Modernizing Latin American Company Law: Creating an All-Purpose Vehicle for Closely Held Business Entities

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The wave of corporate governance reforms that has permeated most major systems of Latin America has not significantly impacted the legislation applicable to closely held companies. This appears to be a misdirected approach since the region’s economic reality is characterized by family control and concentrated ownership. Even listed corporations are generally subject to a block-holding structure. Policy-makers have not given enough weight to these factors when determining the current legislative agenda in Corporate Law. Surprisingly most legal reforms in this field have targeted agency problems more commonly arising in the context of dispersed equity ownership models. Corporate governance reforms such as mandatory independent directors, auditing committees and certification of financial statements have become common place in the securities regulations across the region. Albeit important in improving the legal framework of listed companies, most of these legal reforms disregard the basic underlying agency problem between controlling shareholders and their minority counterparts. Regulatory provisions for non-listed firms impose severe restrictions on private ordering and prevent parties from contracting around cumbersome imperative norms. These suboptimal approaches are justified on the grounds of public policy and defended at any cost by local legal operators. In several cases path dependence in Company Law represents an unsurpassable obstacle for the adoption of modern rules suitable for market economies. Company Law in most of Latin American jurisdictions continues to follow the taxonomy of business associations inherited from the nineteenth century’s French codification movement. Such business forms generally lack the necessary flexibility to cope with new economic realities due to obsolescence and rigidity. New hybrid business forms appear to be an appealing solution to deal with closely held firms in the region. However, attempts to undertake legal reform in this field must follow a structural transplant approach; namely, it cannot be restricted to the simple adoption of substantive law provisions.

This article is intended to provide an analytical framework for the adoption of a hybrid business form as a model law for closely held firms in Latin America. It is suggested that the advantages of flexibility and freedom of contract make such business form especially suitable for family-owned firms, start-ups, professional undertakings, and all sorts of small and medium firms within this region. The introduction in December 2008 of the Colombian Simplified Stock Company (Sociedad por Acciones Simplificada or SAS) is an example of a successful efficiency-minded law-making effort in a Civil Law jurisdiction. The SAS is aimed at providing its users with flexibility in organization and capitalization, complete freedom of contract and full-fledged limited liability. The Colombian example proves that

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even in the absence of competition for corporate charters it is possible to undertake structural transplants of company law with extraordinary results. The enthusiasm with which entrepreneurs have greeted the new legal development is reflected in the high number of SAS formations occurred after its inception. Within the first 6 months after the statute was passed, more than 5,000 simplified stock companies were created, outnumbering every other form of company.

Section 1 addresses the basic types of business associations that exist in the major jurisdictions in the area; Section 2 analyses some of the basic problems ensuing from the current regulation for closely held firms as it appears in codes and statutes across the region; Section 3 assesses the advantages of a simplified stock corporation and the Annex contains a model act on simplified stock corporations for Latin America.

1. BUSINESS ASSOCIATIONS IN LATIN AMERICA

In December of 2008, the Congress of the Republic of Colombia enacted a new law creating a new form of hybrid-business entity referred to as the Simplified Stock Corporation (SAS)\(^1\). Following an Anglo-American approach to corporate law, this act reduced all formalities for incorporation to a simple registration before a public registry. It also ameliorated expenses associated with the formation and operation of boards of directors, fiscal auditors, multiple managers and other formalistic requirements. The Act made it plain that shareholders would be shielded from any liability concerning any obligations arising from the business activities of the corporation. Furthermore, it reduced old-fashioned prohibitions regarding the activity of shareholders and managers and, above all, introduced a straightforward and effective principle of freedom of contract. Following a *structural transplant* approach, the new law introduced an innovative enforcement environment in which arbitration and administrative adjudication superseded an inefficient judiciary of that country. Only six months after the enactment of this law, more than 5,000 simplified stock corporations had been created. All kinds of business enterprises, irrespective of their size or activities, took quick advantage of the multiple innovations offered by the SAS. Corporate groups rushed to convert their previous subsidiaries into the new flexible business form. More significantly, all the types of business associations that existed before the enactment of this law rapidly fell behind, and in only four months the SAS was the number one business entity, as measured by the amount of new incorporations. The revered and highly valued limited liability companies (*sociedad de responsabilidad limitada*) and stock corporations (*sociedad anónima*) were rapidly defeated in this race for new incorporations. This rather unusual experiment may evidence that the anachronistic *status quo* of company law in Latin America can be successfully challenged.

**Table 1: Incorporation of new Simplified Stock Corporations (SAS)**

\(^1\) Law 1258 of 2008.
Notwithstanding characteristic skepticism, backward approaches by legal elites and path dependence, efficiency-minded legislators could easily enact statutes such as the one mentioned above on other major Latin American jurisdictions. Latin American countries could certainly benefit from a more progressive and investor-friendly corporate form. The following description of existing business forms in the region will provide a clear evidence of the urgent need to update the legal framework for company law in Latin America.

The company law systems of Latin America share a rather homogenous taxonomy of business associations. The point of departure for these systems can be found in the 19th century codifications in which the basic types of companies were included. With the exception of the closely held corporation (sociedad de responsabilidad limitada), the basic business forms already existed in those codes.2 Accordingly, most countries in the region have regulated four basic types of business associations: (1) Stock corporations (sociedades anónimas); (2) Partnerships (sociedades colectivas); (3) Limited partnerships (sociedades en comandita), and (4) Closely held corporations (sociedades de responsabilidad limitada).3

The traditional classification is closely linked with a distinction between business entities the nature of which is mostly related to the identity of the associates (intuitus personae) and the importance of capital contributions that are given by the parties (intuitus pecuniae). Both legal approaches fall under the ancient notion of societas that encompasses all the different forms of business entities. This taxonomy is somewhat advantageous, as it allows for the existence of general legal principles applicable to all the different forms of business associations. Within these general principles (general part) there are common rules for several different aspects such as company formation, causes for nullification, legal capacity of shareholders and partners, capital contributions, profit allocation, amendments to

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2 The ‘srl’ was introduced in Brazil after the Portuguese ‘sociedade por quotas’ of 1905. The same type of business entity was brought to other Latin American countries after the enactment of the Spanish statute of 1927.

the company’s by-laws, structural changes, mergers, split-ups, dissolution, liquidation, etc. The typification of each business entity requires that there exists a special part within these company law statutes, dealing with the specificities concerning each one of the business forms provided therein. The two extremes of the continuum are the partnership (sociedad colectiva) that is characterized by the highest relevance given to the intuitus personae element. On the other side of the continuum there is the stock corporation (sociedad anónima) that is usually depicted as the quintessential capitalist business entity. There is a middle ground between those two extremes in which the rules for composite business entities are laid out. In this type of companies elements of a personal nature are mingled with capitalist ingredients to create a syncretism usually devised for small or medium sized entities. These mixed entities include the limited liability company (sociedad de responsabilidad limitada) and the limited partnerships (sociedad en comandita). Within this last form there are in turn two separate species: the limited partnerships by quotas and the limited partnership by stocks. The obvious difference between these two forms lies with their differing capital structure. As a consequence, the former is assimilated partially to the limitada, whereas the latter partly resembles the anónima.

1.1 Partnerships (Sociedad colectiva)

A sociedad colectiva is very similar to a partnership and can even be defined in a similar way as a contract between two or more persons that make contributions in cash, in labor or in kind with the purpose of carrying on a business for profit. The partners are jointly and severally liable for all debts and obligations in which the partnership may incur. As different to Common Law systems, partnerships in Latin America are generally subject to the same formalities that are required in order for any other company to operate regularly. Therefore, it is usual for the law to require that a public deed be granted as well as a registration for public record before a mercantile registry. In the absence of such formalities, the partnership will not form a legal entity separate and distinct from its partners (i.e., it will lack legal personality).

There is an emphasis of a personal trait (intuitus personae) that permeates the partnership’s structure, inner workings, operation and even its dissolution. The partners enjoy a high degree of contractual flexibility. Consequently, it is generally possible to provide for very restrictive constraints to the partners, including, for instance, the inability to compete with the business activities of the partnership as laid out in the purpose clause or the possibility to expel partners if certain obligations set up in the constitutional documents are not met. Control over the businesses and assets of the partnership is exercised directly by the partners, who are entitled to represent the business entity vis-à-vis third parties unless such representation is delegated in a centralized administrative body or manager.

Even if this contractual flexibility appears to be highly convenient –since it allows the partners to provide sophisticated internal governance mechanisms –, such advantage is offset by the unlimited liability regime to which the partners are exposed.

As a result, the number of colectivas that are formally created tends to be extremely low. As an alternative to the regular partnership (i.e., formally created), the parties who purport to carry out a certain business can generally opt to create the so-called sociedad de hecho (literally a de facto partnership) in which no formalities whatsoever are required.

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4 See, for instance, Law 19.550 for Argentina, the Colombian Commercial Code, the company law of Ecuador, the general law of Commercial Companies of Mexico, etc.
Consequently, the mere consent – even tacitly granted – of the partners suffices for the legal existence of the de facto partnership. The only difference in terms of liability between a de facto partnership and a regular partnership is normally related to the secondary nature of the liability of the latter as compared to the direct and personal exposure of the former.

1.2 **Stock corporation (Sociedad anónima)**

On the other end of the spectrum, the sociedad anónima (stock corporation) epitomizes the prevalence of the intuitus pecuniae namely the higher weight that is given to capital contributions over the identity of the individuals forming the business entity. This feature normally identifies the sociedad anónima with large dimension undertakings. Anónimas are the appropriate vehicle for an enterprise to go public. In fact, securities regulation and stock exchange rules generally restrict IPOs to companies formed as anónimas. Nevertheless the anónima is also very popular among small and medium enterprises.

The bureaucratic structure that is usually required in order to set up an anónima is much more complicated than the one necessary to run any other business association. In fact, pursuant to corporate statutes in the region it is normally needed, in addition to the shareholders’ assembly, to appoint a board of directors, managers (legal representatives), mandatory auditors, etc., regardless of whether the company is listed or not. Even if this cumbersome structure is clearly excessive for small enterprises, many businesspeople are forced to use it in small and medium undertakings only to achieve the benefits of full limited liability. As a result of this choice, entrepreneurs could be subject to high transaction costs when using this form.

In most jurisdictions the anónimas’ capital is divided into shares of stock that are freely negotiable unless a right of first refusal is set forth in the corporation’s by-laws. Normally, the business of the corporation is carried out under a board of directors that in turn appoints officers and managers who undertake its day-to-day operations. Such centralized management is usually characterized by an election system with proportional representation such as cumulative voting, so as to allow minority shareholders to directly participate in management. Liability is restricted to each shareholder’s capital contribution and, thus, there is affirmative and defensive asset partitioning. In some Latin American jurisdictions piercing the corporate veil doctrines have been incorporated in statutory provisions. Nonetheless its actual enforceability is very limited, showing a great disparity between law in the books and law in action.

1.3 **Limited liability company (Sociedad de responsabilidad limitada)**

A highly popular form of business association is the sociedad de responsabilidad limitada (limited liability company), which exists in all Latin American jurisdictions and closely resembles the original model of the German GmbH of 1892 and the société a responsabilité limité introduced in France in 1927. The original 19th century European LLC model is an attempt to reconcile the basic feature of limited liability provided for stock corporations and the broader level of flexibility allotted to partnerships. In that sense, it was originally a

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hybrid business form that was transplanted into Latin American legislations under a similar conception.

A caveat must be made concerning the significant difference that exists between the United States LLC and the Latin American limitada. To be sure, even if the first LLC statute enacted in the state of Wyoming is said to have been crafted along the lines of the Panamanian limitada, present American LLC’s are very distant from their originating model. While a process of modernization has taken place in the United States over the past three decades, the Latin American limitadas are still linked to their early twentieth century European model. For this reason, this type of entity is characterized by all kinds of formalistic proceedings that make it a highly rigid business form. As an example, it is interesting to highlight the cumbersome proceedings for the processes for incorporation, conveyance of quota shares, by-law amendments, capital contributions, right of first refusal, inter alia.

1.4 Limited partnership (Sociedad en comandita)

The sociedad en comandita (limited partnership) is one of the oldest forms of business association dating back to medieval times, when the famous commenda was created as a contract between a person who made a contribution in labor (tractator) and another who would make contributions in money or in kind (commendator). The latter is usually referred to as a dormant partner, for he was not entitled to participate in the proposed business. The commendator was shielded from liability vis-à-vis third parties concerning any unsatisfied that could arise from the venture. The tractator carried on the business and representative activities and, as a result, was personally liable for all debts and obligations incurred in the course of the undertaking. This structure was disseminated through all European countries and served as the basis for the modern sociedad en comandita as it exists in European and Latin American jurisdictions.

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7 The tax-driven legislative process carried out in the US for the inception of the LLC was aimed at obtaining a pass-through treatment to overcome double taxation for a vehicle endowed with limited liability. Therefore, the new business entity had to surpass the four-item test set up by the Internal Revenue Service in order not to be treated as a corporation. Consequently, while the original model granted limited liability it lacked continuity of existence, centralized management and free transferability of shares. Opting these three elements out of the IRS’ four-item test for corporations, required to use a rather anachronistic approach in which shareholders had the direct administration of the LLC’s day-to-day affairs, a term of fixed duration was mandatory in the organizational documents and a right of refusal was also included as an imperative stipulation. The newer US statutes on LLCs are of a facilitating nature and therefore the Wyoming model has been upgraded through enabling provisions in a manner in which regulatory rules are exceptional. Robert R. Keatinge, ‘The Limited Liability Company, A Study of the Emerging Entity’, in The Business Lawyer, Vol. 47, Feb. 1992, p. 378.
8 According to Folsom and Levasseur, the US regulation concerning Limited Partnerships can be traced back to the Civil Law sociedad en comandita. ‘This business form was first introduced in the United States via a 1822 statute enacted in the state of New York’ (Ralph H. Folsom and Alain A. Levasseur, Pratique du droit des affaires aux États-Unis (Paris, Ed. Dalloz 1995) p. 250.
The *sociedad comanditaria* is characterized by the presence of a general partner (*socio gestor*) who conducts the affairs of the company and is subject to unlimited liability for all obligations arising in connection with the undertaking. General partners are governed under the laws applicable to *sociedades colectivas* (general partnerships). Limited partners provide capital contributions and are precluded from engaging themselves in managing the company. As a result of such management system, limited partners, as a general rule, do not incur liability for the company’s debts beyond the amounts that they have infused into the venture. Profits are allocated between the general and limited partners in the proportions laid out in the organizational documents or by-laws. It is usually possible for a limited liability company or a stock corporation to be a general partner within a limited partnership. In this manner, the effect of unlimited liability is offset due to the usual undercapitalization of the vehicle appointed as a general partner.

This business association is divided into two separate sub-species that depend on the manner in which the company’s capital is divided. In accordance with this classification, there is a first type in which the capital is divided into quotas. This entity is referred to as simple limited partnership (*sociedad en comandita simple*). In the second type the capital is divided into shares of stock; the resulting company is called limited partnership by stock (*sociedad en comandita por acciones*). This entity is more suitable for larger enterprises since it allows for a more expeditious capitalization. Both sub-types of limited partnerships are particularly suitable for family businesses due to the ability to separate the roles of founding partners – who have the direct administration of the company’s business – from those pertaining to limited partners – who are excluded from management.

It follows from the previous analysis of existing business associations in Latin America that the legislative approach is rather restrictive. This is partly due to the fact that the legal framework was conceived along the lines of company law theories developed in 19th century European codifications and their progeny. Reluctance by traditional legal scholars and legislators in the region to switch to a more advanced conception of company law has prevented the inception of more flexible rules and regulations for company law.

2. **BASIC PROBLEMS IN CURRENT LEGISLATIVE APPROACHES**

2.1 **Codification of company law**

All Latin American countries belong to the Civil Law tradition. Its most salient features are evident: prevalence of legislative law-making processes over judge-made law, deductive methods of reasoning on the judicial adjudication process and codification. Civil and Commercial Codes define the backbone of private law across the region. Given the influence of European scholarship since colonial times, there is a continued reliance on the evolution of French and Spanish legislations. Such dependence is still significant today in the field of company law.10

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9 For an explanation regarding the codification movement in 19th century Latin America see Boris Kozolchyk, *La contratación comercial en el derecho comparado* (Madrid, Editorial Dykenson S.L. 2006), at pp. 130-133. This author describes the so-called Latin American codification family, which encompasses three master codes drafted by great jurists: Dalmacio Vélez-Sársfield (1800-1875) for...
Although there are advantages to codification, such as the systematic organization of legal provisions, it is obvious that codes also create a rigid framework that is difficult to update due to the implications regarding multiple rules directly or indirectly related to those to be amended. In practice, the fear of desynchronizing the code structure usually results in delays concerning any legislative reform. The idea that any code reform affects legal certainty is always a good one to prevent the modernization of private law in Latin America. The so-called *numerus clausus* approach inherited from Roman Civil Law also contributes to the stiffness of legal institutions. To be sure, such rigid classifications are based upon elements deemed to be essential to each contract. Legislative innovation and change are hindered by this Aristotelic approach in which all too often a *substance* represents an unsurpassable theoretical obstacle to the modernization of business law rules.

Breaking company law dependence on Civil and Commercial Codes should be of paramount importance in order to set up a flexible environment for legal reform in the region. One avenue for change consists of creating separate statutes dealing with each business law subject matter individually. The usefulness of such an approach is evidenced by a higher level of flexibility to amend statutory provisions without affecting provisions regarding other legal matters. There basically are two ways of severing the company law from the Civil and Commercial Codes. The first approach recommends the creation of a statute containing *general company law* in which both general principles and specific provisions for each type of entity coexist. A separate and independent statute for each form of business entity is another legislative possibility.

### 2.2 Public order nature of most Company Law provisions

A considerable deterrent to business activities is related to the regulatory nature of a substantial part of company law provisions. The ‘public policy’ and ‘public order’ character of such regulations is usually argued to be one of the main reasons to maintain the legislative status quo in Latin American codes and statutes. The highly restrictive nature of these provisions is related to the underlying purpose of protecting investors mostly in the field of publicly held corporations. However, since most of the business entities in the region operate outside the stream of the securities market, the applicable company law rules become unnecessarily restrictive and cumbersome.

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10 Regarding codification in Latin America see, generally, John Henry Merryman, et al, *Comparative Law: Western European and Latin American Legal Systems, Cases and Materials* (Charlottesville, The Michie Company 1978), at pp. 208-220. Schlesinger points out to the so-called exogenous influence, which is particularly noticeable in instances in which legislators have resorted to the wholesale importation of foreign law. ‘Most of the codes presently in force in Latin America are the result of extensive comparative study and eclectic choice among European models’ (Rudolf Schlesinger, et al., *Comparative Law, Cases-Texts-Materials*, 6th edn. (New York, The Foundation Press 1998) at p. 11). Schlesinger also adds that this process involves the danger – evident in Latin America – that foreign institutions may be copied without sufficient adaptation to local conditions (id.).

11 See for Brazil, section 8 of Law 6404; Mexico, section 105 of the LGSM; Argentina, section 168 of Law 19.550, and Colombia, section 203 of the Commercial Code, that requires the permanent presence of an internal fiscal auditor in every stock corporation (sociedad anónima)
Paradoxically, Civil and Commercial Codes across the region embrace the principles of 19th century liberalism, including freedom of contract. Lip service is paid to the latter principle to the extent that almost every company law treatise includes explicit reference regarding its supposed broad application.

Some company law statutes contain specific provisions regarding the freedom of contractual stipulation, although limited by the typology of business association forms. For instance, Article 110-14 of the Colombian Commercial Code determines the basic contents of the public deed of association, including “all other arrangements which might be set forth by the associates to regulate the relations arising from the contract, provided that they are compatible with each type of association.” (emphasis supplied).

Notwithstanding the apparent flexibility of the quoted provision, it is obvious that the ‘compatibility’ issue results in a significant deterrent to private ordering. The existence of public policy provisions is always a good argument to prevent parties from opting out an imperative statutory rule. This legal rigidity also impacts the way in which by-laws and other association documents are drafted. In fact, standardization -characterized by the propagation of boiler-plate corporate forms- hinders innovation and deters transaction cost-effective legal engineering.

In contrast, corporate law systems such as the ones prevailing in other jurisdictions including the United States provide a set of enabling non-regulatory corporate statutes.

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12See for Brazil, section 983 of the Civil Code; Mexico; section 1 of LGSM; Argentina, section 1 of Law 19.550, and Colombia, section 110, subsection 2 of the Commercial Code. For instance, in Mexico there are certain association forms which are formally recognized, therefore as according to section 1 of the LGSM, “This Law recognizes the following kinds of mercantile companies: 1. General Partnerships. 2. Special Partnerships (Partnerships en commandite). 3. Limited Liability Companies. 4. Joint Stock Companies (corporations). 5. Special partnerships with shares. (Partnerships en commandite with shares.) 6. Cooperative associations.

13See for Brazil, section 997 of the Civil Code, for Mexico Section 6 of the LGSM; for Argentina Section 11 of Law 19.550, and for Colombia Section 110 of the Commercial Code. Pursuant to Section 11 of Argentinean Law 19.550, “the instrument of constitution should contain the following, without prejudice to that which may be established for certain types of companies: 1) the name, age, civil status, nationality, occupation and identification card number of the associates; 2) the firm name or the trade name, and domicile of the company. If the contract only contains the domicile, the address of the headquarters must be registered by petition signed separately by the organ of administration. All notices effected at the headquarters will be valid and retained; 3) the designation of its purpose, which must be determined precisely; 4) capital stock, which must be expressed in Argentine currency, and the contribution of each associate should be mentioned; 5) term of duration, which must be determined; 6) organization of the administration, control, and of the meetings of associates; 7) rules for distributing the profits and supporting the losses. In default of the latter, they will be distributed in proportion to the contributions. If only the manner of distribution of profits is provided, it will apply also to supporting the losses, and vice versa; 8) in order to establish the rights and obligations between partners and with respect to third parties, the necessary clauses will be established precisely; 9) clauses relevant to the functioning, dissolution and liquidation of the company.”
Parties, therefore, are entitled to bargain for the most appropriate contractual framework to deal with the problems arising from a specific business arrangement. Accordingly, these statutes provide off-the-rack housekeeping rules that can be opted out by the parties. In the absence of negotiation, the legal provisions contained in the corporate statute are applicable by default. Certainly, such flexible system requires the parties to ideally negotiate a comprehensive contractual framework by addressing \textit{ex ante} all relevant matters from which a conflict may arise.

2.3 The dichotomy of corporation law in Latin America

The anachronistic dichotomy of Private Law is an all-pervasive phenomenon in Latin America. In fact, most codes and corporation statutes in the region have maintained a differentiation between civil and commercial companies. Following the French 19th century model, separate substantive rules apply according to the nature of the business company. In order to determine such nature it is usually necessary to undertake an analysis of the purpose clause as laid out in the company's by-laws. Through the application of this \textit{objective} approach the concerned entity can be labeled commercial or civil. Accordingly, a commercial company will be such entity that has been set up for the purpose of undertaking commercial acts pursuant to the list contained in the relevant statutory provision. Conversely, a civil company will be the one created to carry out acts not contained in such list of commercial acts. The legal consequences ensuing from the private law dichotomy are not irrelevant. They range from mere substantive law provisions to procedural aspects as well as tax treatments, etc. Even formation proceedings may differ to the extent that commercial firms are generally subject to higher standards as compared with civil companies. Such differences are not exclusively related to formation requirements, but also include aspects such as tax rates, disclosure of information, etc.

This two-fold regulatory scheme creates significant transaction costs and legal uncertainty. In several cases it is not easy to determine the nature of a business entity. Complex or multiple purpose clauses are difficult to read in light of the dichotomy. The analysis is not prone to error and usually submitted to difficult analytical assessment and subjective interpretation.

\textsuperscript{14} Statutory provisions are said to reflect a \textit{hypothetical bargaining} in which all the constituencies' interests are considered by the legislator. Therefore, the legislator's role is to provide an optimal set of rules, which should reflect a balance between the parties' expectations. According to Bainbridge, "the legislator should ask the prospective shareholders, employees, contract creditors, tort victims and the like to bargain over what rules they would want to govern their relationships. Adopt that bargain as the corporate law default rule. Doing so reduces transaction costs and therefore makes it more efficient to run a business (Cf., Stephen Bainbridge, \textit{Corporation Law and Economics}, New York, Foundation Press (2002) at 30)"

\textsuperscript{15} These careful and sometime costly negotiations may not always be feasible for the incumbent parties. It is true that this kind of statutes require the parties to carefully negotiate the terms and conditions of their specific arrangements. The flexibility provided to contracting parties may cause an increase of negotiation expenses to opt out default rules. Pursuant to Bainbridge, lack of appropriate negotiation may result in future conflicts between shareholders (\textit{Id.}, p. 9).

\textsuperscript{16} Commercial Codes list all acts and enterprises that are considered as mercantile. Within those acts, there are basic intermediation transactions, leasing activities, engineering, banking, insurance, etc. The same Codes regulate non-commercial (i.e., civil) acts, including the exercise of professional activities, agricultural business carried out by an individual, etc.
Even in continental European countries where the dichotomy subsists a solution has been crafted for business associations. It basically consists in creating a typical criterion to define the firm’s nature. Such criterion is more readily defined in terms of the type of business association at stake. Instead of defining the civil or commercial nature of a business association depending on the scope of their purpose clause or activity, the assessment is made on the grounds of the form adopted by the business entity. Normally stock companies, closely held corporations and limited partnerships are deemed to be commercial entities irrespective of the activities set forth in their purpose clauses. Therefore, the civil company arises as an isolated business entity of a limited usefulness. This is the approach adopted for instance by the French and Spanish legislations.

Another approach – which appears to be highly recommendable – would consist of the eventual suppression of the civil company in favor of a fully unified system of company law characterized by a unique substantive and procedural regulation such as the one that exists in the corporate statutes of the United States.

2.4 The contractual nature of company law in Latin America

The Roman law concept of societas, which was later developed into different forms of business entities, was strongly grounded upon a contractual scheme. The French Commercial Codes maintained the idea whereby all forms of business associations arise out of an agreement between two or more persons. The adoption of Commercial Codes and company law statutes in Latin America, allowed for the inception of a full fledged contractual theory all over the region. Such an all-pervasive concept is relevant to define requirements for the creation and maintenance of new companies in the area. The idea of a multi-owner entity as the basis for legal personality and limited liability represents a deterrent to admit single member corporations and wholly owned subsidiaries.

Therefore, most countries in this region have rejected legislation suppressing multi-ownership requirements. In some cases the statutes are so stringent that two shareholders do not suffice for the purpose of incorporation. Obviously this restrictive approach creates severe transaction costs, for it forces entrepreneurs either to undergo joint ventures or to create simulated and often illegal contracts in which straw-men act as shareholders for the sole purpose of fulfilling a formalistic requirement.

A sound solution adopted in continental Europe after the issuance of the twelfth communitary directive (regarding single member entities) was to allow companies to be formed through contracts or ‘unilateral acts’. The implementation of this directive in the European Union allowed for the presence of one-person stock corporations.

2.5 Reluctance to provide full enforcement to shareholders’ agreements

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17 An advantage of the contractual approach is that all regulations regarding obligations and contracts contained in Civil and Commercial Codes will be automatically applicable. Case law and doctrine regarding these rules and principles will also be invoked.

18 Art. 98 of the Colombian Commercial Code: ‘By means of the Company Contract two or more persons undertake to make a contribution in cash, work or in other goods representing currency, for the purpose of sharing in the profits derived from their enterprise. On legal formation of a company, it will turn into a juridical person distinct from each individual shareholder.’
There has been a traditional reluctance in the Latin American company laws to recognize and enforce shareholders’ agreements. This lack of recognition disregards the importance of private ordering which is central to foster innovation and creativity. The Brazilian corporate law is certainly an important exception to this rule. Certainly, after the enactment of Law 10.303 of 2001, various legal devices were created to allow for the enforceability of this kind of agreements. The general disregard of such important contractual devices hinders the development of more flexible and useful schemes for firms characterized by a multi-ownership structure.

2.6 **Exceptions to limited liability**

The influence of new political constitutions and Constitutional Courts in Latin American countries has created several piercing the veil hypothesis grounded on causes outside the scope of corporate law. Further tax, labor and environmental regulations set up numerous causes of action that allow a plaintiff to request that the legal entity be disregarded. Aside from the cases of general and limited partnerships, in which there has been a traditional liability extension in the event of bankruptcy, there is no justification for such a broad extension of liability.¹⁹ Such written rules and judicial precedents discourage local and foreign investment leading to simulation or otherwise wrongful configuration of the corporate contract. Parent companies are exposed to excessive risks in which piercing the veil becomes tantamount to strict liability.²⁰ Defending weak creditors through expeditious writs – in which the true merits of each case are not carefully assessed by constitutional courts – affects certainty and reliance on the legal systems.

Piercing the veil has been justifiably criticized in common law systems due to legal uncertainty concerns. However, such judicial solution has enjoyed support in the United States for it is decided on a case-by-case basis under an inductive method in which facts are carefully scrutinized by each court.

2.7 **Excessive legal formalities for incorporation**

Legal formalities for incorporation constitute one of the most significant entry barriers for entrepreneurs in Latin America. Forming a regular business entity may cost hundreds of dollars and require the fulfillment of time-consuming and cumbersome steps. Some of these proceedings are reminiscent of ancient institutions, many of which are kept mainly due to pressure groups that can hinder legal reform. The necessary participation of a notary public in the process of incorporation is a good example of such widespread formalism. Notaries are well-paid bureaucratic officers whose income is mainly associated with the so-called ‘public faith’ that is given to contracts and other instruments once their authorized stamp and signature have been apposed onto a document. Aside from notaries, other professionals such as attorneys and certified accountants may also have a part in the process of incorporation, ¹⁹ Even in these forms of business associations it is viable to provide for a limitation on the liability of general partners. New forms of entities have arisen such as the Limited Liability Partnership (LLP) and Limited Liability Limited Partnership (LLLP). These business associations combine the advantages of partnerships and limited partnerships with the benefits of business corporations, i.e., they add to a person-based business entity, the useful feature of limited liability.

²⁰ See for instance Decision SU-1023 of 2001 rendered by the Colombian Constitutional Court holding a parent company liable on the grounds of the simple fact of being the parent.
not to mention the requirement to obtain certain governmental authorizations as well as to publish excerpts of the articles of incorporation in official gazettes.

Paradoxically, this formalistic approach represents a significant obstacle for the formalization of business enterprises. There is empirical evidence that the most flexible legal systems are more suitable to attract investment and, correspondingly, to obtain higher income arising from registration of new companies. It is a fact that the citizens of Delaware are subject to a lower income tax due to the significant amounts that are contributed by corporations in the form of franchise taxes. In fact the so-called franchise tax represents almost a fifth of the overall revenue gathered by the State of Delaware. Of course there are several factors that characterize the institutional framework that is needed to administer such an important body of law. It is not only the substantive regulation that makes Delaware so attractive for corporations, the judiciary and even the specialization of the state’s bar also play a significant role.21

Conversely, those systems that make it difficult for business people to create corporations tend to fall behind. In the recent competition for corporate chartering taking place in Europe burdensome legal provisions, such as minimum capitalization requirements, two-tiered corporate governance structures, the participation of notaries as well as other bureaucratic authorizations have created a new market in which some businesspeople will prefer to incorporate in the United Kingdom, where the processes seem to be simpler. After the Centros v. Erthvers-og decision back in 1997, several businesses have fled to London, taking advantage of the great flexibility offered by British company law. Migration of business and capital propelled by the new market has created a unique economic incentive for company law reform in Europe. In fact, some of the company laws of France have been overhauled apparently reflecting new trends in the regulation of business associations.

It is to no avail to maintain a formalistic approach in which useless and burdensome formalities are still needed to set up a business entity. To be sure, public deeds granted before public notaries, registration before a mercantile registry, authorization granted by a governmental office, publication in an official could be reduced to a single act of registration before a company’s office or a similar agency.

2.8 The limited role of the mercantile registry

The so-called commercial publicity is an important factor in the configuration of company law in civil law jurisdictions. Pursuant to a general rule, any act or contract that is duly registered before a mercantile registry will be deemed to have legal effects. This concept is relevant in company law, for it provides legal certainty for third parties, who can rely upon the information certified by the mercantile registrar. Due to purely theoretical reasons, it has been held that the only function performed by the registry is to provide publicity. Thus, the possibility of allowing registration to become a determinant factor for the legal formation of companies has been generally denied by most systems in Latin America. A more practical approach is offered by the corporate laws of the different American states in which the existence of the corporation is conclusively presumed upon the filing of the articles of incorporation before the relevant governmental office (i.e., the Secretariat of State) (See, Revised Model Business Corporation Act).

On the other hand, the registrar is usually deprived of the ability to scrutinize the legal foundations of any act or contract that is subject to registration. As a result, a company that has been duly registered is still subject to challenges that may arise from several different factors. Virtually any person that proves a legitimate interest has standing to sue and request that the corporation contract be set aside on the grounds of non-compliance with certain formalities.

Alternatively, it would be useful to introduce in the different jurisdictions of Latin America the so-called constitutional mercantile registry. Under this system, registration provides legal certainty regarding the existence of the corporation as well as all validity of business transactions been carried out by its officers and directors after such registration has taken place. This principle can be stressed out in simple terms such as a straightforward provision whereby the company's legal personality arises after the formation documents have been filed before the relevant office. Furthermore, such system of registration ameliorates the problems associated with so-called de facto corporations. Certainly, where the law only requires a single act for the creation of a company the difficulties arising out of pre-incorporation transactions tend to be significantly reduced. The unpredictability and uncertainty concerning the validity of acts undertaken by a company in formation disappears under such constitutional registration system. At the same time, the liabilities of directors, officers, and shareholders are clearly defined as of the moment in which the formation documents are filed before the mercantile registry. Obviously, this recommendation is closely linked with the suppression of any notarial intervention in the formation process. A simple private document, duly executed by the relevant parties should suffice for the purposes of registration.

2.9 Overreaching causes for nullification

Several causes for the nullification of the corporate contract can be found within commercial codes and corporate statutes. These regulations allow any party to challenge the existence of the corporation. Through the so-called absolute and relative nullification regime, company law provisions contribute to create legal uncertainty and instability of existing business entities. These regulations are inconsistent with modern trends in which the causes for nullification are reduced to a minimum. The first European Community directive regarding disclosure, ultra vires and nullity adopts a restrictive approach in this respect. Pursuant to this directive nullity can only be decided through a judicial proceeding. Therefore, a court can declare that a company is void provided that the restrictive grounds specified in Section 2 are fully proven. Such grounds include, inter alia, that no instrument of formation was executed, that certain required legal formalities were not fulfilled, or that specific requirements provided for under the national legislation were not complied with. The European directive is intended to provide legal certainty and protection to third parties dealing with the company. By restricting the grounds upon which a person can challenge the act of incorporation, the validity of the legal entity is enhanced and the chances for opportunistic challenges are severely reduced.

2.10 Regulatory nature of most company law rules

Company law statutes and codes are mostly of a regulatory nature. Provisions concerning all aspects of corporate governance, minority shareholders rights, structural changes, mergers, dissolution and liquidation are overwhelming. Regulations concerning the basic contents of the articles of association or bylaws tend to be comprehensive and imperative. To be sure, company law statutes contain lists of clauses that have to be included within the bylaws of any company that is created. Failure to provide any of those required clauses may result in
The nullification of the entire contract. In contrast with modern corporate law in which most provisions are not regulatory, the approach in this region is increasingly complex and astringent. The approach existing in all American jurisdictions characterized by enabling statutes has not been followed in Latin America. Notwithstanding the well-known and highly publicized principle of freedom of contract imbedded in 19th century codifications, the flexibility afforded to shareholders at the moment of drafting or amending the company's constitutional documents is insignificant.

Such a cumbersome regulation hinders the economic activity, creates transaction costs, and prevents the parties from reaching adequate agreements concerning the basic elements of the business association. As it has been said before, these restrictions are particularly detrimental as they regard the closely held corporation. Most of these imperative legal provisions appear to be designed to deal with the problems arising in the context of publicly held entities. They are needed to protect a myriad of anonymous and dispersed shareholders and to resolve problems associated with collective action. These situations obviously demand a comprehensive legal framework. The extant regulation of shareholders’ meetings as well as rules on quorum, election of board members, structural changes, appraisal remedies, forceful dissolution, etc., is appropriate to protect investors undertaking securities transactions in stock exchanges.

The closely held corporation constitutes an altogether different scenario. The specific problems that are germane to this form of private association require flexibility in order for the concerned parties to be able to lay down appropriate rules to govern their business relationships. Private ordering is an essential element without which the company law system cannot respond effectively to the challenges arising from the different interests that shareholders may have.

Therefore, reduction of unnecessary mandatory provisions constitutes a natural step in the modernization of Latin American company law. Specifically, the reduction in the number of imperative clauses that have to be included within the constitutional document could provide enable the parties to freely define the framework within which the company will operate. At the same time, such flexibility will foster the drafting of shareholders agreements, which – at least for the time being – are usually unenforceable vis-à-vis the corporation.

2.11 The negative impact of the ultra vires theory

The so-called specialty theory whereby the company’s legal capacity depends upon the business activities provided for under the purpose clause in the corporation's bylaws is an anachronistic reminiscence of the concepts that were in vogue in the beginning of the 20th century. The purported advantages that arise from this theory in terms of protection to the shareholders are overshadowed by its detrimental impact on third parties. The latter are clearly affected due to the uncertainty concerning the validity of business transactions carried out by the corporation. Under the general approach existing in Latin America it is obvious that the corporation can easily find a way out from inconvenient contracts through the simple expedient of showing that the relevant act is ultra vires.

This theory has been abolished in most advanced legal systems. The movement began in the United States, where old state legislation used to embrace such theory. The difficulties arising from its application caused the state legislators to repeal it altogether from all corporate statutes. Also, the requirement to stress out a fully defined purpose clause in the articles of incorporation by describing the business activities to be carried out by the business entity was also repealed. Such important legislative step weakened the ultra vires theory by enhancing the legal capacity of the corporation and its ability to carry out any lawful legal transaction.
From the moment in which the First Communitary Directive was enacted, a similar approach was undertaken for European company law. Even if such directive departs from the fact that the corporation’s legal capacity is defined by the purpose clause as it has been laid out in the articles of Association, it is also said held that third parties shall be protected concerning the validity of any *ultra vires* business transaction to which they were a party, provided that they did not know that the corporation lacked sufficient capacity to undertake such transaction. Pursuant to the same directive bad faith will not be presumed on the grounds that the relevant party had access to a certificate rendered by the relevant company’s registrar, in which the purpose clause may appear.

2.12 **Rigid regulations regarding capital contributions**

An excessive reverence is given to the concept of legal capital and par value. There is almost an obsession with the so-called integrity and maintenance of legal capital. Some regulations even provide that a corporation shall be dissolved whenever losses affect its capital (i.e., whenever, as a result of losses, the corporation’s equity falls below the amount of subscribed paid in capital). Under a related provision contributions cannot be made for any amount below the par value set up at the inception of the corporation contract. This rule clearly contradicts the economic reality in the frequent case in which the corporation’s equity value has been reduced as a result of losses. The only exception to this drastic rule requires an amendment of the articles of association to reduce the shares’ par value.

Likewise, various legal provisions concerning the terms and conditions for the payment of capital contributions tend to reduce the corporation's ability to attract capital, particularly when it is undergoing financial stress. In-kind contributions are in many cases subject to several different formalities, including requirements such as independent appraisal, governmental authorization, and even imposing unlimited liability for those who make the contribution. These obstacles for capitalization are notoriously inconvenient for companies seeking to expand operations or to carry out financial reorganization. Furthermore, these cumbersome regulations are a source of transaction costs and protracted litigation.

Some of these provisions contradict contemporary financial theories in which it is usually more important for a company to have substantial cash flows to pay all debts as they become due, rather than to show a fixed amount of subscribed paid in capital in the balance sheet.

2.13 **Lack of an effective judicial control on business associations**

Some of the most relevant authors in the field of legal transplant in corporate law (i.e., a Katarina Pistor, Luca Enriques, etc.), have stressed out the importance of the so-called structural transplants. This concept refers specifically to the adoption of substantive legal rules which are suitable to be applied and enforced by the judicial and administrative authorities of the country to which the legal principle is being transplanted. Thus, it is generally acknowledged that it does not suffice to introduce appropriate substantive rules, but it is also necessary to emulate the institutional framework for the enforcement of such legal provisions that exists in the jurisdiction from which rules are being transplanted. Therefore, the determination of legal proceedings and judicial actions as well as the strengthening of the institutions are essential aspects without which legal reform becomes effective.

Latin American procedural law is characterized by a formalistic approach in which several different instances are granted to challenge every single decision rendered by the court. As a result, most processes tend to be lengthy and bureaucratic. Protracted litigation
is, therefore, the rule. A peculiar system for adjudication that exists in some Latin American countries is based upon the granting of quasi-judicial powers to administrative agencies. Entities such as the General Inspection of Justice in Argentina or the Superintendency of Companies from Colombia have proven to be useful for the purpose of providing expeditious and more technical solutions to conflicts arising in the field of corporate law.

Several procedural and even substantive regulations create obstacles that make it difficult for shareholders and other stakeholders to pursue legal actions before courts. Cumbersome regulations of this sort represent an entry barrier for litigation. Furthermore, the lack of predictability and the expectation of long-lasting and expensive processes are serious deterrents for the creation of an appropriate scenario, where shareholders’ rights would find an adequate development.

Pursuant to Luca Enriques, the creation of an effective company law framework relies heavily upon the so-called good corporate law judge\textsuperscript{23}. Such concept features several different attributes, including a clear understanding of the core problems that underlie the corporate conflict as well as a non-formalistic approach and a serious concern for the precedential value of any decision rendered in this field.

The simplification of the legal process has been achieved in several Latin American countries through the consecration of the writ of constitutionality (amparo, tutela or mandado de segurança). These legal actions can be easily filed, are not subject to complicated formalities and can be handled through an expeditious and prioritary proceeding. This model provided for the defense of constitutionality-protected individual rights could be adapted for shareholder suits. The creation of a specific proceeding to deal with conflicts related to company law is a solution that has been recently adopted in Italy, through the so-called rito societario.

3. THE SIMPLIFIED STOCK CORPORATION AS AN OPTIMAL BUSINESS FORM FOR LATIN AMERICAN SYSTEMS

The optimal corporate law model depends on the specific conditions of a relevant system. Substantial differences in the economic models, as well as the legal traditions give rise to different approaches and various ways to deal with agency problems. However, the common core of Latin American Law, its shared colonial heritage and the existence of a comparatively homogenous culture, provide an appropriate scenario to set up a plain level field for most of the jurisdictions in this area.

The preliminary aspect that must be taken into account refers to the priority areas of legal reform. Thus far most efforts have focused in the field of publicly held corporations, and the manner in which the securities markets’ liquidity could be improved across Latin America. For this purpose, a wave of corporate governance reforms fostered specially by the OECD has affected the regulations of company law in all major Latin American jurisdictions. The consequences of these new regulations are still to be assessed. However, recent empirical research suggests that such regulatory changes have had little or no impact in the number of listed companies. Furthermore, securities exchange activity measured

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through the number of IPOs and other significant transactions proves that no substantial change has taken place after those corporate governance reforms took place.24

On the other hand, the regulation of corporations contained in Commercial Codes and business associations’ statutes prevailing in the Latin American region cannot be blamed for the reduced development of the local stock markets. The widespread use of the sociedad anónima (joint stock company) as the vehicle to undertake public issuances of securities bears no relationship whatsoever with the structural path dependence factors that determine the lack of a robust and efficient market. In fact, modern corporate governance provisions somehow resemble the regulatory nature of Latin American corporate law. The long lasting tradition of several rules of a mandatory nature, including those regarding notices for annual meetings, voting rights, inspection and information rights, cumulative voting, compulsory auditing officers and various types of dissenting remedies make of the anónima, a classical business entity for publicly held entities. At least in the books, only a few changes are needed to adapt this traditional form of business entity to modern corporate governance standards (i.e., including independent directors in the boards of listed companies).

Therefore the slowdown in the Latin American stock markets should suggest a strategic turnaround in enforcement intensity, instead of focusing on rather useless substantive changes like those introduced in corporate regulations across the region during the previous decade at the OECD’s request. Other structural factors such as tax evasion in closely held companies, costs of compliance with securities regulations, and the consequent reduction in the spread between financial credit and the cost of capital, represent a discouraging factor for new listings. Furthermore, the low number of listed companies gives rise to low liquidity and the inapplicability of the efficient market hypothesis.

The Sao Paulo stock exchange has devised a different approach to the securities market by creating a multi-tier system in which the corporate governance standards vary from one level to another. In the so called novo mercado (or new market) the corporate governance standards applicable to corporations listed in this segment have been raised in order to reduce the perception of risk among investors. Although this measure has been useful for the purposes of increasing the amount of listed companies, it is still uncertain whether increased costs of compliance may offset the reduction in the cost of capital. The ability of this new market to survive in times of crisis is also a matter of debate.

Segmenting the market in accordance with different levels of corporate governance intensity seems to be a sensible solution as it may provide an interesting testing scenario regarding the usefulness of various corporate governance devices.

In any event, the amount of resources that has been spent in the assumed need to foster new listings and enhance the liquidity of securities markets in Latin America has not only been excessive, but it may not be conducive to a substantial improvement in the financial conditions of countries that have adopted recommendations ensuing from the proposed amendments to the securities market legal infrastructure.

To be sure, Professor Robert Cooter has suggested that stock issuances and secondary market trading of these securities is not a necessary factor for development in poor countries. Based upon the Chinese and Indian experiences, Cooter concludes that economic development in the private sector can be sufficiently financed by banks and other

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24 There were no IPOs or public issuances of stocks of any listed company in the Colombia stock exchange in 2008. In the same year such exchange experienced a reduction of 12% of listed companies. In fact, they went down from 106 in 2007 to 2008 (See Financial Superintendency, Resolution of January 2009).
financial institutions (private financing), even in the absence of a developed and liquid stock market.25

It is striking, on the other hand, to realize that only small efforts have been made to amend or repeal the laws and regulations concerning the closely held corporation still anchored in 19th century notions. From a practical standpoint, it is obvious that non-listed companies are not only the broad majority of all business associations operating in Latin America, but also the most powerful instrument to create employment in developing economies.

3.1 Structural transplants and the good corporate judge

The rule of thumb for the importation of corporate law provisions has been referred to by certain authors as the structural legal transplant. Pursuant to Katharina Pistor, such concept implies that it is not sufficient for the importation of a rule to merely incorporate into the borrowing country the substantive principles or provisions that work properly in the foreign lending jurisdiction. Along with such substantive norms it is also necessary to incorporate the rules (procedural or otherwise) and factors that cause such provisions to operate properly, including all circumstances that determine its efficiency and enforceability.26

Therefore, any corporate law reform in which a legal transplant is involved should encompass all substantive, procedural and institutional legal and factual circumstances that are necessary to make the institution work efficiently in the foreign recipient country. In accordance with Rafael La Porta, the honesty of judges and their efficiency (measured in terms of enforceability of their final decisions) are necessary elements for a corporate law system to be effective.27 The increasing amount of substantive (non-structural) corporate legal transplants constitutes a serious problem, particularly in developing countries.28 Transplanting substantive legal provisions without importing the corresponding operational and institutional background creates at best a deceptive illusion of a significant change in the legal system.

Luca Enriques has analyzed the features that in his opinion constitute the so-called good corporate judge. The theory is based on the assumption that in order for corporate law to be as useful on the books as in real life, it is crucial for a system to have highly qualified judges available. Such qualification is not restricted to basic legal training in the general areas of procedural and private law, but specifically, in the field of corporate law in theory and practice. Independence is also a very significant aspect in which Enriques emphasizes. In summary, specialized professional qualifications and independence are necessary factors for the corporate judge to apply a comprehensive body of modern corporate law.29

25 Robert Cooter and Hans-Bernd Schaefer discuss the importance for innovation and economic development of three separate stages of finance (relational, private and public). The second stage is referred to as private because it comes from a small group of experts in evaluating innovations in an early stage of development (Solomon’s Knot, How law can end the poverty of nations, Draft February, 2009, pp. 8-9).
28 Buscaglia and Daklias, quoted by Luca Enriques, at p. 259.
29 Luca Enriques, at pp. 257-294.
These and other features are supposed to enable the judge to detach herself from the imbedded formalism that characterizes some of the most backward systems pertaining to the civil law tradition. Professor Enriques also points out to the fact that certain legal systems of continental Europe, such as the Swedish and other northern European countries are efficient in the prevention of value shifting transactions and other fraudulent schemes that occur in corporate practice. Opportunistic behavior undertaken by agents (officers, directors and controlling shareholders) cannot be counteracted only by permanent monitoring, but also requires prompt availability of a good corporate judge before whom the abuse can be denounced for the purpose of obtaining an expeditious and final decision.

A similar theory has been held by prominent scholars such as Robert Cooter for whom ‘high quality judges have good education, understand business and markets, do not take bribes, and do not bend to political influence. The power to interpret contracts’ flexibility works better in their hands than in the hands of judges without these strengths.’

Within the common law tradition, one of the best examples of a good corporate judge has to be the judicial system of the State of Delaware, which along with the substantive provisions contained in the Delaware General Corporation Law, and a qualified bar of corporate lawyers constitutes a highly reliable framework to generate confidence in the business entities incorporated in that State. The corporate law jurisdiction of the State of Delaware is, therefore, one of the most specialized corporate law judiciaries in the world. The effectiveness of this corporate law judge is measured by two factors: (i) the knowledge and skills in solving complex corporate law problems and (ii) the ability to produce final decisions within a reasonable timeframe.

For the sake of comparison, it is fair to say that the formalistic procedural and bureaucratic operation of the civil law jurisdictions of Latin America epitomizes the general lack of a good corporate judge in the region. With the amount and length of procedural obstacles existing in the area, the expectation of a prompt, technical and reasonable resolution becomes elusive. In several jurisdictions in the region the number of corporate law complaints filed before civil courts is insignificant as compared with, for instance, processes for collection of promissory notes filed before the same jurisdictions.

However, the Delaware case does not suggest the need for a division of the ordinary jurisdiction to split up a specialized commercial law judicial branch for Latin American countries. The creation of specialized courts severed from the ordinary jurisdiction normally leads to the same inefficiency and lack of qualification that characterizes the latter.

The enormous obstacles to improve the access to justice in corporate law matters, has forced certain jurisdictions in the area to adopt alternative systems for corporate dispute resolution. The Chilean Corporate Law 20.190 of 2007 sets forth the obligation to subject

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30 Robert Cooter and Hans-Bernd Schaefer, Solomon’s Knot: How can law end the poverty of nations (February 2009).


32 Robert Cooter provides an example of a jurisdiction that has devised a system to ameliorate the presence of bad judges. ‘The judges in India’s Supreme Court and the High Court are well educated and independent. They have authority to use the principle of good faith to develop law. In contrast, the lower court judges are poorly educated and too often corrupt. They are not allowed to use the principle of good faith to develop law’ (See Cooter, at p. 16).
any dispute arising in the context of this law to corporate arbitration. Therefore, the ordinary courts are inhibited to adjudicate in corporate law disputes involving stock corporations (sociedades por acciones). It is that same statute that deprives the ordinary courts of the power to decide any cases regarding sociedades por acciones. Even if this solution may appear to have extreme consequences, it is only a response to the need for an effective system of justice to which complicated corporate cases can be submitted. Under this recent regulation, the arbitration panel seems to be a good corporate judge or at least a better court than the ordinary civil jurisdiction.

The suggested Model Simplified Stock Corporations Act for Latin America (MSSCALA) provides that dispute resolution can only be handled by a specialized corporate law court of an administrative nature or, alternatively, by corporate arbitration in the manner provided for under the corporate by-laws. There are previous examples of this kind of a successful delegation of judicial functions in administrative authorities, such as the Superintendency of Companies in Colombia and to a lesser extent the General Inspection of Justice in Argentina. Due to the obvious risks associated with the concession of judicial functions to officers pertaining to the executive branch of government, it is recommendable to provide specific entry requirements based upon experience and independence for the purposes of appointment and tenure.

3.2 Path dependence and company law reform

In order to define an appropriate model after which the business associations law could be overhauled, it is important to bear in mind the practical implications of path dependence. Professors Lucian Bebchuk and Mark Roe describe this theory under two separate concepts: (i) structural path dependence, and (ii) rule-driven path dependence. The former refers to the “the direct effect of initial ownership structures on subsequent ownership structures”; the latter is associated with all pre-existent rules applicable to corporations. The first category is related to analyzing the manner in which corporate ownership structures are preserved. Pursuant to this theory, there are five factors that allow for the continuing preservation of an existing economic system. According to Bebchuk and Roe those factors are:

(i) sunk adaptive costs, i.e., expenses in which firms have incurred in order to adapt with a given set of practices, rules and institutions;

(ii) complementarities, which relate to the existence of an integrated system of institutions, practices and skills, the value of which could be lost if a significant change were to take place;

(iii) network externalities, which can be explained as the benefits that stem out of the use of a practice or institution by a significant amount of people. This common use implies a relevant advantage in terms of a reduction of expenses and other costs, and

33 ‘All conflicts among shareholders, among shareholders and the corporation, its managers or liquidators, or among the corporation and its managers or liquidators, shall be addressed through arbitration(…)’ (Art. 441 of the Chilean Commercial Code, as amended by Law 20.190 of 2007).

34 The initial structure of an economic system has a direct influence on the subsequent choices regarding the prevailing property structures. Two basic factors can be identified with such structural dependence: the first one is based on efficiency; the second relates to rent seeking (Lucian Bebchuk and Mark J. Roe, A Theory of Path Dependence in Corporate Ownership and Governance, 1999, SSRN Id. No. 202748).
endowment effects, which are associated with the overestimation given to existing institutions and practices by their users. “Players’ having control under an existing structure might affect their valuation of having such control, which would in turn affect the total value that alternative structures would produce”.

multiple optima, which relates to the possibility of operating under several different ownership structures that could yield equally optimal results in each given context.

Besides the previously mentioned five factors, there is another one referred to as rent seeking. Such concept is closely associated to the economic benefits that some individuals obtain as a consequence of the preservation of certain ownership structure. Since such individuals have the power to make the relevant decisions that could determine a change in the ownership structure, the possibility of such a change is, at best, remote. This factor alone may be responsible for the persistence of an economic model (concentrated or diffuse ownership). Even if the initial model is not optimal in terms of benefits for all shareholders, rent-seeking may cause it to remain unaltered as long as controlling stockholders retain the power to extract private benefits of control (in excess of the rights conferred by law). In the context of dispersed ownership, directors’ rent seeking is associated with their ability to remain indefinitely in their posts and to enjoy the corresponding corporate perks.

The authors also suggest that rent seeking by controlling majority stockholders in concentrated ownership systems makes it difficult to migrate to a system characterized by diffused stockholding. As a consequence, a majority shareholder who enjoys private benefits of control will be obviously reluctant to undertake an IPO, due the imminent loss of such benefits. In fact, there will be no incentive for the controlling shareholder (within a corporation characterized by concentrated ownership) to make decisions leading the corporation towards a system of dispersed ownership. The parties in charge of the decision-making machinery will retain all private benefits of control.

It must be taken into account that a concentrated ownership structure is not necessarily inefficient from the economic standpoint as long as there are advantages to offset the drawbacks arising from such concentrated ownership structure. However, if the advantages arising from a concentrated ownership structure (extraction of private benefits of control) exceed reasonable limits and offset all possible economic benefits for the corporation, the system becomes inefficient.

Excessive extraction of private benefits of control is pervasive in the so-called inefficient corporate law systems. Such excessive shifting of value by controlling shareholders or directors does not depend exclusively on the absence of legal protections contained in substantive provisions, but also on the enforcement intensity of such legal rules. For instance, a comparison between European and Latin American civil law countries may show significant differences in terms of institutional framework and enforceability of

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35 Id.
36 According to McCahery and Vermeulen, such advantages are related with strong ties to local governments and local communities, centralized and efficient decision-making processes, reduction of monitoring expense for minority shareholders (i.e., agency costs), etc. See Joseph A. McCahery, Erik Vermeulen, Understanding Unincorporated Business Ventures (Amsterdam, Center for Corporate Finance 2005) No. 12.
37 Ronald Gilson, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, August 2005, SSRN Id. No. 784744.
corporate laws. Such differences also reflect the existence of controls – or lack thereof – regarding the extraction of private benefits of control.\textsuperscript{38}

Certain forms of path dependence lay out the basis for some degree of stability in a legal system. This is due to the burdensome processes that are required to introduce radical reforms. In fact, it has been held that such forms of path dependence may give rise to competitive financial and economic systems even under divergent economic circumstances.\textsuperscript{39} A good example of such efficiency is given by the models of dispersed ownership prevailing in the United Kingdom and the United States, where substantive regulations have been crafted to deal with agency problems arising from the separation between ownership and control.\textsuperscript{40} Positive and negative incentives are set into play in order to align the interests of shareholders and directors. Those devices tend to reduce monitoring expenses, bonding costs and residual losses stemming from \textit{adverse selection} and \textit{moral hazard}.\textsuperscript{41} The latter situations are associated, in turn, with the information asymmetries present in agency relationships. Such agency relationships must be structured in a manner in which the agent has the appropriate incentives to enhance the principal’s wealth. In the absence of these incentives it is possible for the agent to act opportunistically. This propensity may be caused by the uncertainty regarding the future activity that the agent must undertake, as well as the principal’s inability to closely monitor the agent’s performance. The basic agency problem arising in the context of dispersed ownership between shareholders and management is usually reflected, among other wrongful activities in the possibility of obtaining corporate perks, insider trading, excessive executive compensation and the usurpation of corporate opportunities.

As it will be explained in further detail below, the above-mentioned agency problems are different to the ones existing between majority and minority shareholders. One of those distinctions can be analyzed from the changes in incentives that take place whenever the majority’s control block is reduced. This reduction takes place when the controlling shareholder obtains additional cash through sales of shares in the corporation. According to Jensen and Meckling, as the controlling block shrinks the incentives of the agent (i.e., the controlling shareholder) to search for new opportunities and to engage in creative activities will be hindered due to the corresponding reduction of private benefits of control. The owner-manager will avoid these stressful efforts that usually include learning new technologies and other time-consuming activities. In doing so, the agent will avoid these personal costs generating an additional profit. This reduced activity on the part of the agent

\textsuperscript{38} Id., at 9.
\textsuperscript{41} See Michael Jensen and William Meckling, \textit{Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure}, 1976, SSRN Id No, 94043. According to these authors, the scope of agency costs may vary from one corporation to another since they depend on factors such as directors’ preferences, the discretionary authority that has been granted to them (as opposed to the maximization of the corporation’s value), monitoring expenses, bonding expenses, etc.
will lead in turn to a substantial loss of value to the corporation and its minority stockholders.\(^{42}\)

On the other hand, certain Western European countries in which capital concentration takes place have achieved high levels of economic development comparable to that existing in dispersed ownership systems.\(^{43}\) A plausible explanation for this development lies in the existence of effective legal mechanisms for counteracting the specific agency problems that arise in countries with concentrated ownership. Henry Hansmann and Reinier Kraakman have emphasized on the specific nature of the agency problems arising in the context in which there is no separation of ownership and control (\textit{concentrated or block-ownership systems})\(^{44}\). Obviously, in the event of concentrated ownership the basic agency problem concerns the tensions between majority and minority stockholders (not between director and shareholders as a class). Consequently, specific mechanisms must be devised in order to align, through several different incentives, the interests of majority and minority stockholders.

The previously mentioned assertions can also be linked with the already mentioned theory of \textit{multiple optima}, whereby competing ownership structures might have equally positive results in different countries.\(^{45}\) Moreover, every system has an optimal regulatory degree that could be inadequate if it is applied haphazardly to any other economic system. It follows that there might be multiple adequate levels of regulations according to the specific features of each system. This explains why countries with diverging economic models have attained comparable high levels of economic development.

Most efforts in company law reform in Latin America during the last decade have been aimed at improving the framework for publicly-held corporations in the expectation of creating a better regulatory environment for a deep and liquid securities market. The wave of corporate reform for publicly-held corporations has resulted in the overhaul of securities regulation in most major jurisdictions in the area. However, even if the OECD White Paper on Corporate Governance in Latin America has been partially implemented in these countries, the results of such implementation have been at best innocuous and at worst detrimental to the securities markets in the area. The increases in costs of compliance for listed corporations far exceed the reductions in the cost of capital. This is due in part to the formalistic nature of these recommendations and the lack of enforcement mechanisms that could foster their actual compliance. The basic criticism to these corporate governance reforms is based on the extrapolation of a model devised to deal with agency problems arising in the context of ownership dispersion, to countries with highly concentrated capital. The argument draws from the substantial differences between the agency problems that arise between shareholders and directors as compared to the relationships between majority and

\(^{42}\) Id. According to Jensen and Meckling, the loss of value stemming out of directors’ opportunism will only be sub-optimal or inefficient when compared with a \textit{Coasean World} – in which the agent’s performance is complete, without the need to incur in monitoring expenses – or when compared with a hypothetical world in which agency costs were effectively lower than in reality. Nevertheless, all these costs (monitoring, bonding and residual losses) are an inevitable result in any agency relationship.

\(^{43}\) See Coffee, ‘Law and the Market’, \textit{supra} n. 32.


\(^{45}\) Lucian Bebchuk and Mark J. Roe, \textit{A Theory of Path Dependence in Corporate Ownership and Governance}, 1999, SSRN Id. No. 202748.
minority stockholders. This misguided legislative agenda for corporate law disregards a conspicuous economic reality in which closely-held corporations normally dominate the landscape of business in these countries. A high level of concentrated-ownership in Latin America – which has been described as the highest in the world – cannot be counteracted with formalistic recommendations that bear no relationship with the agency problems identified for the area. This is particularly true absent an institutional framework which can be used to increase enforcement intensity. An adaptation of the theory of path dependence provides an insightful tool to analyze corporate law reform for Latin America. Realizing that even in the context of concentrated ownership there can be significant economic growth may be a valuable step towards shifting legislative efforts to the closely-held corporation. This will necessarily require a reshuffling of priorities in the policy agenda aimed at a complete overhaul of the business association’s regulation contained in anachronistic company law codes and statutes. An upgrade in this area can easily be achieved by the introduction of a multifunctional hybrid business form that could coexist and compete with previously created company types. The successful Colombian example regarding the SAS speaks loudly of the benefits that could be obtained if such a step were to be taken.

3.3 The impact of corporate law for economic development

Ownership patterns (dispersed or concentrated) are not the only factors that have to be taken into account for the purposes of comparative company law. A substantial amount of recent academic production on the economic analysis of law draws from the econometric studies of Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer and Robert Vishny (also known as LLSV). LLSV attempted to demonstrate through empirical analysis that the main differences regarding the protection afforded to investors in multiple jurisdictions could be attributed to the legal tradition that each country had inherited (legal origins theory). In a couple of articles published in 1997 and 1998 these authors held the controversial theory whereby those countries belonging to the common law tradition were better endowed with investor protection mechanisms as compared to their civil law counterparts. After analyzing samples taken in 49 countries, LLSV showed that there was a direct statistical correlation between the legal tradition existing in each nation and its level of financial development. Not only did they divide the world into three separate categories, i.e. 1) common law; 2) German and Scandinavian civil law and 3) French civil law), but they rated

46 For an explanation as to the shortcomings of these corporate governance reforms and the inadequacy of many of the solutions recommended by the OECD, see Francisco Reyes, ‘Corporate Governance in Latin America: A Functional Analysis’, in Inter-American Law Review, Vol. 39, No. 2, Winter 2008.
47 José Antonio Ocampo and Juan Martín (eds.), Economic Commission for Latin America and the Caribbean (ECLAC), 2003.
48 Professor Robert Cooter has recently held that a publicly traded market for stock is not essential for the economic development of poor countries (see Solomon’s Knot, How law can end the poverty of nations, available at Bepress No. 144).
50 LLSV found a negative correlation between the degree of ownership concentration and the protection afforded to investors in each of the concerned countries. Based on such correlation they concluded that those systems that lacked a sufficient protection were not suitable to support a fully developed securities market.
the countries included in the first category as number one and assigned the last position to French civil law systems. According to this research, common law origin countries had grown at a higher rate (4.3% per capita) in comparison with French civil law countries (3.18%). The study suggested the convenience of transplanting common law-type legal provisions into civil law countries. In their opinion, the importance of legal origins in defining investor protection suggests that many rules must be changed in order for an inefficient legal system to adhere to best practices.

Notwithstanding LLSV’s significant contribution, their conclusions have been vigorously challenged. Although the proposition whereby law matters is broadly acknowledged, the legal tradition may not be all that important as the LLSV texts suggest. John C. Coffee points out to at least the following five factors that can be used to challenge the legal origins theory: (i) Even if the analysis assumes the inefficiency of the French legal system, France has experienced a higher economic growth than the United Kingdom during most of the period that runs from 1820 until today. French civil law appears to have been efficient, at least for France; (ii) The statistical data that have been used to prove that common law countries have outperformed civil law countries is due to a high extent to the spectacular failure of Latin American countries during the last century. Even the assertion that Latin American systems belong to the French civil law tradition is highly debatable; (iii) The statistical analysis used by LLSV is suspect to the extent that certain critics have held that it has been unduly applied; (iv) There are important examples regarding countries that have reached rapid economic development irrespective of their civil law tradition. Alternatively, there are common law countries that have not been able to reach a high level of economic development and (v) some authors debate the assertion whereby law could have an importance even comparable to structural factors such as geography, free trade or colonial heritage.

Coffee concludes, ironically, that the failure of French civil law may have arisen from its inception in too many tropical climates, as compared with the common law that was received in more temperate countries. Therefore, it is his opinion that a legal system has an impact on economic growth as long as substantive norms are supplemented by an

51 ‘Legal rules protecting investors vary systematically among legal traditions or origins, with the laws of Common Law countries (originating in English Law) being more protective of outside investors than the laws of Civil Law countries (originating in Roman Law) and particularly French Civil Law.’ Rafael La Porta, Florencio López-de-Silanes and Andrei Shleifer, *The Economic Consequences of Legal Origins*, November 2007, at p. 2.


53 It follows from this analysis that it would be convenient to undertake the transplant of legal provisions regarding investor protections originating in common law countries. However, Holger Spamann has held that the analysis should not be approached from the standpoint of the legal tradition from which the rules are borrowed. In his opinion, the differences between the civil law and its common law counterpart are not as relevant as the nature of the jurisdiction. For this purpose, the author classifies legal systems between so-called *core* and *peripheral* jurisdictions. In the former, the legislative-making process is endogenous whereas in the rest of the countries the process is exogenous, namely, it is achieved through the importation of legal rules designed in core jurisdictions (Holger Spamann, *Contemporary Legal Transplants: Legal Families and the Diffusion of Corporate Law*, 2006).

appropriate level of enforcement intensity. Such intensity can be measured both at the level of public and private enforcement. The most accurate way to undertake such measurements is by considering the amount of resources allocated to governmental enforcement agencies (inputs) and compare it with the consolidated amounts that are collected by such agencies (outputs). As enforcement intensity increases the quality of corporate law is also upgraded.55

3.4 Proposals for Latin American company law reform

3.4.1 Publicly held corporations

As a general rule, economic growth can be assessed through the measurement of capital market development and the creation of new businesses. However, Professor Robert Cooter has held that a vigorous stock market is not necessarily an essential factor for the economic development of poor countries. Using specific examples from economies in transition such as India and China, the author points out to the significant growth attained in those countries within the last decade. In determining the manner in which financing has taken place in these jurisdictions he has concluded the relative absence of highly operational systems for publicly traded stocks56.

A brief review of statistical data regarding stock exchanges in Latin America reveals how the stock markets are comparatively depressed as compared with those existing in developed economies (see Table 3, showing the number of listed corporations per million inhabitants in Latin America). The amount of IPOs and other public offerings is limited and the market capitalization of listed companies is relatively small as a percentage of GDP (see Table 4) and the number of issuers of securities is small.57

Under the international benchmark method, a comparison is made between GDPs for the some of the largest economies in Latin America and market capitalization in each of their national stock exchanges.

Table 3 - Number of listed corporation per million inhabitants in major Latin American jurisdictions

<table>
<thead>
<tr>
<th>Position</th>
<th>Country</th>
<th>Number of listed companies</th>
<th>Population</th>
<th>No. of corporations listed per million inhabitants</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Chile</td>
<td>246</td>
<td>16.134.219</td>
<td>15,24709687</td>
</tr>
</tbody>
</table>

55 Id. An objective criterion to assess enforcement intensity in securities markets is closely linked to the so-called bonding premium that arises in the context of cross-listings, where an issuing corporation undergoes an IPO in a foreign with better quality corporate and securities law. There is a direct correlation between the higher or lower enforcement intensity and the amount of the bonding premium. If, for instance, the issuing corporation is originally listed in a jurisdiction with poor corporate and securities laws, listing its securities in the New York Exchange will result in a high premium that can be easily assessed through event studies after information on the cross-listing has been disclosed.


57 As an example there are only 94 corporations registered in the Colombian Stock Exchange. Only shares of stock issued by 22 of these companies have significant liquidity. Moreover, no IPOs or any other public issuance of stock took place during 2008. Transactions regarding stock represent only 2% of the total amount of securities traded in the Colombian stock exchange.
There appears to be an unfortunate coincidence between the wave of corporate governance reforms and the significant decrease in the number of listed firms in all major Latin American jurisdictions (see Table 5 showing the number of firms listed in domestic in Latin American domestic stock exchanges). Aside from other macroeconomic factors a hypothesis can be ventured regarding the increasing costs of compliance (mostly due to multiple requirements of a formalistic nature) without any positive impact on investor confidence. Therefore, these reforms have not resulted in a reduction in the cost of capital.

Table 5 - Number of firms listed in domestic in Latin American domestic stock exchanges
These data suggest that a listing may not entail a significant reduction in the cost of capital or, worse yet, other factors such as tax evasion (which would have to be reduced after listing due to higher disclosure requirements) represent a negative incentive to list a corporation in a Latin American stock market. Furthermore, this suggests shifting the corporate law agenda towards the improvement of the legal framework for closely-held corporations instead of devoting additional resources to the development of a publicly-held corporation the future of which is at best uncertain.

3.4.2 Closely-held corporations

As a general rule, Latin American corporate statutes for closely-held corporations lack relevant innovation present in most modern jurisdictions. The incidence of outmoded notions such as the lack of single member companies, a strict *ultra vires* doctrine, a fixed term of duration, the existence of several formalistic prohibitions supposedly aimed at the protection of shareholders and a plethora of regulatory provisions better suited for publicly-held entities than for small and medium family businesses, are only but a few of the features characterizing an anachronistic regime that needs to be torn down.

The Colombian system in which corporate law reform has been underway for the last 15 years, is a good example of a shifting from the rigidities of an *ancien régime* such as the one described above to a reform agenda prioritizing flexibility, contractual freedom and limited liability. The goals advanced in the recent act introducing the simplified stock corporation (*sociedad por acciones simplificada*) in 2008 match the contemporary policy agenda which gives prevalence to the so-called hybrid business forms, also known as unincorporations.\(^{58}\) The ability of hybrid business forms to operate as all-purpose vehicles has

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\(^{58}\) See draft legislation for the SAS, prepared by Francisco Reyes in 2006. For the original draft that gave rise to the Colombian law on simplified stock corporations, see Gaceta del Congreso No. 111, Bogotá, April 11 of 2007, at pp. 1-6.
led to their introduction in common law and civil law jurisdictions across the board, as well as in certain Asian countries.59

3.4.3 The draft legislation on simplified stock corporations for Latin America

The case for developing new business forms is a strong one in Latin America. Family-owned businesses and closely-held companies abound in the region, creating significant demand for entities that allow parties to engage in extensive private ordering. Existing business forms have proven to be inflexible to suit the needs of family-owned and multi-owner firms. However, most Latin American legislators – much like their European counterparts – have been reluctant to develop new hybrid vehicles. Increasing entrepreneurial demand for reform has only recently spurred several initiatives within the region. Such statutory enhancements are currently being outmatched by the introduction of a new business form: the Sociedad por Acciones Simplificada (SAS) or Simplified Stock Corporation. Even though it draws upon the French Société par Actions Simplifiée, this entity closely resembles the hybrid business entities that have been set in place in the United States and the United Kingdom. By providing a mixture of corporate and partnership-like components, the SAS allows for significant contractual flexibility, while still preserving the benefits of limited liability and asset partitioning.

The model act on Simplified Stock Corporations for Latin America -crafted after the Colombian example- is not intended to serve as an amendment of traditional business forms contained in national codes and statutes. Instead, it is recommended that its enactment take place on a separate legislation that could be linked to the existing system.60 In this manner, the SAS should have to compete with other types of business forms. The first advantage of this legislative system is that it avoids cumbersome and lengthy discussions with regressive-minded legal operators and other agents that favor ancient local corporate law traditions. Included within these operators, McCahery and Vermeulen mention judges, notary publics, law professors, etc.61 The second advantage of this approach refers specifically to the creation of an internal competition among different business entities. This exercise allows to observe entrepreneurial preferences when they choose among the items in the company law menu.62 The SAS is expected to gain a hefty advantage in this competition, owing to its swift process for incorporation and its ample private ordering potential. This competition could ultimately lead to the undoing of the most conservative approaches to company law, as statu quo advocates are forced to relent in their positions when confronted with incontestable economic realities.

(a) General aspects

59 Joseph A. McCahery and Erik Vermeulen, Corporate Governance of Non-listed Companies (Oxford, Oxford University Press 2008) at p. 54.
60 See McCahery and Vermeulen, supra n. 52.
61 See The New Company Law, supra n. 5.
62 This competition is already taking place in Colombia after the inception of Law 1258 of 2008 regarding the simplified stock corporation (SAS).
The basic framework for this proposed legislation is based upon the following five pillars: (i) full-fledged limited liability; (ii) simple incorporation requirements; (iii) contractual flexibility; (iv) supple organizational structure and (v) single level tax structure.

Under the simplified stock corporation, shareholders acquire broad flexibility to freely regulate their relationships pursuant to a set of enabling provisions containing off-the-rack housekeeping rules. Therefore, shareholder protection can be achieved through devices of a contractual nature. In this manner, the antagonism between majority and minority shareholders may be ameliorated through *ex ante* negotiations. For this purpose, the model act not only proposes facilitating provisions, but also enhances the enforceability of shareholders’ agreements. Through the latter device, it is possible to reach certain equilibrium between stockholders by means of sophisticated mechanisms in which rights and obligations can be used to carefully determine *a priori* expectations of all corporate participants. Following the incomplete contracts theory, this enhanced freedom of contract complemented by gap-filling through an efficient adjudication process is intended to provide an improved conflict-resolution scenario for shareholders.

Following the theory of *structural transplants*, the remedy of specific performance is introduced to allow for the adequate enforcement of these agreements in the event of default. Furthermore, the model act incorporates a comprehensive regulation on the *abus de droit* (abuse of rights) theory, which is extrapolated from the French jurisprudence on corporate law. Under this theory, shareholders have the ability to bring judicial actions or arbitration complaints not only on the grounds of abuses of controlling shareholders, but also concerning the same conduct where it has been deployed by minority shareholders and also in the event of abuse in symmetrical block shareholdings (i.e., dual ownership on a 50%-50% distribution). The abuse of right action may give rise to damages for the aggrieved party, as well as rescission of the abusive act. Fiduciary duties of care and loyalty can also be applicable to the officers and directors of the SAS. To complete the scenario of corporate law protections, the model act allows for the application of the shadow director doctrine, by means of which any person who intrudes in a positive management activity, without being a legally appointed manager or director, can be disciplined under fiduciary duties as if she were acting in such managerial capacity.

The SAS is as useful for local businessmen as it is for foreign investors. This usefulness is especially significant to structure corporate groups in which the SAS can be used to incorporate wholly-owned subsidiaries, irrespective of their size or business activity. This light structure substantially reduces transaction costs and facilitates their operation.

The Model Act for the Simplified Stock Corporation seeks to remedy the legislative void existing throughout the region concerning hybrid business forms as well as to reduce transaction costs and provide entrepreneurs with enough flexibility to allow for private ordering in a multi-functional business form, suitable for all kinds of undertakings.

(b) **Specific aspects of the SAS Model Act**

The proposed draft legislation is based on a basic principle: granting ample freedom to entrepreneurs in structuring their relationships through contractual provisions. And yet, when parties are loath to incur the costs of contractual bargaining, the Model Act sets forth ready-made provisions to govern intra-firm relationships. These off-the-rack rules have been laid down following a two-tier system. The first regulatory tier is comprised of provisions designed specifically for the Simplified Stock Corporation. The second one remands parties to the statutory rules governing the standard corporate form, as it exists in the corresponding State of incorporation.

Some of the most salient features of the SAS can be summarized as follows:

(i) formation by one or more shareholders;
(ii) incorporation by simple private or electronic document (as opposed to granting a public deed for incorporation);
(iii) simple registration before Mercantile Registry;
(iv) full limited liability, with the exception of piercing the veil hypothesis for fraud or abuse of the corporate form;
(v) abolition of the *ultra vires* doctrine
(vi) unlimited corporate duration;
(vii) full contractual freedom for corporate organization;
(viii) suppression of superfluous internal controls such as statutory auditors;
(ix) admission of several different classes of stock including shares with multiple voting rights;
(x) simple majority to make corporate decisions;
(xi) waiver of notice for shareholders’ meetings;
(xii) specific regulation for abuse of rights;
(xiii) flexibility to define subscribed capital (without minimum capitalization requirements);
(xiv) long term for the effective contribution of paid-in capital;
(xv) ample contractual freedom to execute shareholders’ agreements;
(xvi) remedy of specific performance to enforce shareholders’ agreements in the event of default;
(xvii) dividend distribution and regulation detached from regulatory thresholds or mandatory minimum proportional allocation of profits;
(xviii) freedom to provide for arbitration for all kinds of conflicts (including disputes among shareholders or with management);
(xix) restrictions on the free transferability of shares (beyond the right of first refusal);
(xx) possibility to squeeze-out shareholders in the event of changes of control or merger (provided that an appropriate compensation at market value is granted);
(xxi) definition of the sale of all or substantially all assets;
(xxii) introduction of triangular mergers and full dissenters’ remedies.

Even if limited liability is one of the main features of the SAS, the model act provides for piercing the corporate veil in order to extend liability to controlling shareholders in the event of fraud or abuse of the corporate form. Such mechanism has to be brought before a specialized jurisdiction or an arbitration panel that will guarantee a more technical and expedited resolution for aggrieved creditors.

4. **Conclusion**

Understanding the underlying economic model in Latin American countries allows for the determination of the most frequent agency problems present in business corporations in the region. Taking into account the high degree of concentrated ownership that prevails across Latin American countries, solutions should be devised in order to counteract the potentiality for oppression of minority shareholders at the hands of blockholders. The theory of structural transplants is useful for the introduction of a system that is based upon two pillars. The first pillar is composed of enabling statutes that allow parties to opt out default legal provisions. Private ordering facilitates the creation of tailor-made rules appropriate for closely held entities. Such freedom of contract contributes to achieving a higher degree of completeness in the corporate contract. The second pillar concerns procedural provisions that are intended to increase the degree of enforcement intensity so that gap-filling by arbitrators, judicial authorities and other entities is facilitated. The model act on simplified stock corporations for Latin America is an attempt to incorporate modern trends into legal
systems characterized by a formalistic and backward structure in which regulatory provisions prevail to an overwhelming extent. The extremely successful, empirically measured result of Colombian Law 1258 of 2008 -with more than 6,000 simplified stock corporations created in 8 months- clearly suggests that businesspeople prefer flexibility to old fashioned misguided paternalism. The widespread adoption of the model act would not only allow for a certain degree of convergence in countries that require a higher level of legal integration, but also could foster innovation and foreign investment. Overall, statutes such as the model act are aimed at the increase of economic development and welfare-enhancement. To sum, the rules included within the Model Act are meant to foster innovation and entrepreneurship throughout the region.
Section 4

Model Act on the Simplified Stock Corporation

Chapter I
General Provisions

Section 1. Nature.- The simplified stock corporation is a for profit legal entity by shares, the nature of which will always be commercial irrespective of the activities set forth in its purpose clause.

Section 2. Limited Liability.- The simplified stock corporation may be formed by one or more persons or legal entities. Shareholders will only be responsible for providing the capital contributions promised to the simplified stock corporation. Except as set forth in Section 41 of this Act, shareholders will not be held liable for any obligations incurred by the simplified stock corporation, including but not limited to labor and tax obligations. There shall be no labor relationship between a simplified stock corporation and its shareholders, unless an explicit to that effect has been executed to that effect.

Section 3. Legal Personality.- Upon the filing of the formation document before the Mercantile Registry (include the name of the corresponding company registrar's office), the simplified stock corporation will form a legal entity separate and distinct from its shareholders.

Section 4. Inability to Become a Listed Entity.- The shares of stock and other securities issued by a simplified stock corporation shall neither be registered within a stock exchange, nor traded in any securities market.

Chapter II
Formation and Proof of Existence

Section 5. Contents of the Formation Document.- A simplified stock corporation will be formed by contract or by the individual will of a single shareholder, provided that a written document is granted. The formation document shall be registered before the Mercantile Registry (include the name of the corresponding company registrar's office), and set forth:

1. Name and address of each shareholder;
2. The name of the corporation followed by the words “simplified stock corporation” or the abbreviation “S.A.S.”;
3. The corporation’s domicile;
4. If the simplified stock corporation is to have a specific date of dissolution, the date in which the corporation is to dissolve;
5. A clear and complete description of the main business activities to be included within the purpose clause, unless it is stated that the corporation may engage in any lawful business;
6. The authorized, subscribed and paid-in capital, along with the number of shares to be issued, the different classes of shares, their par value and the terms and conditions in which the payment will be made;
7. Any provisions for the management of the business and for the conduct of the affairs of the corporation, along with the names and powers of each manager. A simplified stock
corporation shall have at least one legal representative in charge of managing the affairs of the corporation in relation with third parties.

No additional formalities of any nature shall be required for the formation of the simplified stock corporation.

Section 6. Attestation.- The Mercantile Registrar [include the name of corresponding company registrar’s office] shall attest to the legality of the provisions set forth in the formation document and any amendments thereof. The Registrar shall only deny registration where the requirements provided under Section 5 have not been met. The decision rendered by the Registrar shall be issued within three days after the relevant filing has been made. Any decision denying registration will only be subject to a rehearing conducted by the Registrar.

Upon the approval of a formation document by the Mercantile Registrar, challenges will not be heard against the existence of the simplified stock corporation and the contents of the formation document will constitute the simplified stock corporation’s by-laws.

Section 7. Assimilation to Partnership.- Where a formation document has not been duly approved by the Mercantile Registrar [include the name of corresponding company registrar’s office] the purported corporation will be assimilated to a partnership. Accordingly, partners will be jointly and severally liable for all obligations in which the partnership is engaged. If the partnership has only one member, such member will be held liable for all obligations in which the partnership is engaged.

Section 8. Proof of Existence. The certificate issued by the Mercantile Registrar [include the name of corresponding company registrar’s office] is conclusive evidence as regards the existence of the simplified stock corporation and the provisions set forth in the formation document.

Chapter III
Special Rules Regarding Subscribed, Paid-in Capital and Shares of Stock

Section 9. Capital Subscription and Payment.- Capital subscription and payment may be carried out under terms and conditions different to those set forth under the Commercial Code [include the name of the relevant Code, Decree, Law or Statute]. In any event, payment of subscribed capital shall be made within a period of two years to be counted from the date in which the shares were subscribed. The rules for subscription and payment may be freely set forth in the by-laws.

Section 10. Classes of Shares.- The simplified stock corporation may issue different classes or series of shares, including preferred shares with or without vote. Shares may be issued for any consideration whatsoever including in-kind contributions or in exchange for labor pursuant to the terms and conditions contained in the by-laws.

Any special rights granted to the holders of any class or series of shares shall be described or affixed upon the back of the stock certificates.

Section 11. Voting Rights.- The by-laws shall depict in full detail the voting rights corresponding to each class of shares. Such document shall also determine whether each share will grant its holder single or multiple voting rights.

Section 12. Share Transfers to a Trust.- Any shares issued by a simplified stock corporation may be transferred to a trust provided that an annotation is made in the corporate ledger concerning the trustee company, the beneficial owners and the percentage of beneficial rights.

Section 13. Limitation on the Transferability of Shares.- The by-laws may contain a provision whereby the shares may not be transferred for a period not to exceed ten years to be counted from the moment in which the shares were issued. Such term may only be extended by consent of all the holders of outstanding shares.
Any such limitation on share transferability shall be described or affixed upon the back of
the stock certificate.

Section 14. Authorization for the Transfer of Shares.- The by-laws may contain
provisions whereby any transfer of shares or of any given class of shares will be subject to
the previous authorization of the shareholders’ assembly granted by majority vote or by any
supermajority included in the by-laws.

Section 15. Breach of Restrictions on Negotiation of Shares.- Any transfer of shares
carried out in a manner inconsistent with the rules set forth in the by-laws shall be null and
void.

Section 16. Change of Control in a Corporate Shareholder.- The by-laws may impose
upon an incorporated shareholder the duty to notify the simplified stock corporation’s legal
representative about any transaction the effect of which may cause a change in control
regarding such shareholder.

Where a change in control has taken place, the shareholders’ assembly by majority decision
shall be entitled to exclude the corresponding incorporated shareholder.

Aside from the possibility of being excluded, any breach of the duty to inform changes in
control may subject the concerned shareholder to a penalty consisting of a 20% reduction of
the fair market value of the shares, upon reimbursement.

In the event set forth in this article all decisions concerning the exclusion of shareholders as
well as the determination of any penalties shall require an approval rendered by the
shareholder’s assembly by majority vote. The votes of the concerned shareholder shall not
be counted for the adoption of these decisions.

Chapter IV
Organization of the Simplified Stock Corporation

Section 17. Organization.- Shareholders may freely organize the structure and operation
of a simplified stock corporation in the by-laws. In the absence of specific provisions to this
effect, the shareholders’ assembly or the sole shareholder, as the case may be, will be
entitled to exercise all powers legally granted to the shareholders’ assemblies of stock
corporations, whilst the management and representation of the simplified stock corporation
shall be granted to the legal representative.

Where the number of shareholders has been reduced to one, the subsisting shareholder shall
be entitled to exercise the powers afforded to all existing corporate organs.

Section 18. Meetings.- Meetings of shareholders may be held at such place as may be
designated by shareholders either within or without the corporation’s domicile. For any of
these meetings, the regular quorum provided in the by-laws will suffice pursuant to Section
22 hereof.

Section 19. Meetings by Technological Devices or by Written Consent.- Meetings of
shareholders may be held through any available technological devices or by written consent.
The minutes of such meetings shall be drafted and included within the corporate records no
later than 30 days after the meeting has taken place. These minutes shall be signed by the
legal representative or, in the absence of the former, by any shareholder that participated in
the meeting.

Section 20. Notice of Meeting.- In the absence of stipulation to the contrary, the legal
representative shall convene the shareholders’ assembly by written notice addressed to each
shareholder. Such notice shall be made at least five days in advance to the meeting. The
agenda shall in all cases be included within any notice of meeting.

Whenever the shareholders’ assembly is called upon to approve financial statements,
conversion of the corporation into another form, mergers or split-off proceedings,
shareholders will be entitled to exercise information rights concerning any documents
relevant to the proposed transaction. Information rights may be exercised during the five
days prior to the meeting, unless a longer term has been provided for in the by-laws.

Any notice of meeting may determine the date in which Second Call Meetings will take
place, whenever quorum is insufficient to hold the first meeting. Second Call Meetings shall
take place at any date following the next 10 days after the first meeting should have taken
place. This Second Call Meeting shall not take place later than 30 days following the date of
the failed meeting.

Section 21. Waiver of Notice.- Shareholders may at any point in time submit written
waivers of notice whereby they forego their right to be convened to a meeting of the
shareholders’ assembly. Shareholders may also waive in writing any information rights
granted under Section 20.

Even in the absence of a notice of meeting, the attendees in a given shareholders’ assembly
will be deemed to have waived the right of being convened, unless such shareholders make a
statement to the contrary before the meeting takes place.

Section 22. Quorum and Majority.- A majority of the shares entitled to vote, present in
person or represented by proxy, shall constitute a quorum at a meeting of shareholders, unless
the by-laws specify otherwise.

The affirmative vote of the majority of shares present in person or represented by proxy at
the meeting shall be the act of the shareholders, unless the by-laws contain supermajority
provisions.

The sole shareholder of a simplified stock corporation may adopt any and all decisions
within the powers granted to the shareholders’ assembly. The sole shareholder will keep a
record of such decisions in the corporate books.

Section 23. Vote Splitting.- Shareholders may split their votes during cumulative voting
proceedings for the election of directors or the members of any other organism.

Section 24. Shareholders’ Agreements.- Agreements entered into between shareholders
concerning the acquisition or sale of shares, preemptive rights or rights of first refusal,
exercise of voting rights, voting by proxy or any other valid matter shall be binding upon the
simplified stock corporation, provided that such agreements have been filed with the
corporation’s legal representative. Shareholders’ agreements will be valid for any period of
time determined by the relevant agreement, not exceeding 10 years, upon the terms and
conditions stated therein. Such 10 year term may only be extended by unanimous consent.

Shareholders that have executed an agreement shall appoint a person who will represent
them in receiving notices from the corporation and providing any information that could be
requested. The simplified stock corporation may request in writing to such representative
clarification as regards any provisions set forth in the agreement. In this event, the response
shall be provided also in writing within the five days following the request.

Subsection 1.- The President of the shareholders’ assembly or of the concerned corporate
organ shall exclude any votes cast in a manner inconsistent with the terms set forth under a
duly filed shareholders’ agreement.

Subsection 2.- Pursuant to the conditions set forth in the agreement, any shareholder shall be
entitled to demand the specific performance of any obligation arising under such agreement,
before a court with jurisdiction over the corporation.

Section 25. Board of Directors.- The simplified stock corporation is not required to have
a board of directors, unless such board is mandated in the by-laws. In the absence of a
 provision requiring the operation of a board of directors, the legal representative appointed
by the shareholders’ assembly shall be entitled to exercise any and all powers concerning the
management and legal representation of the simplified stock corporation.

If a board of directors has been included in the formation document, such board will be
formed with one or more directors for each of whom an alternate director may also be
appointed. All directors may be appointed either by majority vote, cumulative voting or by any other mechanism set forth in the by-laws. The rules regarding the operation of the board of directors may be freely established in the by-laws. Lacking a specific provision on the by-laws, the board will be governed under the relevant statutory provisions.

**Section 26. Legal Representation.**- The legal representation of the simplified stock corporation will be carried out by an individual or legal person appointed in the manner provided in the by-laws. The legal representative may undertake and execute any and all acts and contracts included within the purpose clause as well as those which are directly related to the operation and existence of the corporation.

**Section 27. Liability of Directors and Managers.**- All Commercial Code [include the name of the relevant Code, Decree, Law or Statute] provisions relating to the liability of directors and managers may also be applicable to the legal representative, the board of directors and the managers and officers of the simplified stock corporation, unless such provision is opted-out in the by-laws.

**Subsection 1.**- Any individual or legal entity who is not a manager or director of a simplified stock corporation that engages in any trade or activity related to the management, direction or operation of such corporation shall be subject to the same liabilities applicable to directors and officers of the corporation.

**Subsection 2.**- Whenever a simplified stock corporation or any of its managers or directors grants apparent authority to an individual or legal entity to the extent that it may be reasonably believed that such individual or legal entity has sufficient powers to represent the corporation, the company will be legally bound by any transactions entered into with third parties acting in good faith.

**Section 28. Auditing Organs.**- A simplified stock corporation shall not, in any case, be legally mandated to establish or provide for internal auditing organs [include the name of corresponding auditing entity e.g. fiscal auditor, auditing committee, etc.].

**Chapter V**

**By-Law Amendments and Corporate Restructurings**

**Section 29. By-law Amendments.**- Amendments to the corporate by-laws shall be approved by majority vote. Decisions to this effect will be recorded in a private document to be filed with the Mercantile Registry [include the name of corresponding company registrar’s office].

**Section 30. Corporate Restructurings.**- The statutory provisions governing conversion into another form, mergers and split-off proceedings for business associations will be applicable to the simplified stock corporation. Dissenters’ rights and appraisal remedies shall also be applicable.

For the purpose of exercising dissenters’ rights and appraisal remedies, a corporate restructuring will be considered detrimental to the economic interests of a shareholder, inter alia, whenever:

1. The dissenting shareholders percentage in the subscribed paid-in capital of the simplified stock corporation has been reduced;
2. The corporation’s equity value has been diminished, or
3. The free transferability of shares has been constrained.

**Section 31. Conversion into Another Business Form.**- Any existing business entity may be converted into a simplified stock corporation by unanimous decision rendered by the holders of all issued rights or shares in such business form. The decision to convert into a simplified stock corporation shall be registered before the Mercantile Registry [include the name of corresponding company registrar’s office].
A simplified stock corporation may be converted into any other business form governed under the Commercial Code [include the name of the relevant Code, Decree, Law or Statute] provided that unanimous decision is rendered by the holders of all issued and outstanding shares in the corporation.

**Section 32. Substantial Sale of Assets.**- Whenever a simplified stock corporation purports to sell or convey assets and liabilities amounting to 60% or more of its equity value, such sale or conveyance will be considered to be a substantial sale of assets. Substantial sales of assets shall require majority shareholder approval. Whenever a substantial sale of assets is detrimental to the interests of one or more shareholders, it shall give rise to the application of dissenters’ rights and appraisal remedies.

**Section 33. Short-form Merger.**- In any case in which at least 90% of the outstanding shares of a simplified stock corporation is owned by another legal entity, such entity may absorb the simplified stock corporation by the sole decision of the boards of directors or legal representatives of all entities directly involved in the merger. Short-form mergers may be executed by private document duly registered before the Mercantile Registry [include the name of corresponding company registrar’s office].

**Chapter VI**

**Dissolution and Winding Up**

**Section 34. Dissolution and Winding Up.**- The simplified stock corporation shall be dissolved and wound up whenever:

1. An expiration date has been included in the formation document and such term has elapsed provided that a determination to extend it has not been approved by shareholders, before or after such expiration has taken place;
2. For legal reasons or otherwise, the corporation is absolutely unable to carry out the business activities provided under the purpose clause;
3. Compulsory liquidation proceedings have been initiated;
4. An event of dissolution set forth in the by-laws has taken place;
5. A majority shareholder decision has been rendered or such decision has been made by the will of the sole shareholder;
6. A decision to that effect has been rendered by any authority with jurisdiction over the corporation, and

Whenever the duration term has elapsed, the corporation shall be dissolved automatically. In all other cases, the decision to dissolve the simplified stock corporation shall be filed before the Mercantile Registry [include the name of corresponding company registrar’s office].

**Section 35. Curing Events of Dissolution.**- Events of dissolution may be cured by adopting any and all measures available to that effect, provided that such measures are adopted within 1 year following the date in which the shareholders’ assembly acknowledged the event of dissolution. Events of dissolution consisting in the reduction of the minimum number of shareholders, partners or members in any business form governed under the Commercial Code [include the name of the relevant Code, Decree, Law or Statute] may be cured by conversion into a simplified stock corporation, provided that unanimous decision is rendered by the holders of all issued shares or rights or by the will of the subsisting shareholder, partner or member.

**Section 36. Winding Up.**- The simplified stock corporation shall be wound up in accordance with the rules that govern such proceeding for stock corporations. The legal representative shall act as liquidator, unless shareholders appoint any other person to wind up the company.
Chapter VII
Miscellaneous Provisions

Section 37. Financial Statements.- The legal representative shall submit financial statements and annual accounts to the shareholders’ assembly for approval. In the event that there is a single shareholder in a simplified stock corporation, such person shall approve all financial statements and annual accounts and will record such approvals in minutes within the corporate books.

Section 38. Shareholder Exclusion.- The by-laws may contain causes by virtue of which shareholders may be excluded from the simplified stock corporation. Excluded shareholders shall be entitled to receive a fair market value for their shares of stock. Shareholder exclusion shall require majority shareholder approval, unless a different procedure has been laid down in the by-laws.

Section 39. Conflict Resolution.- Any conflict of any nature whatsoever, excluding criminal matters, that arise between shareholders, managers or the corporation may be subject to arbitration proceedings or to any other alternative dispute resolution procedure. In the absence of arbitration, the same disputes will be resolved by (include specialized judicial or quasi-judicial tribunal).

The decisions rendered by the tribunal are final and shall not be subject to appeals before any court.

Section 40. Special Provisions.- The legal mechanisms set forth under Sections 13, 14, 38 and 39 may only be included, amended or suppressed from the by-laws by unanimous decision rendered by the holders of all issued and outstanding shares.

Section 41. Veil Piercing.- The corporate veil may be pierced whenever the simplified stock corporation is used for the purpose of perpetrating fraud. Accordingly, joint and several liability may be imposed upon shareholders, directors and managers in the case of fraud or other wrongful acts done in the name of the corporation.

Section 42. Abuse of Rights.- Shareholders shall exercise their voting rights in the interest of the simplified stock corporation. Votes cast with the purpose of inflicting harm or damages upon other shareholders or the corporation or the intent of unduly extracting private gains for personal benefit or for the benefit of a third party shall constitute an abuse of rights. Any shareholders who act abusively may be held liable for all damages caused, irrespective of the judge’s ability to set aside the decision rendered by the shareholders’ assembly. A suit for damages and nullification may be brought in case of:

1. Abuse of majority;
2. Abuse of minority, and
3. Abusive deadlock caused by one faction under equal division of shares between two factions.

Section 43. Cross-References.- The simplified stock corporation shall be governed:

1. By this Law;
2. By the formation document, as amended from time to time, or
3. By statutory provisions contained in the Commercial Code [include the name of the relevant Code, Decree, Law or Statute] governing stock corporations.

Section 44. Promulgation.- This Act shall be effective as of the date of its promulgation and repeals any and all statutes, acts, codes, decrees or provisions of any nature that are inconsistent with this Act.