸ See @17-15-105(d).

⁶⁹ Such a company is known as *Vorgruendungsgesellschaft*.

⁷⁰ See ss 12 BGB, 37 HGB. The BGB is the *Buergerliches Gesetzbuch* (German Civil Code), <http://www.bundesregierung.de/-/418/Gesetze.htm> (last accessed 25 September 2003).

⁷¹ It is only necessary to add the legal form, here *i.G.* for *in Gruendung* (in the process of formation).

⁷² For details regarding the registered agent, see @17-15-110.

⁷³ S 1 GmbHG, @17-15-103.

⁷⁴ To give an example, for many years German lawyers were not allowed to organise as a GmbH. Just recently, the legislator has acknowledged the lawyer-GmbH (s 59c BRAO).

⁷⁵ S 3(I) GmbHG.

⁷⁶ Whereas the formation as a flexible LLC (@17-15-144) reduces the extent of statutory regulation, the formation as a close LLC (@17-25-101 to 109) results in further restrictions to the members'

(ii) Additional contents

The articles are not limited to contain only the compulsory statements. Beyond that, the articles – or a separate operating agreement – may include additional stipulations.⁷⁷ Whereas it is common for the GmbH to have detailed articles, setting up an operating agreement is the usual procedure for the LLC.⁷⁸ Naturally, mandatory provisions restrict party autonomy. As shown throughout this analysis, the GmbHG contains more mandatory provisions, therefore leaving less party autonomy to the participants in the end.

(iii) Required form

Both GmbH and LLC articles must comply with certain formal requirements. GmbH articles have to be in writing, signed by all shareholders and notarially certified.⁷⁹ In contrast, LLC articles must only be in writing and signed by the organiser.⁸⁰ The organiser may, but need not be a member of the LLC. The filing may also be done by a third person (promoter).⁸¹ This is a concession to foreign investors, and also enables a confidential formation, as the names of the members do not have to be disclosed.

rights as far as transfer of ownership interest, withdrawal or resignation from the company, return of capital contributions or dissolution matters are concerned.

⁷⁷ S 45 GmbHG; @17-15-104(x), @17-15-107(xi).

⁷⁸ In *Bubbles and Bleach LLC v Becker* (16 May 1997) Lexis 7471 (US Dist), it was held that the operating agreement is an agreement between the members, not the members and the LLC. In *Advanced Orthopedics, LLC v Moon* (1995) 656 So 2d 1103 (La Ct App), the court held that a missing operating agreement does not prove the non-existence of an LLC, neither does the failure to sign an existing operating agreement work as dissolution. In *Goldstein & Price v Tonkin & Mondl* (1998) 974 SW 2d 543, 548 (Mo Ct App), it was held that a written operating agreement can be orally modified.

⁷⁹ S 2(I)(1) GmbHG.

⁸⁰ @17-15-106. See also @17-15-144(d), whereupon a single-member-LLC is possible.

⁸¹ Under LLC law, it is possible for the promoter to take shares of the LLC as remuneration. Under GmbH law, remuneration can be paid only if the available assets exceed the share capital. However, because of the strict capital raising rules, it is not possible to directly give company shares as remuneration. See part V B 4 (c) of this paper. Marcus Lutter and Peter Hommelhoff *GmbH-Gesetz* (15 ed, Dr. Otto Schmidt Verlag, Cologne, 2000) s 3, para 42.

(b) Filing proceedings

Once the articles are drafted in the required form, they have to be filed to the competent authority. The GmbH articles have to be filed to the register court by the company's managers.⁸² More precisely, the filing has to be done by all managers.⁸³ The express requirement that all managers have to get involved in the GmbH filing process reveals a significant difference to LLC law. As already mentioned above, the LLC filing may be done by any prospective member or manager or even a third person. This clearly facilitates the formation process and, as mentioned before, enables a confidential entity formation.

Filing of the GmbH articles is only allowed if at least 25 per cent of each cash contribution has been paid to the company, amounting to a minimum of €12,500.⁸⁴ In case of a single-person-GmbH, 25 per cent are not sufficient. The cash has to be paid completely or, alternatively, guarantees for the outstanding amount have to be provided. This special requirement is supposed to replace the outfall liability that occurs if a shareholder fails to perform his contribution in a several-member-GmbH.⁸⁵ Not only cash has to be (partly) contributed, also contributions in kind must be made prior to the filing.⁸⁶ As the GmbH does not come into existence before it is registered, the aforementioned filing requirements provide that a substantive part of the share capital has to be actually raised prior to the formation.⁸⁷

Regarding the LLC, the original and one copy of the articles have to be filed to the Secretary of State by the organiser.⁸⁸ The LLC comes into existence once a certificate of formation has been issued. For that to happen, neither cash contributions nor contributions in kind have to be actually made. So in contrast to the GmbH, the implementation of contributions may be postponed to a date after the actual formation, enabling a far quicker and easier entity formation.

⁸² S 7(I) GmbHG.

⁸³ Ss 78, 7(I) GmbHG.

⁸⁴ S 7(II) GmbHG.

⁸⁵ Pursuant to s 24 GmbHG, shareholders are not only liable for their own contribution, but also for all other contributions if one of the shareholders fails to make the contribution. This may, in the end, result in a liability up to the total amount of the share capital.

⁸⁶ S 7(III) GmbHG.

⁸⁷ Ss 19 FGG provide for appeal from denied registration.

(i) Required documentation; additional formation efforts

When filing, a certain amount of documentation needs to be enclosed with the articles. In this regard, the GmbH is subject to an extensive regime.⁸⁹ At the outset, the articles have to be filed together with an application for registration, which needs to be certified.⁹⁰ The application itself must only include sample signatures of all managers.⁹¹ Articles and application must then be supplemented by a list of all shareholders indicating name, birthday, address and contribution. Moreover, the company must provide a shareholder resolution appointing one or more managers.⁹²

Fourthly, if contributions in kind are agreed upon, all documents relating to the respective legal transactions and a report on the contributions must be supplied.⁹³ The aforementioned report on contributions is statutorily required and has to be signed by all shareholders. It needs to contain detailed information on the character, age and value of all contributed assets. Also the valuation method has to be indicated, and the report must be supplemented with supporting evidence, for instance purchase documents and expert opinions.⁹⁴ The filing documents then have to include a declaration of compliance signed by all managers. In this declaration, the managers must assert that the company has complied with all contribution requirements,⁹⁵ and that there are no circumstances that conflict with their appointment.⁹⁶ Finally, any needed permits have to be supplied.⁹⁷

These far-ranging requirements certainly are burdensome and reduce the participants' flexibility. Gathering all information and the essential documents is a time-consuming matter. Particularly the report on contributions is also very cost-intensive. In contrast, for the LLC far less documentation is needed. Only consent to appointment of the registered agent must be provided to the Secretary of State.⁹⁸

⁸⁸ @17-15-108(a).

⁸⁹ See s 8 GmbHG (310 words).

⁹⁰ S 12(I) HGB.

⁹¹ S 35 HGB.

⁹² This is necessary because centralised management is compulsory for the GmbH.

⁹³ See s 5(IV) GmbHG.

⁹⁴ Guenther H Roth and Holger Altmeppen *GmbH-Gesetz* (4 ed, Beck, Munich, 2003), s 8, para 6.

⁹⁵ To prove that cash contributions have been paid in the required extent, upon the register court's discretion the management may have to provide a bank confirmation, see BGHZ 113, 335, 345.

⁹⁶ Such circumstances are specified in s 6(II) GmbHG, for example criminal charges.

⁹⁷ For instance, banks need a permit pursuant to s 32(I) KWG, pubs and restaurants a permit pursuant to s 2 GaststättenG, retail businesses a permit pursuant to s 3(I) EinzelhandelsG, all available at <http://www.bundesregierung.de/-418/Gesetze.htm> (last accessed 25 September 2003).

⁹⁸ @ 17-15-107(c).

Setting up a company not only involves filing articles and supplementary documentation. Throughout the formation process, additional paperwork may be necessary. Regarding the GmbH, the (potential) shareholders may enter into a pre-incorporation agreement. Here, basic features of the proposed entity are ascertained before actually drafting the final articles. To be legally binding, such an agreement must be notarised.⁹⁹ Secondly, individual subscription agreements are to be drafted. As contributions have to be made prior to filing the articles, legal transactions have to be conducted beforehand.¹⁰⁰

Thirdly, centralised management calls for further efforts. As mentioned above, the shareholders have to make a decision appointing the management. In addition, a contract of service has to be drafted and signed, outlining in particular remuneration issues or non-competition clauses. Fourthly, the establishment of branch offices requires administrative efforts. This is in particular important for retail businesses. It is not sufficient to name the head office as registered office when registering the GmbH, but each single branch office has to be individually registered at the trade register.¹⁰¹ Finally, the GmbH has to be registered at a specific department of the local government, as this department is competent for trade control. This registration is statutorily required,¹⁰² but in comparison with the registration at the commercial register not a step to bring the GmbH into existence.

For the LLC, less additional paperwork is necessary. The (potential) members may also enter in a pre-formation arrangement and subscription agreements can be necessary. Furthermore, the members might want to stipulate a management agreement, however, the paperwork for setting up a centralised management can be avoided, as the LLC is generally member-managed.

⁹⁹ Guenther H Roth and Holger Altmeyden *GmbH-Gesetz* (4 ed, Beck, Munich, 2003), s 2, para 48.

¹⁰⁰ For example, if a shareholder wants to contribute a piece of real estate, the transfer of title requires a notarised conveyance of property and the registration in the land register, ss 873, 925 BGB, GBO.

¹⁰¹ This is regulated by ss 13 et seq HGB, comprising nine provisions amounting to 2,157 words.

¹⁰² S 14 GewO, <http://www.bundesregierung.de/-,418/Gesetze.htm> (last accessed 25 September 2003).

(ii) Disclosure of information regarding formation

Having looked at the documents that have to be filed, it is also important to consider what becomes visible to the public. For most businesses it is favourable to disclose as little information as possible. Regarding the GmbH, the company name and seat, its purpose, the share capital, the names and authorisation of all managers, and the company's duration become part of the commercial register.¹⁰³ This register is not only open to the public without any limitation,¹⁰⁴ the registered information is also published in the Federal Bulletin and at least one regional newspaper. The LLC articles as well become a matter of public record. In contrast to some of the LLC statutes, however, the Wyoming statute requires no publication at all.¹⁰⁵

(iii) Formation costs

An important issue of formation is the question of cost. Naturally, cost requirements are mandatory. Besides raising the minimum share capital, formation costs for the GmbH are made up of notarisation, court and publication costs. The formation of a €25,000 GmbH costs approximately €1,500. Filing costs for a LLC with a share capital of up to US\$50,000 are US\$100. In conclusion, the formation of an LLC is generally cheaper than the formation of a GmbH.

However, in the end formation costs for the LLC may even exceed formation costs for the GmbH, as the LLC faces higher costs for legal services.¹⁰⁶ The LLC statute, contrary to the GmbHG, does not provide for a broad range of operational rules. Therefore, the costs for drafting a proper LLC operating agreement are likely to be in excess of the costs for drafting reasonable GmbH articles, as the LLC agreement cannot rely on default rules and needs to be more comprehensive. However, as many of the GmbHG's operational rules are not only inappropriate for small firms but also mandatory in character, higher legal costs might be the reasonable prize for a smooth functioning of the business.

¹⁰³ S 10 GmbHG. The shareholders' names do not have to be registered, see Marcus Lutter and Peter Hommelhoff *GmbH-Gesetz* (15 ed, Dr. Otto Schmidt Verlag, Cologne, 2000) s 10, para 5.

¹⁰⁴ See s 9(I) HGB.

¹⁰⁵ For example, s 206 of the New York statute requires weekly publication of detailed information in at least two newspapers for six consecutive weeks.

(c) Civil and criminal liability regarding formation

For both GmbH and LLC, failure to comply with certain formation procedures attracts liability. As far as civil liability is concerned, participants are liable if they act in the name of the entity before the entity is actually formed.¹⁰⁷ Secondly, incorrect statements and fraudulent behaviour may result in liability.¹⁰⁸ As far as criminal liability is concerned, both GmbH and LLC participants are subject to a range of criminal provisions.¹⁰⁹

As shown, the fact that involvement in formation procedures might incur civil or even criminal liability is characteristic for both GmbH and LLC. However, the GmbHG sets up a far more extensive regime of mandatory provisions. Therefore, non-compliance and, consequently, liability are more likely to occur for GmbH shareholders. Particularly because non-compliance needs not be intentional, this is a barrier for a smooth functioning of the business entity. For example, the GmbHG requires all contributions in kind to be valued accurately.¹¹⁰ Failure to do so results in civil liability not only for the contributing shareholder,¹¹¹ but also for all other shareholders and managers.¹¹² A deliberate misrepresentation is not necessary to incur this (civil) liability. However, if the incorrect statement has been given on purpose, also criminal liability might arise.¹¹³ In contrast, the LLC statute does not contain any requirements as to the valuation of contributions in kind and, therefore, reduces the likelihood of any (civil and criminal) liability.¹¹⁴

¹⁰⁶ Charles W Murdock "Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future" (2001) 56 Bus Law 499, 499.

¹⁰⁷ S 11(II) GmbHG; @17-15-133.

¹⁰⁸ S 9a GmbHG; @17-15-132(b), @17-15-133.

¹⁰⁹ The GmbHG itself contains criminal provisions. Ss 82, 84, 85 GmbHG penalise incorrect statements, preferential treatment of selected creditors, and concealment of facts concerning insolvency proceedings. The Wyoming LLC statute, in contrast, does not contain any criminal provisions. However, other state and federal laws provide for various criminal provisions. For example, the Sherman Antitrust Act (1890) introduces criminal liability for anti-trust violations. Furthermore, s 1341, title 18, United States Code penalises mail fraud.

¹¹⁰ S 5(IV) GmbHG.

¹¹¹ S 9(I) GmbHG.

¹¹² S 9a(I) GmbHG. Liability pursuant to this section requires that an incorrect statement has been made. The indication of an incorrect value of contributed assets is such an incorrect statement. It needs to be emphasised that not only those shareholders and managers are liable that make the incorrect statement, but every shareholder and manager; see Marcus Lutter and Peter Hommelhoff *GmbH-Gesetz* (15 ed, Dr. Otto Schmidt Verlag, Cologne, 2000) s 9a, para 3.

¹¹³ S 82 GmbHG.

¹¹⁴ A further example of a transactional liability trap is presented in part V B 4 (b) (ii) of this paper.

Though being structured similar to a corporate formation, the formation of an LLC resembles a partnership formation in so far that the LLC statute provides only few mandatory rules. This leaves more flexibility to the members and enables an easier and quicker entity formation. Furthermore, the risk of non-compliance and thus (civil and criminal) liability is reduced. The only downside is that the LLC statute includes fewer default rules and requires the members to put more efforts in tailoring a comprehensive operating agreement, this naturally increasing legal costs. However, it needs to be considered that this situation might be more advantageous than having a whole range of operational rules if these rules are mandatory in character. This is the case for the GmbH. Here, the shareholders are forced under a regime that often is inappropriate. For instance, the GmbH provides a set of rules governing meetings and voting that is overly formal and restrictive and, therefore, for small and informal businesses unfitting. In conclusion, the formation process clearly is an advantage of the LLC form.

(d) Overview: Minimum formation steps in a chronological order (table)

GmbH	LLC
1. Draft articles: comply with requirements concerning compulsory contents and form.	1. Draft articles: comply with requirements concerning compulsory contents and form.
2. Shareholder resolution: appointment of management.	2. <i>Not necessary if member-managed.</i>
3. Perform contributions.	3. <i>Not necessary before filing.</i>
4. File articles and supplementary documentation. <ul style="list-style-type: none"> ○ Application for registration. ○ List of all shareholders with details. ○ Shareholder resolution appointing the management. ○ Documentation concerning contributions, in particular statutory report. ○ Declaration of compliance of all managers. ○ Any needed permits. 	4. File articles and supplementary documentation. <ul style="list-style-type: none"> ○ Written consent to appointment of registered agent.

4 Capital structure

It has been shown that the formation procedure for the GmbH and the LLC is structured similarly. However, as already pointed out, formation involves more administrative efforts for the GmbH. This is particularly true with regard to contribution requirements, leading directly to the aspect of capital structure. Here, the most striking differences between the two business forms are revealed. Differences become apparent not only with regard to contents, but also with regard to the nature of the respective provisions. Whereas the GmbHG mainly provides for mandatory capital rules, the LLC financial provisions predominantly take the form of default mechanisms, which may be varied by the articles or the operating agreement. An outline of the strict GmbH capital requirements and the straightforward LLC rules clearly shows that small and medium-sized businesses are far better off with the LLC regime.

(a) Minimum share capital

First, s 5(I) GmbHG requires a share capital of at least €25,000 for the GmbH. This comes along with exceedingly restrictive and overly complicated rules regarding the alteration of the share capital figure.¹¹⁵ In contrast, the LLC statute requires no minimum share capital at all, and so allows for the formation of a business entity with less financial means.

(i) No need for a minimum capital figure

Most businesses would prefer the more flexible US system that abstains from a minimum share capital requirement. On the other hand, many academics point out the importance of such a concept.¹¹⁶ The main argument that is frequently brought forward in favour of a minimum share capital is creditor protection. The required

¹¹⁵ Capital alterations are regulated in ss 55 et seq GmbHG, comprising 26 provisions (3,371 words).

¹¹⁶ Adolf Baumbach and Goetz Hueck *GmbHG* (17 ed, Beck, Munich, 2000) s 5, para 1; Guenther H Roth and Holger Altmeppen *GmbHG* (4 ed, Beck, Munich, 2003) s 5, para 23; John Armour "Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law" (2000) 63 Mod L Rev 355, 355.

capital figure is said to ensure a minimum level of assets.¹¹⁷ It is even claimed that not only creditors but also shareholders are protected.¹¹⁸ It is suggested that a solid financial basis for the company's operation increases the likelihood of economic success and, thereby, raises the shareholders' profits.¹¹⁹ Furthermore, the requirement is said to act as a deterrent to fraudulent incorporations.¹²⁰

However, a minimum share capital in fact does not achieve efficient protection of either creditors or shareholders. First, a minimum capital figure does not prevent the diminution of the capital through company losses, as there is no guarantee that assets will not be depleted through trading losses.¹²¹ Even if a minimum capital figure could generally provide for creditor protection, the determination of an appropriate level is virtually impossible. A figure that is too low provides no protection at all.¹²² A figure that is too high prevents businesses from entering the market. Consequently, a static capital figure fails to correspond to the specific capital needs of most businesses.¹²³ Furthermore, a system of minimum share capital generates costs. For instance, there are administrative costs of policing firms compliance, which generate a disproportionate burden on smaller companies. Finally, firms incapable of raising or maintaining the minimum are unable to obtain limited liability. This puts such firms at a competitive disadvantage, creating barriers to entry and thus reducing the competitive pressure on incumbent firms.¹²⁴

¹¹⁷ Adolf Baumbach and Goetz Hueck *GmbHG* (17 ed, Beck, Munich, 2000) s 5, para 1; Guenther H Roth and Holger Altmeyen *GmbHG* (4 ed, Beck, Munich, 2003) s 5, para 23; John Armour "Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law" (2000) 63 Mod L Rev 355, 355.

¹¹⁸ Preamble to the Second Council Directive of 13 September 1976, 77/91/EEC 1977 OJ L 26/1.

¹¹⁹ Preamble to the Second Council Directive of 13 September 1976, 77/91/EEC 1977 OJ L 26/1.

¹²⁰ Judith Freedman "Limited Liability: Large Company Theory and Small Firms" (2000) 63 Mod L Rev 317, 336.

¹²¹ Guenther H Roth and Holger Altmeyen *GmbHG* (4 ed, Beck, Munich, 2003) s 5, para 24; John Armour "Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law" (2000) 63 Mod L Rev 355, 371.

¹²² So it is claimed that €25,000 are not sufficient, Paulina Dejmek "Das künftige Europa und die Europäische Privatgesellschaft" (2001) 2001 NZG 878, 882.

¹²³ Guenther H Roth and Holger Altmeyen *GmbHG* (4 ed, Beck, Munich, 2003) s 5, para 24; John Armour "Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law" (2000) 63 Mod L Rev 355, 371; Rebecca J Huss "Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine Into the Statutory Age" (2001) 70 U Cin L Rev 95, 131.

¹²⁴ John Armour "Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law" (2000) 63 Mod L Rev 355, 371

Alternative concepts are much more promising to achieve creditor protection. For example, legislation on insolvency should be tightened. Furthermore, it might be worth considering not appointing managers unless they pass an examination or show fitness to run a company in some other way, such as attending a course.¹²⁵ Mandatory insurance could cover liability risks that arise from malpractice, this concept being already used for professional entities as the US LLP.¹²⁶

With regard to German law, a look at European law further supports the argument against a minimum share capital. Having such a requirement would be a competitive disadvantage of the German business location to other European countries having no such requirement.¹²⁷ This is particularly true when taking into account recent judgments of the European Court of Justice (ECJ). In *Centros*¹²⁸ and the follow-up decision *Ueberseering*,¹²⁹ the ECJ adjudicated that a Member State of the European Communities has to acknowledge a company that has been effectively formed in another Member State.¹³⁰ Consequently, businesses can choose their place of formation according to the most flexible company law. This phenomenon of "forum shopping" puts Germany at a disadvantage, as most businesses would certainly choose a jurisdiction offering a limited liability vehicle that requires no minimum share capital. In conclusion, not only is the minimum share capital requirement an ineffective instrument of creditor protection, but keeping hold to this requirement also compromises Germany as a business location.

¹²⁵ J Hudson "The Limited Liability Company: Success, Failure and Future" (1989) 161 Royal Bank of Scotland Review 26.

¹²⁶ Rebecca J Huss "Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine Into the Statutory Age" (2001) 70 U Cin L Rev 95, 131.

¹²⁷ For instance, the UK offers the LLP as an attractive alternative to the German GmbH. The UK LLP statute does not require a minimum share capital.

¹²⁸ C-212/97 (9 March 1999) OJ C 136 (15 May 1999) 3. The ECJ allowed an English Private Limited Partnership, which did not conduct business activities in any Member State, to establish a branch in Denmark, which was to conduct all the company's business activity. The ECJ held that Member States cannot refuse to recognise a company incorporated under the laws of another Member State.

¹²⁹ C-208/00 (5 November 2002) OJ C 323 (21 December 2002) 12. In this case, German courts had denied the capacity of a Dutch company to sue, as it did not meet the requirements of German company law. The ECJ held that this denial breached Articles 43, 48 EC Treaty. It thereby confirmed the holdings of *Centros*, whereupon a Member State has to recognise any company that has been effectively formed under the laws of another Member State.

(ii) Shelf companies

According to the wording of s 5(I) GmbHG, the minimum share capital requirement only applies to the formation process. As the formation of a GmbH is a time-consuming matter, quite a few businesses abstain from forming the GmbH themselves and instead buy an existing entity. This demand has led to a roaring trade with shelf companies, meaning that GmbHs with basic features are solely formed for the reason of subsequent sale. The buyer can change the entity's articles and, thereby, adapt the GmbH according to his needs.

The formation and sale of shelf companies is generally allowed under German law.¹³¹ However, such a practice is likely to evade the minimum share capital requirement. The initial capital as raised by the seller may be exhausted, and the purchaser might not be willing to throw in new capital. New firms possibly start business activities without being equipped with the minimum share capital. The question is whether the purchaser has a legal duty to ensure that, at the time of sale, the GmbH has assets at least amounting to €25,000. Courts and scholars predominantly support the application of the minimum share capital requirement and, thereby, treat such a sale as a formation.¹³² It is claimed that the sale and adaptation of a shelf company economically resembles the formation of a GmbH. Therefore, the purchaser is said to be liable for the statutory minimum figure of €25,000,¹³³ or even for the complete share capital if it exceeds the minimum figure.¹³⁴

Evidently, this is an obstacle for German businesses. The practice of shelf companies helps to avoid many of the formation formalities and ensures quick availability of limited liability vehicles. The analogue application of the minimum capital requirement compromises this practice, as it means greater financial commitment and increases the reluctance to resort to shelf companies.

¹³⁰ In BGH (2002) 2002 NJW 3539, the BGH expressly acknowledged the ECJ's holdings.

¹³¹ Guenther H Roth and Holger Altmeyden *GmbHG* (4 ed, Beck, Munich, 2003) s 3, paras 11, 12.

¹³² In BGH (2003) 2003 NZG 170, the BGH confirmed that the purchaser of a shelf GmbH has to ensure that the GmbH has, at the time of sale, assets amounting to at least €25,000. See also Adolf Baumbach and Goetz Hueck *GmbHG* (17 ed, Beck, Munich, 2000) s 3, para 15.

¹³³ In LG Düsseldorf (2002) 2002 ZIP 2215, the court restricted the purchaser's liability in case of a shelf company sale to €25,000; also Adolf Baumbach and Goetz Hueck *GmbHG* (17 ed, Beck, Munich, 2000) s 3, para 15.

¹³⁴ This is the BGH's position, see the aforementioned judgement BGH (2003) 2003 NZG 170.

This practical argument is supported by the fact that outside the scope of a shelf company sale, an actively operating GmbH may undergo a structural change in order to take up different business activities. In this case, it is undisputed that the minimum capital requirement does not apply.¹³⁵

The phenomenon of shelf companies exists in LLC law as well. LLCs are formed with no particular purpose and are taken off the shelf when the need arises. Authorities that regulate company registration approve of this practice without restrictions. This backs up the argument for an LLC-like company form in Germany. Evidently, such a company form would not feature a minimum share capital and, therefore, not raise the concerns regarding the practice of shelf companies.

(b) Form of contributions

The minimum share capital is only one aspect of the capital structure. In addition to this, it needs to be examined as to how the agreed share capital can be contributed. Before looking at the rules governing the raising and maintenance of capital, possible forms of contributions need consideration.

When recalling the process of formation as outlined above, it stands out that its complexity is to a great extent dependant on the kind of consideration agreed upon for the shares. In general, GmbH shareholders and LLC members can make cash contributions as well as contributions in kind.¹³⁶ Whereas cash contributions rarely cause severe problems,¹³⁷ contributions in kind are more likely to bring about complications. For the LLC this is not that obvious, as virtually anything of value can be contributed, including any kind of property, promissory notes and services.¹³⁸

¹³⁵ In BayObLG (1999) 1999 DSStR 1036, the court denied any liability resulting from a shelf GmbH purchase regarding the (minimum) share capital figure. See also Guenther H Roth and Holger Altmeyden *GmbHG* (4 ed, Beck, Munich, 2003) s 3, para 11; Holger Altmeyden "Zur Mantelverwendung in der GmbH - Besprechung von BGH, Beschluss vom 9. 12. 2002 - II ZB 12/02" (2003) 2003 NZG 145, 178.

¹³⁶ S 5 GmbHG; @17-15-115.

¹³⁷ However, problems can arise in two situations. First, a payment may not amortise the contribution debt if it is made prior to the creation of that debt. Secondly, it is discussed whether a cash payment amortises a contribution debt if the company's account is on the debits side or previous utilisation agreements exist; in BGH (2002) 2002 WM 967, the BGH held that neither a company account with a debit balance nor a previous utilisation agreement do affect payments by shareholders.

¹³⁸ @17-15-115.

In contrast, for the GmbH many restrictions apply. Generally, GmbH shareholders are also able to contribute any assets with an economic value. Different to the LLC, however, promissory notes and services cannot be contributed.¹³⁹ Further restrictions apply, which are not based upon a consistent system but a case-by-case approach. For instance, know-how and good will as such cannot be contributed.¹⁴⁰ Overall, the restrictive GmbH regime forms an obstacle for German businesses. If there is (restricting) case law, businesses might be forced to contribute cash instead of contributing other available assets. If courts have not yet decided about the validity of specific assets as a contribution, businesses have the burden of legal uncertainty, and bear the risk of non-compliance and liability.¹⁴¹ This could result in an even greater reluctance to organise as a GmbH.

(i) Contributing a business

A particular aspect is the question whether it is possible to contribute a business. This is quite a practical issue, which particularly arises when an existing family business is to be transferred to a family-owned limited liability vehicle. Apparently, contributing a business is possible under LLC law, as it was shown that no restrictions as to contributions in kind apply. A valuation of the business might be desired by the LLC members or necessary for the purposes of federal tax law, but company law does not require it. The contribution has to conform only to the doctrine of consideration. Therefore, contributions have to represent an economic value, which does not necessarily have to be equivalent in value to the shares distributed for that contribution.

GmbH law as well allows for such a contribution, as the GmbHG expressly acknowledges the possibility of contributing a business.¹⁴² If the business as such is the subject of a contribution, there is an assumption that not only tangible but also intangible assets as know-how and good will are part of the contribution.¹⁴³

¹³⁹ S 27(II) AktG analogue; Uwe Hueffer *AktG* (5 ed, Beck, Munich, 2002) s 27, para 29.

¹⁴⁰ In BGH (1993) 1993 DB 323, the BGH held that know-how and good will as such cannot be contributed in exchange for GmbH shares. However, know-how and good will can be contributed as part of a business, see part V B 4 (b) (ii) of this paper.

¹⁴¹ If the contribution is not valid, the shareholder has to pay cash, ss 19(V), 5(IV) GmbHG.

¹⁴² S 5(IV)(2) GmbHG; general comments in Guenther H Roth and Holger Altmeyden *GmbHG* (4 ed, Beck, Munich, 2003) s 5, para 48.

¹⁴³ Adolf Baumbach and Goetz Hueck *GmbHG* (17 ed, Beck, Munich, 2000) s 5, para 26.

However, requirements are quite intense. For a business to be contributed, the GmbHG requires to provide information about the annual profit or loss of the last two years.¹⁴⁴ Additionally, shareholders are likely to be asked for an expert valuation.¹⁴⁵ This is because the GmbHG does provide that contributions in kind have to be adequate,¹⁴⁶ and that the value of the contributed assets has to correspond to the shares issued for those assets.¹⁴⁷ Furthermore, the register court has to refuse the GmbH's registration if it is convinced that the value of the contributed assets is not appropriate.¹⁴⁸ Therefore, the register court routinely asks for an expert valuation if assets of a supposedly high and unpredictable value are to be contributed.

The actual implementation of a business contribution differs remarkably, depending on the kind of business being contributed. In the case of a company, simply the shares can be contributed.¹⁴⁹ In the case of a sole proprietorship, the matter is rather complicated. Under German law, it is not possible to transfer the business as such, for example by registering the sale.¹⁵⁰ All assets have to be transferred individually, including realties, movables, and intangible assets. For know-how and good will, the transfer even requires an effective briefing, for instance the delivery of the customer list and information about previous experiences and trade secrets.¹⁵¹ Obviously, this is overly cumbersome. Therefore, it is advisable not to contribute a family business as part of the formation of a GmbH, but to convert a sole proprietorship into a GmbH pursuant to the provisions of the UmwG. Such a conversion effects a universal succession of all titles and rights (and all liabilities) associated with the business.¹⁵² In conclusion, the UmwG significantly facilitates the process of "contributing" a business.

¹⁴⁴ See s 5(IV)(2) GmbHG.

¹⁴⁵ Guenther H Roth and Holger Altmeyden *GmbHG* (4 ed, Beck, Munich, 2003) s 8, para 6.

¹⁴⁶ S 5(IV)(2) GmbHG.

¹⁴⁷ S 8(I) No 5 GmbHG.

¹⁴⁸ S 9(I) GmbHG.

¹⁴⁹ Adolf Baumbach and Goetz Hueck *GmbHG* (17 ed, Beck, Munich, 2000) s 5, para 30

¹⁵⁰ Adolf Baumbach and Klaus Hopt *HGB* (3 ed, Beck, Munich, 2000) ss 1-475h, para 42.

¹⁵¹ Adolf Baumbach and Klaus Hopt *HGB* (3 ed, Beck, Munich, 2000) ss 1-475h, para 42.

¹⁵² Adolf Baumbach and Goetz Hueck *GmbHG* (17 ed, Beck, Munich, 2000) s 5, para 26. Actually, the conversion of a sole proprietorship into a GmbH is not a conversion pursuant to ss 190 et seq UmwG. These provisions only apply to companies (partnerships and corporations), but not to sole proprietorships. However, ss 152 et seq UmwG provide the opportunity of a spin-off, which – in this case – resembles the character of a conversion. The business (sole proprietorship) is separated from the rest of the businessman's private estate (spin-off), and commuted into a GmbH. So theoretically it is construed as a spin-off, but practically it is a conversion. The legal requirements for such a transaction are a written report outlining all relevant aspects (for example itemising the assets), an examination of the report by independent auditors, and the registration at the commercial register.

(ii) Concealed contributions in kind

The previous remarks have addressed possible contributions in general, and the contribution of a business in particular. In the following, a third aspect needs to be mentioned, revealing that it is not the GmbH alone creating a regulatory thicket. Sophisticated case law as well adds to the high complexity of GmbH law. German courts have started an unparalleled development by establishing rules, under which agreed cash contributions may be treated as contributions in kind (“*verschleierte Sacheinlage*”, “concealed contribution in kind”). As will be shown, this case law leads to a perilous liability trap for GmbH shareholders.

The fact pattern behind this liability trap may be illustrated by an example. A GmbH is formed. One of the shareholders contributes €100,000 in cash. Five months after the registration of the GmbH, the same shareholder sells various goods to the GmbH and receives €100,000 as consideration, which shall be assumed to be an adequate amount. A couple of years later, the GmbH becomes insolvent. A court appoints an insolvency administrator. On behalf of the GmbH, the insolvency administrator now confronts the shareholder with a claim amounting to €200,000.

Taking into account German case law, the insolvency administrator’s claim is likely to be successful. If there is a close coherence of a cash contribution and a later transaction between the contributing shareholder and the GmbH, German courts assume that the shareholder never truly intended to contribute cash, but in fact wanted to contribute the assets, which were the subject of the later transaction. With regard to the aforementioned example, courts would presume that the shareholder always wanted to contribute the goods and not the €100,000 cash.

This assumption has three major consequences. First, the shareholder has paid the €100,000 without reason, as there was never an obligation to contribute cash. Therefore, the shareholder can reclaim this amount. However, he will probably receive little or no payment. As the GmbH is insolvent, the shareholder is just one creditor among many others.

Secondly, the transaction regarding the goods is held to be void. The courts assume that this transaction, though formally construed as a sales transaction, actually concerns the contribution of assets in exchange for shares. The GmbHG requires that all contributed assets have to be listed in the company's articles.¹⁵³ Because such a listing is missing here, the transaction is void. Consequently, the GmbH may reclaim the purchase price of €100,000, and the shareholder may reclaim the goods. However, as the goods are likely to be resold meanwhile, this claim is probably not successful. Thirdly, if a contribution agreement concerning assets other than cash is invalid, the shareholder is liable to contribute cash amounting to the worth of the assets.¹⁵⁴ As the shareholder wanted to contribute goods amounting to €100,000, he is liable for that amount.

In the end, the shareholder has an obligation to pay €200,000, including €100,000 refund of the purchase price, and €100,000 compensation for the invalid contribution agreement. His counterclaims (€100,000 and the goods) are likely to be frustrated, as the GmbH is insolvent and a set-off of mutual claims between shareholder and GmbH is generally not allowed under GmbH law.¹⁵⁵

The objective of this case law is that courts want to prevent an evasion of contribution rules. As was shown above, GmbH contributions are governed by an overly restrictive set of rules. In particular the fact that the register court routinely asks for expert valuations if expensive assets are contributed, is a time-consuming and also costly burden. Thus, courts want to prevent a practice, where shareholder always contribute cash first, and later on transfer other assets to the company and receive as consideration the cash they have originally contributed. This case law is heavily criticised.¹⁵⁶ Indeed, German courts have further complicated GmbH law and needlessly added to the strictness of GmbH law. The courts' objective to prevent shareholders from evading contribution rules is acceptable. However, as intentional behaviour is not a condition for the liability to occur,¹⁵⁷ courts have created a hazardous liability trap.

¹⁵³ S 5(IV) GmbHG.

¹⁵⁴ S 19(V) GmbHG.

¹⁵⁵ According to s 19(II)(2) GmbHG, a shareholder cannot offset his contribution debt against a debt owed by the company.

¹⁵⁶ Guenther H Roth and Holger Altmeyden *GmbHG* (4 ed, Beck, Munich, 2003) s 5, para 69; Herbert Roth "Gruendungstheorie: Ist der Damm gebrochen?" (1999) 1999 ZIP 861, 863.

¹⁵⁷ Adolf Baumbach and Goetz Hueck *GmbHG* (17 ed, Beck, Munich, 2000) s 19, para 30a.

(c) Raising of capital

The minimum share capital and the contribution rules are only the tip of the iceberg. Rules governing the raising of the capital further complicate the GmbH regime. The aspect of capital raising relates to all rules that govern the actual implementation of the agreed contributions.

At the outset, GmbH shareholders and LLC members are liable for their contribution.¹⁵⁸ However, this liability has different dimensions. Whereas the LLC member is only liable for their own contribution, a GmbH shareholder may be liable for all contributions, in the worst case resulting in a liability amounting to the share capital figure.¹⁵⁹ For both GmbH and LLC it needs to be discussed whether it is possible to compromise the obligation to contribute. A GmbH contribution cannot be waived at all.¹⁶⁰ The only way to eliminate a contribution obligation is to reduce the share capital, which is a lengthy and complicated process.¹⁶¹ In contrast, the LLC statute approves a waiver by consent of all members.¹⁶² Besides all members consenting, such a compromise requires the articles of organisation to be amended accordingly.¹⁶³ With regard to third parties, it needs to be considered that such a waiver does not affect those creditor rights that have been established before the amendment of the articles.

The previous remarks all concern initial contributions. However, both GmbH and LLC law also allow for contributions to be made subsequent to the formation. The LLC statute requires that in case of subsequent contributions the company's articles have to be amended accordingly.¹⁶⁴ The subsequent issue of GmbH shares also necessitates an amendment of the entity's articles. Such an amendment requires a shareholder resolution with a three-quarter majority, a notarisation of that resolution, and a notarised statement of the new shareholder(s).¹⁶⁵

¹⁵⁸ S 19(I) GmbHG, @17-15-121(a)(ii).

¹⁵⁹ See s 24 GmbHG. However, before this comprehensive liability is enforced, attempts must be made to sell the interest by public auction, see ss 21 et sqq GmbHG.

¹⁶⁰ See s 19(II)(1) GmbHG.

¹⁶¹ See ss 58 et sqq GmbHG.

¹⁶² See @17-15-121(c).

¹⁶³ @17-15-120(a)(iii).

¹⁶⁴ @17-15-129(b)(i). The original and one copy of the amendment must be filed to the Secretary of State, accompanied by a filing fee. An amendment is required at most once a year, @17-15-129(c).

¹⁶⁵ Ss 53, 55(I) GmbHG. The resolution, the declaration and the complete (new) text of the company's articles have to be filed to the register court, s 4(I) GmbHG.

(d) Maintenance of capital

The GmbHG is not only very intent on actually raising the agreed contributions. It also provides strict rules to ensure that contributed assets continuously remain part of the company's estate. First, it has already been shown that contribution liabilities cannot be waived.¹⁶⁶ Furthermore, payments to shareholders are unlawful as long as the company's assets do not cover the share capital.¹⁶⁷ Therefore, GmbH contributions can generally not be returned.¹⁶⁸ In contrast, LLC contributions can be returned. It only requires that all creditor claims could be satisfied at the time of return and all members' consent.¹⁶⁹ Unless otherwise provided in the operating agreement, the members' consent is not necessary if the claiming member has a right to get the contribution returned. Such a right exists if the company is dissolved or if the member gives a written notice regarding the claim six months in advance.¹⁷⁰

(i) Bail out mechanism

Consequently, an LLC member has a statutory right to claim the return of contribution as long as proper notice is given and creditor rights are not affected.¹⁷¹ This rule traces back to principles of partnership law.¹⁷² It provides members with a bail out mechanism, which in practice is a cost-effective tool of dispute resolution. Conflicts between members are, therefore, not likely to put a continuous strain on the company, but may be easily solved by a member's dissociation.

¹⁶⁶ S 19(II)(1) GmbHG.

¹⁶⁷ Ss 30, 31 GmbHG. More details in part V B 6 (c) of this paper.

¹⁶⁸ A return of contributions can only be achieved by dissolving the company or decreasing the share capital. However, such a decrease of the share capital is a highly complicated process, which adheres to strict procedural rules, see ss 58 et seq GmbHG.

¹⁶⁹ See @17-15-120(a)(i).

¹⁷⁰ See @17-15-120(b)(ii). The member is only entitled to receive cash, irrespectively of the kind and nature of assets originally contributed, @17-15-120(c). In *Liebermann v Wyoming.com, LLC* (2000) 11 P 3d 353 (Wyo), the LLC terminated a member's position as vice-president. The member then asked for the return of contribution. The court held that the member was entitled to a return of contribution, but could not ask for dissolution and distribution of profits.

¹⁷¹ However, even lawfully returned contributions may have to be payed back within six years if creditor claims need to be satisfied, @17-15-121(d).

¹⁷² See s 601(a)(i) Uniform Partnership Act Wyo St Title 17 Chapter 21 (1977): "A partner is dissociated from a partnership upon...receipt by the partnership of notice of the partner's express will to withdraw as a partner or upon any later date specified in the notice."

The GmbHG, in contrast, does not include such a mechanism. However, GmbH shareholders can generally sell and transfer their shares.¹⁷³ If the company has assets exceeding the amount of the share capital, the company may use those exceeding financial means for a buyback of those shares.¹⁷⁴ In very exceptional cases an undeniable right of shareholders to a return of contribution is acknowledged.¹⁷⁵ However, this right exclusively concerns cases of extreme hardship, and it is only granted if the shareholder has failed to sell the shares beforehand.¹⁷⁶ In conclusion, both LLC and GmbH law provide the possibility of a member's dissociation to resolve internal conflicts. However, methods differ remarkably. Whereas the LLC statute expressly grants a right to return of contribution, GmbH law rather puts a focus on the sale and transfer of shares.

(ii) Shareholder loans

GmbH legislation and German courts have extended the capital maintenance system and established highly complicated rules for shareholder loans that cause this area to be responsible for a great deal of litigation and academic controversy.¹⁷⁷ The fact pattern behind all this is simple. If the GmbH is in a severe crisis, the shareholders basically have two choices. They can dissolve the company or, alternatively, throw in new equity capital. Shareholders often do not want to dissolve, and neither do they want to throw in new equity capital because in case of insolvency the capital is likely to vanish completely. In regard to their contributions, shareholders have lowest priority and are paid out only after all other creditors have been satisfied.¹⁷⁸ Therefore, shareholders tend to choose a third option. They give loans to the company. If it later turns out that the crisis cannot be overcome, they hope to recover the loan money. Obviously, granting a loan instead of bringing in equity capital affects creditor rights, as creditors generally can only access the share capital and not the loan money.

¹⁷³ S 15(I) GmbHG. The transaction agreement needs to be notarised, s 15(III) GmbHG. Furthermore, the articles can restrict the transfer, particularly calling for the other shareholders' consent. In exceptional cases, the shareholders' consent cannot be refused; Guenther H Roth and Holger Altmeyden *GmbHG* (4 ed, Beck, Munich, 2003) s 15, para 100.

¹⁷⁴ See s 33(II) GmbHG.

¹⁷⁵ Guenther H Roth and Holger Altmeyden *GmbHG* (4 ed, Beck, Munich, 2003) s 60, para 101.

¹⁷⁶ Guenther H Roth and Holger Altmeyden *GmbHG* (4 ed, Beck, Munich, 2003) s 60, para 103.

¹⁷⁷ For a comprehensive overview see Markus C Stadler "Treatment of Shareholder Loans to Undercapitalized Corporations in Bankruptcy Proceedings" (1997) 17 J L & Com 1.

¹⁷⁸ Markus C Stadler "Treatment of Shareholder Loans to Undercapitalized Corporations in Bankruptcy Proceedings" (1997) 17 J L & Com 1, 3.

Consequently, the issue becomes whether the loan was in reality a *bona fide* loan or a disguised contribution to the equity capital. In GmbH law, this situation is addressed both by case law and legislation. For many years, courts have developed circumstances, under which a shareholder loan, which is deemed to be more properly characterised as a capital contribution rather than as a loan, is actually treated as a contribution.¹⁷⁹ This case law has later on been put into statutory form.¹⁸⁰ The respective provisions, however, only codify the case law to a certain extent, and provide a standard of protection that is lower than that established by the courts. The courts, therefore, not only apply the statutory provisions, but also resort to the principles as established prior to the codification.¹⁸¹

Similar to German law, US law also provides for rules governing shareholder loans, mainly comprising three different approaches: disallowance, equitable subordination, and recharacterisation of loans as equity rather than debt.¹⁸² These rules mainly apply in bankruptcy proceedings. However, equitable subordination may also be invoked outside the context of a bankruptcy.

Shareholders need to be prevented from unfairly shifting the risks of business ownership to the creditors while retaining the benefits of ownership. However, German courts have carried that reasonable thought to excess. Not only is it overly complex to apply the "old" case law principles, though statutory provisions do exist. German courts have also extended the existing rules without any sense of proportion. For example, the application of the rules is not limited to loans. The rules may also be applied with regard to the assignment of property for usage.¹⁸³ A shareholder agreeing to let the GmbH use his property without any consideration may not be able

¹⁷⁹ Courts have based this case law on ss 30, 31 GmbHG analogue.

¹⁸⁰ See ss 32a, 32b GmbHG. These provisions only apply to shareholder loans, which were granted to the company not earlier than one year prior to the beginning of insolvency proceedings, see ss 135, 143 *Insolvenzordnung* (Insolvency Code), <http://www.bundesregierung.de/-/418/Gesetze.htm> (last accessed 25 September 2003). Outside this period, ss 32a, 32b GmbHG do not apply.

¹⁸¹ In BGHZ 90, 370, the BGH had to deal with a shareholder loan that was granted outside the one-year-period as required by ss 32a, 32b GmbHG. The BGH held that, outside the coverage of the statutory provisions, it is possible to resort to the previous case law principles.

¹⁸² Markus C Stadler "Treatment of Shareholder Loans to Undercapitalized Corporations in Bankruptcy Proceedings" (1997) 17 J L & Com 1, 1.

¹⁸³ In BGH (1997) 1997 NJW 3026, a shareholder had rented factory premises to his GmbH. The GmbH got behind the rent payments and finally became insolvent. The issue was whether the shareholder could claim the outstanding rent and terminate the rental agreement. The BGH held that the extension for payment (of the rent) is comparable to granting a loan and, therefore, can be treated as a capital contribution. As a result, the shareholder could not claim the outstanding rent and had to tolerate the further use of the premises.

to terminate such a usage agreement until the GmbH has finally overcome the crisis. Furthermore, the rules are also extended regarding the persons involved. For example, former shareholders or even relatives of shareholders might be incapable of asking for the return of a loan.¹⁸⁴

Overall, the analysis of the capital structure has revealed apparent differences. The LLC is governed by a straightforward regime. It features no minimum share capital, but flexible contribution rules, and an appropriate bail out mechanism. In contrast, driven by the ambition to provide creditor protection, GmbH law establishes a restrictive and highly complicated set of rules. In principle justified instruments of creditor protection are carried to excess, thereby widely ignoring business interests. GmbH shareholders, therefore, run a relatively high risk of non-compliance. This in fact lowers the attractiveness of the GmbH as a business form substantially, and underlines the need for company law reform in Germany.

5 Management

Capital rules have shown striking differences that result in a disadvantageous position of the GmbH. In the following, operational issues will be compared. Here, it is shown that in particular the flexibility as to the form of management significantly adds to the convenience of the LLC.

(a) Centralised or decentralised management?

Concerning management, the most eye-catching difference is that centralised management is mandatory only for the GmbH. The GmbHG requires the GmbH to have at least one manager.¹⁸⁵ In contrast, the LLC is generally member-managed; management is vested in the company's members in proportion to their capital contribution.¹⁸⁶ Though members may wish to vary the allocation of rights and duties

¹⁸⁴ In BGH (1981) 1982 NJW 386, the son of a shareholder had granted a loan to his father's GmbH. The BGH held that the son could not claim repayment of the loan money unless the company's crisis is overcome or all other creditors are satisfied.

¹⁸⁵ S 6(I) GmbHG. The management is appointed in the articles or elected later on. It can be removed at any time. For details see s 38 GmbHG. Changes in the management have to be filed immediately to the register court, s 39 GmbHG. S 15 HGB provides a sophisticated system protecting third parties; as long as the change is not registered, third parties can rely upon the old status.

¹⁸⁶ @17-15-116.

in a management agreement, the default rules of the LLC statute are overall appropriate and especially beneficial for small and medium-sized businesses. These businesses are often member-managed and can, under LLC law, avoid the formalities of centralised management, for instance the appointment process. Consequently, the combination of direct control and limited liability presents clear advantages over either the corporate or the partnership form for a wide range of business firms.

(b) Authority issues

When looking at authority provisions, differences become obvious in regard to possible restrictions. The GmbH is exclusively represented by its managers.¹⁸⁷ Any restriction to their authority has no effect on third parties.¹⁸⁸ In the case of a single-person-GmbH, the only shareholder can generally not conclude legal transactions between the GmbH and himself, if he is also the only manager.¹⁸⁹

Regarding the LLC, each manager or - if the LLC is member-managed - each member can contract for a debt of the LLC.¹⁹⁰ In contrast to GmbH law, both the managers' and the members' authority can be restricted internally but also externally.¹⁹¹ It needs also to be considered that the ultra vires doctrine applies, restricting the authority to the company's business.¹⁹²

In conclusion, the GmbH rules only allow for internal restrictions and, thereby, protect third parties doing business with the GmbH. In contrast, the LLC provisions also tolerate restrictions with external effect and, therefore, give members the opportunity to protect the company's assets against undesirable transactions by managers and members.

¹⁸⁷ S 35(I) GmbHG. The management can delegate by appointing agents or giving procuration; Guenther H Roth and Holger Altmeppen *GmbHG* (4 ed, Beck, Munich, 2003) s 35, para 10.

¹⁸⁸ S 38(II) GmbHG. While the transaction is valid, the manager acting in contravention of the restriction is liable to the GmbH, s 43 GmbHG. Therefore, internal restriction is possible.

¹⁸⁹ Ss 35(IV) GmbHG, 181 BGB. This rule is designed to prevent conflicts of interest. However, it is rather a formality because it is a default rule, s 35(IV) GmbHG. Articles of single-person GmbHs, therefore, routinely exclude the application of this rule.

¹⁹⁰ @17-15-117. Besides the LLC statute, general agency principles apply. For example, in *Water, Waste & Land v Lanham* (1998) 955 P2d 997 (Colo Supr C), the court held that the LLC as principal must be disclosed at any time.

¹⁹¹ The external effect is not expressly addressed in the Wyoming LLC statute. Section 301 ULLCA provides that the company is generally bound (externally), unless the contracting manager or member had no authority to act and the contracting partner knew of the lack of authority.

¹⁹² See detailed remarks in part V B 1 of this paper.

It has been shown that the operational flexibility adds to the convenience of the LLC. Governance rights and authority are generally vested in the members. However, by appointing managers, LLC members can also adopt a management structure resembling features of corporations.¹⁹³ This “chameleon management” structure¹⁹⁴ means that there is flexibility to choose between decentralised and centralised management. This makes the LLC attractive. By using decentralised management, members can combine direct control and limited liability.

6 Member-related issues

Up to this point, an easier entity formation, flexible capital rules and a choice as to the structure of management have proven to be the most apparent advantages of the LLC form. In the following, some member-related issues further illustrate the benefits of the LLC. In particular this includes diverging approaches regarding fiduciary duties as an instrument of minority protection.

(a) Shares and their transferability

When looking at company shares and their transferability, it first appears that in this regard GmbH law is more convenient. Both GmbH shareholders and LLC members receive shares corresponding to the value of their contributions.¹⁹⁵ These shares can generally be transferred. A transfer of GmbH shares needs not to be approved by other shareholders. However, the transaction agreement has to be notarised.¹⁹⁶ In contrast, for the transfer of LLC shares all members have to give their consent. If that consent is lacking, the transferee does not become a member and can only enjoy financial rewards.¹⁹⁷ In conclusion, GmbH shares are established as tradeable papers, whereas the LLC statute sticks to partnership principles making the transfer rather difficult.¹⁹⁸

¹⁹³ Robert W Hamilton *Cases and Materials on Corporations Including Partnerships and Limited Liability Companies* (7 ed, St Paul, Minnesota, 2001) 190.

¹⁹⁴ Larry E Ribstein “The Emergence of the Limited Liability Company” (1995) 51 *Bus Law* 1.

¹⁹⁵ While the shares cannot be listed on the stock exchange, LLC shares might be considered as security for the Securities Act 1933 and the Exchange Act 1934; In the affirmative *Nutek Information Systems v Arizona Corporation Commission* (1998) 977 P 2d 826 (Ariz App); denying *Great Lakes v Monsanto Company* (2000) 96 F Supp 2d 376 (Del).

¹⁹⁶ See s 15(III) GmbHG.

¹⁹⁷ @17-15-122.

¹⁹⁸ However, GmbH shares are not as tradable as shares of a public corporation.

Nevertheless, both the GmbH and the LLC rules are only default rules.¹⁹⁹ Consequently, GmbH shareholders can agree on a more partnership-like transfer regime, whereas LLC members may decide for a more corporate-like system. Apparently, the GmbH default rules are rather appropriate for larger companies that are characterised by a more frequent fluctuation of shareholders and, therefore, need easily transferable shares. In contrast, the LLC default rules are appropriate for smaller companies. Here, members generally have a more personal bonding and, therefore, need a certain level of protection against the intrusion of new, possibly unwanted members. Consequently, restrictive transfer rules tend to be more suitable for small, particularly family businesses.

(b) Meetings and voting

Whereas the LLC statute does not provide any provisions concerning meetings and voting, the GmbH is subject to an extensive mandatory regime.²⁰⁰ Meetings are generally called by the management.²⁰¹ Holders of at least 10 per cent of the shares may also be able to call a meeting.²⁰² A meeting notice has to be given at least one week in advance by registered mail.²⁰³ At the meeting, the general rule is majority voting.²⁰⁴ However, some voting needs a three-quarter majority or must even be unanimous.²⁰⁵ Votes can be delivered in person or – if all shareholders consent – in writing.²⁰⁶ Finally, it has to be noted that shareholders, who have been outvoted, can take legal action against the respective resolution.²⁰⁷ Obviously, these restrictive rules are not appropriate for small and informal companies. Considering that the rules are not default rules but mandatory rules, particularly family businesses and single-person entities are forced under a formalistic and burdensome regime.

¹⁹⁹ Pursuant to s 15(V) GmbHG, the articles can draw up further restrictions, particularly requiring the approval of the company or all other shareholders. For the LLC see @17-15-144(b).

²⁰⁰ Ss 47 to 51 GmbHG (406 words).

²⁰¹ The management has the duty to call a meeting if that is in the company's interest or if there has been a loss amounting to half of the share capital, see s 49 GmbHG.

²⁰² S 50 GmbHG.

²⁰³ S 51(I) GmbHG.

²⁰⁴ S 47(I) GmbHG.

²⁰⁵ See for example s 53 (II)(1) GmbHG.

²⁰⁶ S 48(II) GmbHG.

²⁰⁷ See ss 241 AktG analogue.

(c) Profit distribution

Both GmbH shareholders and LLC members are entitled to the profits.²⁰⁸ As a default rule, profits are generally allocated on the basis of the value of the paid-up contributions.²⁰⁹ Nevertheless, there are various constraints on the allocation of dividends both under LLC and GmbH law. Most importantly, LLC profits can only be distributed if the company's assets are in excess of all the entity's liabilities.²¹⁰ Similarly, GmbH profits may only be distributed if the company's assets are in excess of the GmbH's liabilities and, moreover, exceed the share capital figure as stated in the articles.²¹¹

However, GmbH and LLC form differ in so far as the procedure of profit distribution is concerned. Whereas under LLC law the actual distribution process is left to the members' discretion in the operating agreement, GmbH law provides for a comprehensive set of mandatory rules. For any profits to be distributed, two shareholder resolutions are necessary. A first resolution has to confirm the annual statement of account. A second resolution then has to determine the actual amount that is to be distributed as dividends.²¹² These formalities may constrain the timing of profit distribution to GmbH shareholders.

A further aspect is whether a dividend may be charged against share capital. This is possible under LLC law.²¹³ With regard to GmbH law, it is essential to make the following distinction. Shareholders cannot charge profit claims against their original contribution obligation.²¹⁴ However, if the share capital figure is increased later on, it is possible to contribute existing profit claims in exchange for new shares. It is only required that the resolution, which is necessary to increase the share capital, clearly states that profit claims are being contributed.²¹⁵

²⁰⁸ S 29(I) GmbHG; @17-15-119.

²⁰⁹ S 29(I) GmbHG; @17-15-119.

²¹⁰ @17-15-119,

²¹¹ Ss 30, 31 GmbHG.

²¹² In most cases, not all of the company's net profits are distributed. Profits can also be allocated to reserves and not distributed. However, there are various restrictions, see s 58b GmbHG.

²¹³ See @17-15-119: "The...company may...divide and allocate the profits...among the members; provided, that...the assets of the limited liability company are in excess of all liabilities of the limited liability company except liabilities to members on account of their contributions."

²¹⁴ See s 19(II)(2) GmbHG.

(d) Fiduciary duties

Finally, differences become apparent when looking at minority protection. It has already been mentioned that LLC law provides a very cost-effective bail out mechanism, which serves as an effective tool for dispute resolution and, therefore, as an instrument for minority protection.²¹⁶ As shown, the GmbHG does not include such a mechanism, but generally allows for an unproblematic transfer of shares.²¹⁷

Besides that, minority protection measures exist both for GmbH and LLC. Among those measures are, for instance, derivative actions (*actio pro socio*),²¹⁸ information rights,²¹⁹ and fiduciary duties.²²⁰ The following part takes a closer look at fiduciary duties only, and limits the analysis to duties owed by members and shareholders to each other and to their company.²²¹ The analysis of fiduciary duties owed by LLC members and GmbH shareholders illustrates that LLC law provides a more flexible approach, whereas GmbH law introduces a highly sophisticated system and, thereby, in particular burdens small and informal businesses.²²²

²¹⁵ Adolf Baumbach and Goetz Hueck *GmbHG* (17 ed, Beck, Munich, 2000) s 5, para 28.

²¹⁶ @17-15-120(b)(ii). See part IV B 4 (d) (i) of this paper.

²¹⁷ See part IV B 4 (d) (i) of this paper.

²¹⁸ In GmbH law, this is an unwritten principle, Guenther H Roth and Holger Altmeppen *GmbHG* (4 ed, Beck, Munich, 2003) s 13, para 48; for the LLC, see @17-15-130.

²¹⁹ For the GmbH, see s 51a GmbHG. The Wyoming LLC statute does not expressly refer to members' information rights; however, such a right is generally acknowledged; see s 408 ULLCA; in *Somerville's Trust v USV Partners, LLC* (2 August 2002) Lexis 103 (Del Ch), the court acknowledged a member's right to inspect company books and records.

²²⁰ For the GmbH, Guenther H Roth and Holger Altmeppen *GmbHG* (4 ed, Beck, Munich, 2003) s 13, para 61; for the LLC, see s 103 ULCCA.

²²¹ Nevertheless, also managers that are not members or shareholders owe fiduciary duties to the company. These duties are not discussed here, as this part deals with minority protection, meaning with instruments that help to protect interests of minority members and shareholders.

²²² The area of fiduciary duties is highly contentious. "A majority of the contested issues in business law scholarship today relates to fiduciary duties", Paula J Dalley "To Whom It May Concern: Fiduciary Duties and Business Associations" (2001) 26 Del J Corp L 515, 516; "Most legal scholarship has examined the potential liability and the scope of the fiduciary duty of the members of an LLC", Leigh A Bacon "Note: "Freedom of" Or "Freedom From"? The Enforceability Of Contracts And The Integrity Of The LLC" (2001) 50 Duke L J 1087. For a general overview see William H Copperthwaite Jr "Limited Liability Companies: The Choice for the Future" (1998) 103 Com L J 222, 236; David L Cohen "Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?" (1998) 51 Okla L Rev 427; Richard A Booth "Fiduciary Duty, Contract, and Waiver in Partnerships and Limited Liability Companies" (1997) 1 J Small & Emerging Bus L 55, 55; Claire Moore Dickerson "Equilibrium Destabilized: Fiduciary Duties Under the Uniform Limited Liability Company Act" (1995) 25 Stetson L Rev 417.

Both the GmbHG and the Wyoming LLC statute do not expressly address fiduciary duties of shareholders and members. However, the existence of such duties is commonly accepted.²²³ The extent and specification of fiduciary duties is multifaceted. Obviously, in a small company members and shareholders are more personally involved, whereas in large companies shareholding is mostly a capital investment. Therefore, fiduciary duties are claimed to be more intense in small companies that feature rather personalistic instead of capitalistic elements.²²⁴

Fiduciary duties relate to very different issues. A few examples may illustrate the scope of such duties. For the GmbH it was decided that the refusal to vote for a necessary amendment of the articles is a breach of fiduciary duties.²²⁵ Both GmbH and LLC law know the corporate opportunity doctrine, whereupon fiduciary duties are breached when a shareholder or member seizes economic opportunities from the company for personal benefits.²²⁶ With regard to the LLC, the court in *Stephen A Cole v Kenneth A Kershaw et al* held that the elimination of a minority owner by a majority owner without compensation was a breach of fiduciary duties.²²⁷ In *Palmer v Moffat et al*, some members withheld capital contributions, and as a result the company defaulted on its finance obligations. This behaviour was held to be a breach of fiduciary duties as well.²²⁸

²²³ For the GmbH, Guenther H Roth and Holger Altmeppen *GmbHG* (4 ed, Beck, Munich, 2003) s 13, para 61; however, some scholars still oppose the existence of such duties, Werner Flume "Die Rechtsprechung des II. Zivilsenats des BGH zur Treupflicht des GmbH-Gesellschafters und des Aktionärs" (1996) 1996 ZIP 161. For the LLC, see *Taurus Advisory Group, Inc et al v Sector Management, Inc et al* (15 April 1998) WL 199353 (Conn Super). As part of the obiter dicta, the court held that also between members of an LLC fiduciary duties do exist. In *Walker et al v Virtual Packaging LLC et al* (1997) 493 SE 2d 551 (Ga App), it was held that in case of a breach of fiduciary duties the aggrieved member is able to claim damages resulting from the breach.

²²⁴ Guenther H Roth and Holger Altmeppen *GmbHG* (4 ed, Beck, Munich, 2003) s 13, para 64.

²²⁵ In BGH (1995) 1995 NJW 1739, the share capital had to be decreased to achieve the company's recapitalisation. For such a decrease, the articles of organisation need to be amended. The court held, that the refusal to vote for such a necessary amendment breached fiduciary duties.

²²⁶ In BGH (1989) 1989 ZIP 986, a shareholder used one of the company's inventions/patents to make personal profits. This was held to be a breach of fiduciary duties. In *US West, Inc et al v Time Warner Inc* (6 June 1996) WL 307445 (Del Ch) the court held that the corporate opportunity doctrine also applies outside the corporate context, meaning to LLCs and even to partnerships.

²²⁷ *Stephen A Cole v Kenneth A Kershaw et al* (30 November 2001) Lexis 43 (Del Ch). The defendants merged the original entity into a new entity that was owned by all former participants except the plaintiff. The court held that the majority owner had no power to remove the minority owner and to forfeit his membership interest.

²²⁸ *Palmer v Moffat et al* (10 October 2001) Lexis 386 (Del Super).

Businesses do not have to worry too much about the existence and extent of fiduciary duties as long as those duties can be defined, restricted or even excluded by agreement. In this regard, GmbH law is very restrictive. Courts are very reluctant to accept a restriction of fiduciary duties in the articles or in a side agreement.²²⁹ Scholars predominantly even support the view that fiduciary duties are mandatory.²³⁰

For the LLC, the situation is different. Though the ULLCA restricts the party's freedom to dispose of fiduciary duties,²³¹ most LLC statutes allow a great deal of party autonomy. Some of the states do not mention fiduciary duties in their LLC statutes, but expressly allow defining duties of members and managers in the operating agreement.²³² Other states include default provisions in their statutes, allowing the parties to modify these duties, though setting a minimum standard under which the duty may not fall.²³³ Finally, other states regard fiduciary duties as an element of contract and allow members to opt-out of fiduciary duties completely.²³⁴ Admittedly, the approach of American States is not consistent. However, overall most LLC statutes feature a very flexible approach to fiduciary duties.

The courts mainly acknowledge this flexibility. Whereas courts still tend not to permit a waiver of fiduciary duties in partnership agreements,²³⁵ this seems to be different for the LLC. In *ELF Atochem North America, Inc v Cyrus A Jaffari and Malek LLC*, the court held that a reduction or exclusion is possible as long as only

²²⁹ In BGH (1995) 1995 NJW 194, the court held that fiduciary duties as to informing minority shareholders about important company transactions can only be restricted if there are strong reasons. Here, the admissible business competition of a shareholder was held to be not a sufficient reason.

²³⁰ Christian Hartmann "Der Schutz der GmbH vor ihren Gesellschaftern" (1999) 1999 GmbHR 1061.

²³¹ See s 103(b)(2), (3), (4) ULLCA.

²³² Ariz Rev Stat Ann. 29-682 (West 1998); Nev Rev Stat Ann 86 281(9) (Michie 1999); Utah Code Ann 48-2b-126 (Supp 1998). These provisions all state that duties of members and managers are subject to the operating agreement.

²³³ Ill Comp Stat Ann 180/15-5(b)(6)(A) provides that the operating agreement can define types or categories of activities that do not violate fiduciary duties, unless being "manifestly unreasonable."

²³⁴ See s 18-1101(c)(2) Del LLC Act: "Member's or manager's or other person's duties and liabilities may be expanded or restricted by provisions in the limited liability company agreement."

²³⁵ In *Wartski v Bedford* (1991) 926 F 2d 11 (1st Cir), a partner took advantage of a company opportunity for his personal profit. The court held that this was a breach of fiduciary duties and awarded damages. The court stated that the fiduciary duty of partners are an integral part of the partnership agreement whether or not expressly set forth therein. They cannot be negated by the words of the partnership agreement.

member rights are touched, not rights of third parties.²³⁶ In *McConnell v Hunt Sports Enterprises*, the court even held that members could simply limit the scope of their fiduciary duties by negotiating them out of the operating agreement of the LLC.²³⁷

This issue is highly contentious among legal scholars. Some scholars allow members to opt-out of fiduciary duties by arguing that such duties are a purely contractual matter.²³⁸ It is further argued that LLC members can be better controlled by incorporating specific contract terms rather than having fiduciary duties.²³⁹ Other scholars argue that fiduciary duties are not waivable.²⁴⁰ However, in the end it should be apparent that a waiver is possible. LLCs are intended to be flexible organisations that allow members to negotiate the terms of their relationships with themselves and the company.²⁴¹ This is in particular helpful for small businesses in need of an informal operation of the company.

Besides an easier entity formation, flexible capital rules, and a choice as to the form of management, member-related issues further underline the attractiveness of the LLC. It has been shown that in particular a flexible approach regarding fiduciary duties facilitates a smooth functioning of the business.

²³⁶ *ELF Atochem North America, Inc v Cyrus A Jaffari and Malek LLC* (1999) 727 A 2d 286, 292 (Del); discussing this decision Robert W Hamilton *Cases and Materials on Corporations Including Partnerships and Limited Liability Companies* (7 ed, St Paul, Minnesota, 2001) 197 et sqq).

²³⁷ *McConnell v Hunt Sports Enterprises* (1999) 725 NE 2d 1193 (Ohio Ct App); see the case note of Tammy Savidge Moore "The Policy of Opting-Out of Fiduciary Duties in a Limited Liability Company: *McConnell v Hunt Sport Enterprises* (1999) 725 NE 2d 1193 (Ohio Ct App)" (2000) 42 S Tex L Rev 183.

²³⁸ Larry E Ribstein „Fiduciary Duty Contracts in Unincorporated Firms“ (1997) 54 Wash & Lee L Rev 537, 539; Terence Woolf "The Venture Capitalist's Corporate Opportunity Problem" (2001) 2001 Colum Bus L Rev 473, 500, 501. The authors of these articles do not draw a distinction between closely held (family) businesses and larger firms.

²³⁹ Larry E Ribstein „Fiduciary Duty Contracts in Unincorporated Firms“ (1997) 54 Wash & Lee L Rev 537, 543.

²⁴⁰ Tammy Savidge Moore "The Policy of Opting-Out of Fiduciary Duties in a Limited Liability Company: *McConnell v Hunt Sport Enterprises* (1999) 725 NE 2d 1193 (Ohio Ct App)" (2000) 42 S Tex L Rev 183, 206; Melvin Aron Eisenberg „The Limits of Cognition and the Limits of Contract“ (1995) 47 Stan L Rev 211, 249.

²⁴¹ Stan Johnson "Duties Under the Utah Revised Limited Liability Company Act: Analysis of a Statutory Conflict" (2002) 2002 Utah L Rev 551, 554.

VI CONCLUSION

It has been shown that an LLC-like business form is missing in the current menu of German company law. For small and medium-sized businesses that strive for limited liability, the German law basically only provides the GmbH. As illustrated in this paper, GmbH law tends to be excessively restrictive and, therefore, the GmbH is often inconvenient for informal small and medium firms.

The restrictive character of GmbH law is due to the fact that legislation has been focusing on creditor protection. However, it has been pointed out that business interests have often not been thoroughly considered, and even the goal of creditor protection has not been attained in many cases. Therefore, it is not advisable to retain the *status quo*. Small and medium businesses should not be limited to the GmbH or partnership forms, but be offered an alternative, more convenient choice.

In this regard, the LLC may well serve as a role model for German reform. It has been shown that various issues contribute to the attractiveness of the LLC. On the whole, the formation process requires less administrative efforts. LLC law is further characterised by flexible capital rules. Moreover, decentralised management is possible, offering the opportunity to combine direct control and limited liability. Finally, fiduciary duties as an instrument of minority protection are more or less disposable, providing more flexibility to business owners. Overall, LLC law is attractive because it is possible to shape an entity that is characterised by a combination of partnership and corporate elements, all selected to best suit the individual business.

It may be argued that company reform should be rather advanced at a European level instead of seeking for a national solution. Not only large companies, but also small and medium-sized businesses increasingly exceed national boundaries and engage in cross-border trade. And indeed, company law has always been an area of law heavily influenced by European legislation.²⁴²

²⁴² In 1985, the Regulation on the European Economic Interest Grouping (EEIG) created a new type of cooperation, which enables separate businesses from different Member States to develop certain joint activities without having to merge or to set up a jointly owned subsidiary: Council Regulation (EEC) No 2137/85 of 25 July 1985 on the European Economic Interest Grouping (EEIG) OJ L 124, 15/05/1990, 52. In late 2004, the Regulation on the Statute for a European company will come into

However, European legislation is likely to take many years to draft. German businesses urgently need a more flexible and convenient business form. Therefore, Germany should take the lead and implement a new LLC-like business form.

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APPENDIX

Appendix 1: State Comparison Chart (US LLCs)

State	LLC Law	Enacted	Type	Fee	Tax
Alabama	Yes	1993	Flexible	\$40.00	None
Alaska	Yes	1994	Flexible	\$250.00	\$200
Arizona	Yes	1993	Flexible	\$50.00	None
Arkansas	Yes	1993	Flexible	\$50.00	None
California	Yes	1994	Flexible	\$70.00	\$800+add
Colorado	Yes	1990	Flexible	\$50.00	None
Connecticut	Yes	1993	Flexible	\$60.00	None
Delaware	Yes	1992	Flexible	\$70.00	\$100.00
Florida	Yes	1982	Flexible	\$125.00	None
Georgia	Yes	1994	Flexible	\$75.00	5%wthhold
Hawaii	Yes	1997	Flexible	\$100	None
Idaho	Yes	1993	Flexible	\$100.00	None
Illinois	Yes	1994	Flexible	\$500.00	None
Indiana	Yes	1993	Flexible	\$90.00	None
Iowa	Yes	1992	Flexible	\$50.00	None
Kansas	Yes	1990	Flexible	\$150.00	Formula
Kentucky	Yes	1994	Flexible	\$40.00	None
Louisiana	Yes	1992	Flexible	\$60.00	None

Maine	Yes	1994	Flexible	\$250+105	None
Maryland	Yes	1992	Flexible	\$50.00	5%wthhold
Massachus.	Yes	1995	Flexible	\$500.00	\$500.00
Michigan	Yes	1993	Flexible	\$50.00	None
Minnesota	Yes	1993	Flexible	\$135.00	None
Mississippi	Yes	1994	Flexible	\$50.00	None
Missouri	Yes	1993	Flexible	\$100.00	None
Montana	Yes	1993	Flexible	\$50.00	None
Nebraska	Yes	1993	Flexible	\$100.00	\$43min
Nevada	Yes	1993	Flexible	\$125.00	None
New Hamp.	Yes	1993	Flexible	\$85.00	None
New Jersey	Yes	N/A	Flexible	\$100.00	None
New Mexico	Yes	1993	Flexible	\$50.00	None
New York	Yes	1994	Flexible	\$200.00	GrsRcptTx
North Carol.	Yes	1993	Flexible	\$125.00	None
North Dako.	Yes	1993	Flexible	\$125.00	None
Ohio	Yes	1994	Flexible	\$85.00	None
Oklahoma	Yes	1992	Flexible	\$100.00	None
Oregon	Yes	1994	Flexible	\$40.00	None
Pennsylvania	Yes	1995	Flexible	N/A	\$300ann
Rhode Island	Yes	1992	Flexible	\$150.00	None
South Carol.	Yes	1994	Flexible	\$135.00	None
South Dako.	Yes	1993	Flexible	\$50min	\$50ann
Tennessee	Yes	1994	Flexible	\$300min	\$300min
Texas	Yes	1991	Flexible	\$200.00	Formula
Utah	Yes	1991	Flexible	\$50.00	None
Vermont	Yes	1996	Flexible	\$70.00	None
Virginia	Yes	1991	Flexible	\$100.00	None
Washington	Yes	1994	Flexible	\$175.00	None
West Virgin.	Yes	1992	Flexible	N/A	N/A
Wisconsin	Yes	N/A	Flexible	\$130.00	None
Wyoming	Yes	1977	Flexible	\$100.00	\$100ann
Washington	Yes	1994	Flexible	N/A	\$50.00

Appendix 2: Entity Comparison Chart (US Company Law)

Characteristic	Sole Prop.	General Part.	Limited Part.	C Corp.	S Corp.	LLC
Limited liability for all owners	No	No	No	Yes	Yes	Yes
Owners can participate in management without losing liability protection	N/A	N/A	No	Yes	Yes	Yes
Easy to form and no need to keep extensive records	Yes	Yes	No	No	No	Yes
Number of owners	One	Two or more	One to 35	Two or more	One to 75	One or more
Restrictions on ownership	No	No	Yes	No	Yes	No
Double taxation	No	No	No	Yes	No	No
Able to deduct business loss on individual return	Yes	Yes	Yes	No	Yes	Yes
Able to add any number of additional investors including other entities	N/A	Yes	No	Yes	No	Yes
Flexible distribution of profits and losses	N/A	Yes	Yes	No	No	Yes

Available at <http://www.llcweb.com> (last accessed 25 September 2003).

Characteristic	Sole Prop.	General Part.	Limited Part.	C Corp.	S Corp.	LLC
Limited liability					Yes	Yes
all owners						
Owners can part						Yes
date in manage						
without losing li						
protection						
Easy to form and						Yes
need to keep ext						
records						
Number of owners						10
Restrictions on						No
ownership						
Double taxation						No
Abile to deduct						Yes
business loss on						
individual return						
Abile to sub any						Yes
number of additional						
investors including						
other entities						
Flexible distribution	NA	Yes	Yes	No	No	Yes
of profits and losses						

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