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Micro, small and medium-sized enterprises

Legal questions surrounding the simplification of incorporation

Note by the Secretariat

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I. Introduction

1. At its forty-sixth session in 2013, the Commission requested that a working group should commence deliberations aimed at reducing the legal obstacles encountered by micro, small and medium-sized enterprises (MSMEs) throughout their life cycle. The Commission agreed that consideration of the issues pertaining to the creation of an enabling legal environment for MSMEs should initially “focus on the legal questions surrounding the simplification of incorporation”.¹

2. The Working Group first considered this topic at its twenty-second session (New York, 10-14 February 2014), at which time it discussed a number of issues relevant to the legal questions surrounding the simplification of incorporation. These issues included: limited liability, legal personality, the protection of third parties and creditors dealing with the enterprise, registration of the business, sole ownership, minimum capital requirements, transparency in respect of beneficial ownership, internal governance issues, and freedom of contract, as well as the possible form that a legal text could take. At the conclusion of its twenty-second session, the Working Group requested the Secretariat “to prepare a template on simplified incorporation and registration containing contextual elements and experiences linked to the mandate of the Working Group, to provide the basis for drafting a possible model law, without discarding the possibility of the Working Group drafting different legal instruments, particularly, but not exclusively, as they applied to MSMEs in developing countries.” This working paper and A/CN.9/WG.I/WP.86/Add.1 were prepared in order to meet that request.

II. Possible approaches to the creation of a legal text

A. Previous discussion in the Working Group

3. The Working Group may wish to recall that at its first session, it had been noted that a main concern of its work was to ensure that sole proprietors could be included in a simplified incorporation regime, even though such entrepreneurs might be engaged in relatively simple business activities.² Moreover, while there was support for the view that a single legislative model for simplified incorporation with built-in flexibility could be appropriately adapted to all forms of MSMEs, it was suggested that such an approach could be both complicated and expensive, particularly for micro and small businesses. In addition, there was also support for the suggestion that a legislative regime for a continuum of different business forms could be explored (sole proprietorship, partnership and limited liability company) that would accommodate different types and sizes of entrepreneurs based on their needs and circumstances.³

¹ *Official Records of the General Assembly, Sixty-eighth Session, Supplement No. 17 (A/68/17)*, para. 321. For a history of the evolution of this topic on the UNCITRAL agenda, see A/CN.9/WG.I/WP.84, paras. 5-14.

² Report of Working Group I (MSMEs) on the work of its twenty-second session (New York, 10-14 February 2014) (“Report of Working Group I”), A/CN.9/800, para. 24.

³ *Ibid.*, paras. 30 and 33.

4. It was also emphasized during the previous session of the Working Group that even a very simple legislative model might be too complex and burdensome to meet the needs of micro-businesses, most of which consisted of sole proprietors. It was observed that one of the greatest needs of micro-entrepreneurs was the ability to set up their businesses quickly and easily,⁴ and that requiring micro-businesses to incorporate, even in a simplified fashion, could work against bringing such businesses into the formal sphere.⁵ Although the Working Group did not determine specifically how best to accommodate the needs of microenterprises, there was agreement that, at least as an initial step, the treatment of micro-entrepreneurs should focus on simplified registration.⁶

B. A possible way forward

5. While the Working Group did not reach agreement at its inaugural session on the specific approach to be adopted in exploring the legal questions surrounding the simplification of incorporation, there was a general view that the needs of micro-businesses warranted particular attention, both due to their size and to their importance in the economy of many States, including in most developing countries. As such, one approach that the Working Group might consider in order to move forward systematically in its analysis could be to study the issues involved by focusing first on the needs of very simple micro-businesses wishing to formalize in the simplest manner possible, and then to review a continuum of possible legal regimes suited to increasingly larger and more formalized business entities.

6. The initial focus of the Working Group could be on business registration, which is the starting point for formalization of all businesses, regardless of size (and is treated in greater detail in A/CN.9/WG.I/WP.85). At the registration stage, it is open to the founder or founders of a business to choose which legal form their business should take; however, it is equally possible for an entrepreneur to choose simply to register a business (and thus to take advantage of whatever benefits and responsibilities that may entail in the entrepreneur's jurisdiction),⁷ but not to choose any particular legal form for the business. This very simple approach to formalization could be attractive for microenterprises or sole proprietorships that determine they do not need legal personality nor the protection of limited liability offered by more structured business entities, but would nonetheless like to derive some benefit from the advantages offered by a particular jurisdiction to businesses that formalize.⁸

7. In order to reflect the emphasis of the Working Group on microenterprises, which consist predominantly of individual entrepreneurs, the next level of formalization for MSMEs that might be considered by the Working Group could be a legislative regime designed specifically for sole proprietors, i.e. a "think small

⁴ Ibid., para. 42. Reference was also made to the need for micro-entrepreneurs to gain access to credit to grow their businesses.

⁵ Ibid.

⁶ Ibid., para. 43.

⁷ See, for example, the advantages to both the entrepreneur and the government outlined in Working Paper A/CN.9/WG.I/WP.85, para. 5.

⁸ See the Report of Working Group I, A/CN.9/800, paras. 47-48 and certain of the legal regimes described in Working Paper A/CN.9/WG.I/WP.87.

first” approach. Such a regime could emphasize simplicity, but nonetheless offer to micro-entrepreneurs an improvement over simple registration by allowing a sole proprietor to form a business with legal personality and the protection of limited liability.⁹ This type of regime could provide to the individual entrepreneur the main advantages seen as particularly attractive to micro- and small businesses: permitting them to use freedom of contract to form, via a simple, low-cost structure, a business that is member-managed and that has legal personality while excluding personal liability via the protection of limited liability.¹⁰

8. An example of a regime that could offer these advantages to an individual entrepreneur has been prepared for possible consideration by the Working Group in Working Paper A/CN.9/WG.I/WP.86/Add.1. The text contains both a draft model law on a single-member business entity (“MLSBE”) and commentary on its various provisions. The single-member nature of the business entity would make it possible for the Working Group to take a pared down approach to examining the legal questions surrounding the simplification of incorporation, and to find agreement first on basic principles prior to addressing more problematic ones that may be associated with more complex business entity structures.¹¹

9. The Working Group may also wish to recall that the text of another model law that could also provide sole proprietors (as well as larger business entities) with limited liability and legal personality for their business was presented to it at its previous session and is contained in an annex to document A/CN.9/WG.I/WP.83 (the Model Act on the Simplified Corporation or “MASC”). The MLSBE was prepared by drawing from principles established in the MASC and in other legislative models creating a legal regime for simplified business entities.

10. Reference will be made to each of these two texts (MLSBE and MASC) in the discussion that follows in order to illustrate the issues identified for possible consideration by the Working Group. Of course, it must be emphasized that the MLSBE and the MASC are only two examples of the many possible approaches that could be taken by the Working Group in its deliberations on the legal issues surrounding the simplification of incorporation aimed at reducing the legal obstacles faced by MSMEs. Examples of other possible regimes that the Working Group may

⁹ Along these lines, the European Commission is exploring a Proposal for a Directive of the European Parliament and of the Council on single-member private limited liability companies, European Commission, Brussels, 9.4.2014 (COM (2014) 212 final). The European Commission’s previous efforts to reach agreement on the adoption of a European Private Company Statute (Proposal for a Council Regulation on the Statute for a European private company, COM (2008) 396) were unsuccessful, and the proposal has been officially withdrawn (Annex to the Communication on “Regulatory Fitness and Performance (REFIT): Results and Next Steps”, COM (2013) 685, 2.10.2013).

¹⁰ International Encyclopedia of Comparative Law, Volume XIII, Business and Private Organizations (1998), Detlev Vagts ed., Chapter 2, Limited Liability Companies and Private Companies, p. 183.

¹¹ As noted by the Working Group in its previous session, efforts to agree on the creation of a single private limited liability company form in the European Union proved to be difficult (Report of Working Group I, A/CN.9/800, para. 35). As further noted above in footnote 9, the proposal for a regulation on the statute for a European private company has been officially withdrawn, and the single-member private limited liability company has been proposed as an alternative approach.

wish to consider can be found in Working Papers A/CN.9/WG.I/WP.82 and A/CN.9/WG.I/WP.87.

III. Outline of the working paper

11. As a preliminary matter, the following discussion reviews three broad principles of key importance to the law of business organizations and on which the Working Group has touched in its previous deliberations. These legal principles underlie the analysis contained in this paper: legal personality, limited liability and freedom of contract.

12. Next, using a framework drawn from various examples of existing legal regimes for privately held business entities, this paper will examine some of the broader issues relevant to a consideration of the legal issues surrounding the simplification of incorporation in the context of MSMEs. This examination is intended to provide an initial review, as requested, of the “contextual elements and experiences linked to the mandate of the Working Group” in order assist it in its deliberations.

IV. Broad legal principles underpinning simplified business entities

13. This paper is prepared on the basis that three main principles relevant to the law of business organizations provide significant advantages to entrepreneurs and provide the foundation for the consideration of legal issues surrounding simplified business entities: limited liability, legal personality, and freedom of contract. Since their inception in the 19th century,¹² privately held companies have enjoyed legal personality and the shield of limited liability for their members; more recently, there has been growth in the importance of the principles of flexibility and freedom of contract for entrepreneurs to shape their businesses as they wish. For the purposes of the following discussion, it is assumed that an entrepreneur or a group of entrepreneurs wishing to formalize a business as a legal entity would base a decision to do so on the advantages offered the entrepreneur as a result of these three principles, bearing in mind that the Working Group may also wish to consider alternative approaches to the problem, examples of which may be found in A/CN.9/WG.I/WP.87.

A. Limited liability

14. Limited liability protection, in which the financial liability of an entrepreneur for the obligations of the business entity is limited to a fixed sum, usually the value of the entrepreneur’s investment in a business entity, has been a fundamental feature of public and private corporate business forms since the 19th century,¹³ and is no less important in terms of modern simplified business forms. Limited liability can play a crucial role for an MSME in that it provides the means to separate the

¹² Supra, note 10, p. 5.

¹³ Ibid., p. 4.

personal assets of its members from those owned by the business, thus protecting personal assets from exposure in the event that the business does not do well or becomes involved in legal disputes.¹⁴ Of course, the business entity itself has unlimited liability to its creditors and all of the assets of the business are available to satisfy those claims; in addition, limited liability does not excuse the members of a business entity from their obligation to make the promised contributions to the capital of the entity.¹⁵

15. The Working Group noted in its previous session that limited liability was an important risk-reducing system that allowed entrepreneurs to take business risks without fear of failure, but it was noted that many MSMEs were currently excluded from such a protective regime and that efforts should be made to include them. Moreover, the Working Group expressed its general support for the view that limited liability, along with legal personality, offered to MSMEs important advantages in doing business and that it was important to provide access to these advantages to such enterprises.¹⁶

16. The Working Group may also wish to note, and to consider in its deliberations on possible approaches to the issue, that some States have established mechanisms that allow an entrepreneur's assets, under certain conditions, to be segregated from business assets without providing specifically for limited liability.¹⁷ Examples of such regimes are explained in more detail in Working Paper A/CN.9/WG.I/WP.87.¹⁸

17. Both the MLSBE (article 3) and the MASC (section 2) include provisions on limited liability for the members of the business entity.

B. Legal personality

18. At its previous session, the Working Group also expressed its support for the well-known concept of legal personality. Legal personality confers upon a business entity the legal rights and duties necessary for it to function within a legal system, including the ability to acquire and hold property, to enter into contracts, to sue or be sued, and to act through agents. As noted above, the Working Group was of the view at its previous session that legal personality also offered key advantages to MSMEs and that it should be available to them.¹⁹ Legal personality has also been one of the defining features of corporate business forms, and as noted in A/CN.9/WG.I/WP.82,²⁰ it is also a standard feature of simplified business forms.

19. As noted previously in the Working Group, some States have established legal regimes that allow for businesses with no legal personality to nonetheless own

¹⁴ See Working Paper A/CN.9/WG.I/WP.82, para. 12.

¹⁵ See, for example, article 7 of the MLSBE in Working Paper A/CN.9/WG.I/WP.86/Add.1.

¹⁶ Report of Working Group I, A/CN.9/800, para. 28.

¹⁷ Report of Working Group I, A/CN.9/800, paras. 29 and 46.

¹⁸ Reference may be had, for example, to the "auto-entrepreneur" system, in which the entrepreneur is not offered limited liability or incorporation, but can declare before a notary that those assets not associated with running the business are exempt from seizure.

¹⁹ Report of Working Group I, A/CN.9/800, para. 28.

²⁰ See Working Paper A/CN.9/WG.I/WP.82, para. 13.

property and be involved in legal actions.²¹ Examples of such regimes are explained in more detail in A/CN.9/WG.I/WP.87.

20. Both the MLSBE (article 2) and the MASC (section 3) grant legal personality to the business entity.

C. Flexibility and freedom of contract

21. The accommodation of entrepreneurs wishing to form flexible legal entities is one of the reforms of a State's legal framework that has been recommended as a supporting pillar for the establishment of best practices in business registration.²² As noted in Working Paper A/CN.9/WG.I/WP.85²³ and in studies by the World Bank Group, entrepreneurs considering whether or not to enter the formal economy often base their decisions on the simplicity of the legal form available in their jurisdiction. Reportedly, the availability of only rigid legal entities may be expected to hinder business entity growth, and States that do not offer a more flexible legal form experience a greatly reduced rate of business entry. A number of States have introduced new types of limited liability vehicles to meet the needs of entrepreneurs for contractual flexibility in the formation of their business entities, while other States have introduced specific legal reforms to simplify the process of formalization for sole proprietorships.²⁴ The Working Group may also wish to recall that Working Paper A/CN.9/WG.I/WP.82 compared the main features of 16 different types of simplified and flexible legal business entities from 11 separate States that have recently reformed their legal framework in this regard.²⁵

22. Indeed, one of the main goals of closely held businesses, including simplified business entities (such as those considered in A/CN.9/WG.I/WP.82), could be said to be to function as independently as possible from the strict rules that govern publicly traded companies.²⁶ As noted in documents previously before the Working Group, the main focus of simplified business entities has been on creating flexible business forms that can be tailored to the needs of certain types of closely held businesses, including: MSMEs wishing to formalize and segregate personal and business assets;

²¹ Report of Working Group I, A/CN.9/800, paras. 29 and 46.

²² Investment Climate (World Bank Group), *Reforming Business Registration: A Toolkit for the Practitioners* (2013) ("Toolkit (2013)"), pp. 17-19 (found at <https://www.wbginvestmentclimate.org/publications/loader.cfm?csModule=security/getfile&pageid=34841>), and Investment Climate (World Bank Group), *Innovative Solutions for Business Entry Reforms: A Global Analysis* (2012) ("Global Analysis (2012)") (found at www.brreg.no/internasjonalt/ISBER_Web.pdf).

²³ See Working Paper A/CN.9/WG.I/WP.85, para. 50.

²⁴ Toolkit (2013), *supra* note 22, p. 18. See also, Proposal for a Directive of the European Parliament and of the Council on single-member private limited liability companies, European Commission, Brussels, 9.4.2014 (COM (2014) 212 final).

²⁵ Further, both the MLSBE and the MASC provide for the creation of flexible legal entities, although the former is limited to single-members.

²⁶ IECL, *supra* note 10, pp. 2 and 13. Despite differences in their particular legal regime from State to State, in addition to being prohibited from being publicly traded, privately held businesses tend to have specific relief from the rules governing publicly traded companies such as: simpler formation rules; nominal or no minimum capital requirement; greater freedom of contract; and fewer disclosure requirements.

family firms; joint ventures; and professional service firms.²⁷ This flexibility is achieved in part by allowing the founders of the enterprise to agree through contractual mechanisms (like joint venture or shareholder agreements) on the internal governance of the enterprise, to contract around the more superfluous and cumbersome protective requirements traditionally associated with publicly traded companies, and to tailor rights and duties that are more consistent with the needs of closely held businesses. Of course, most simplified business entity legislation also includes certain mandatory rules that cannot be contracted out of by agreement among the members.²⁸

23. The Working Group agreed in principle that freedom of contract should be a guiding principle in establishing the internal organization of a company, although it was observed that very unsophisticated micro- and small businesses could find it difficult to establish such rules. To that end, the Working Group agreed that standard forms could be useful to assist such businesses.²⁹ Standard forms to assist micro- and small businesses in this regard could be prepared once the Working Group has agreed on its approach and a text has taken shape.

24. Both the MLSBE and the MASC embrace broad flexibility and freedom of contract, as well as providing default provisions to fill gaps that may exist in the rules established by the members of the enterprise. As observed in A/CN.9/WG.I/WP.82, such default rules may be particularly important for smaller or less sophisticated business persons.³⁰

V. Framework for issues to be considered

25. As indicated earlier, this section of the paper will examine various matters that the Working Group may wish to consider in its deliberations on the issues surrounding the simplification of the legal structure for MSMEs, based upon a framework drawn from various examples of existing legislation on privately held entities. This framework is not intended to be exhaustive nor inflexible, but rather as a starting point for discussion. The Working Group is, of course, invited to address any additional or alternative issues that are considered relevant.

A. General provisions

Definitions and the nature of the entity

26. At the outset, a legal text in respect of simplified business entities could be expected to deal with a number of introductory matters. If the text is to be a model law, this is the portion of the text in which necessary definitions of key terms could be inserted. It is also the section of the text in which the nature of the business entity would be stated (for example, a limited liability company, a single-member business entity, or a simplified stock corporation)³¹ as well as how the nature of the

²⁷ See Working Paper A/CN.9/WG.I/WP.82, paras. 8-11.

²⁸ See Working Paper A/CN.9/WG.I/WP.82, pp. 10-11.

²⁹ Report of Working Group I, A/CN.9/800, para. 63.

³⁰ See Working Paper, A/CN.9/WG.I/WP.82, para. 9.

³¹ See, for example, MLSBE, article 1 and MASC, section 1.

entity should be reflected in its name in order to alert third parties of its nature (for example, by including the full phrases listed in the previous set of parentheses, or by including abbreviations such as LLC, SBE or SAS, respectively).³²

Purpose clause

27. In addition, the general provisions of the text would most likely include reference to the purpose of the business entity. As noted in Working Paper A/CN.9/WG.I/WP.85, some States require business entities to list the specific activities in which the business will engage in their formation document (the document or electronic record that is established by the member on formation of the entity) or operating document (the document or electronic record that governs the affairs of the business entity and would include articles of association, by-laws and similar documents). The goal of such a requirement is said to be to restrain firms from acting beyond their scope in order to protect the interests of members and creditors of the business entity.³³ However, the modern trend in respect of general objectives clauses is to allow business entities to engage in all lawful activities under the law of the relevant State and to leave it open to the members of the entity to decide whether or not they wish to include a more restrictive purpose clause in the operating or formation document.³⁴ Where a business has a general objectives clause, managers have a higher degree of discretionary authority to run the business entity and it is not necessary to amend a business entity's operating document or formation document each time that the enterprise wishes to take advantage of a new business opportunity or to reorient its operations. In fact, the adoption of a legal regime supporting general objectives clauses for business entities is seen as a desirable feature that should be achieved through legal reform and that is necessary to underpin the adoption of best practices in business registration.³⁵

28. Both the MLSBE (article 1) and the MASC (section 1) adopt a general objectives clause as the default approach.

Legal personality and limited liability

29. The introductory section of a legal text in respect of simplified business entities could also be expected to include provisions stating that the entity has the fundamental characteristics of legal personality and a liability shield for its members so that they are not personally liable as a result of activities of the business entity in the ordinary course of business.³⁶

³² See, for example, MLSBE, article 4 and MASC, section 5(2).

³³ See Working Paper A/CN.9/WG.I/WP.85, para. 51.

³⁴ See, for example, MLSBE, article 1 and MASC, sections 1 and 5(5).

³⁵ Toolkit (2013), supra note 22, pp. 17-19, Global Analysis (2012), supra note 22, and Working Paper A/CN.9/WG.I/WP.85, para 51.

³⁶ See, for example, MLSBE, articles 2 and 3 and MASC, sections 2 and 3.

Minimum capital requirement

30. As previously noted in documents considered by the Working Group,³⁷ the modern trend in simplified business forms is that they do not typically include a minimum capital requirement, or that they may require only a nominal amount, thus reducing the initial financial burden on smaller entrepreneurs wishing to formalize their businesses.³⁸ Since the minimum capital required to formalize is often one of the most expensive considerations for new businesses, it is said that a reduction in that amount, or its elimination, could be expected to increase the rate of formalization of business entities.³⁹ Neither the MLSBE nor the MASC requires the contribution of a minimum capital amount by its members prior to formation.

31. The Working Group may wish to note studies prepared by the World Bank Group list the reduction or elimination of the minimum capital requirement as one of the good practices for starting a business⁴⁰ and as one of the key legal reforms underpinning best practices in business registration.⁴¹ In addition, information collected notes while almost 50 economies have abolished or reduced their minimum capital requirements since 2000, many still require entrepreneurs to deposit a certain amount of capital before starting business registration formalities. Noting that the minimum capital requirement has its origins in the 18th century, and was initially intended to protect investors and creditors, it is further observed that in many instances, the deposited capital is often withdrawn immediately after registration and thus of limited value in insolvency. It has also been observed that recovery rates in bankruptcy are no higher in economies with minimum capital requirements than in those that do not have them,⁴² and suggested that such requirements can have counterproductive effects on entrepreneurship.⁴³

³⁷ See Working Paper A/CN.9/WG.I/WP.82, para. 17.

³⁸ Although the Working Group agreed broadly that the modern trend was to move away from minimum capital requirements, some States were of the view that a minimum or a low but progressively increasing capital requirement was a reasonable quid pro quo for a business entity to receive the benefit of limited liability. It was also observed in the Working Group that in the case of MSMEs, a minimum capital requirement could have serious negative effects on the ability of such businesses to enter the formal market, and that even a low initial capital requirement that increased progressively could present a difficult hurdle for MSMEs for which the first few years of operation were most critical. See Report of Working Group I, A/CN.9/800, paras. 29 and 51 to 59; Working Paper A/CN.9/WG.I/WP.85, paras. 26 to 29; and Working Paper A/CN.9/WG.I/WP.86/Add.1, paras. 10-12.

³⁹ Toolkit (2013), *supra* note 22, p. 18.

⁴⁰ www.doingbusiness.org/data/exploretopics/starting-a-business/good-practices#1. Note that the other good practices for starting a business identified by the World Bank Group on the Doing Business website are considered in Working Paper A/CN.9/WG.I/WP.85 in paras. 37-41, 31-35 and 42-46, respectively: creating a single interface; introducing a unique company identifier; and using information and communication technology. See also Toolkit (2013), *supra* note 22, p. 18.

⁴¹ Toolkit (2013), *ibid.*, p. 18.

⁴² Djankov, Simeon, Rafael La Porta, Florencio López-de-Silanes and Andrei Shleifer. 2002. "The Regulation of Entry", *Quarterly Journal of Economics* 117 (1): 1-37.

⁴³ Van Stel, Andre, David Storey and Roy Thurik. 2007. "The Effect of Business Regulations on Nascent and Young Business Entrepreneurship", *Small Business Economics* 28 (2-3): 171-86. www.doingbusiness.org/data/exploretopics/starting-a-business/good-practices#1.

Other ways to protect creditors and third parties

32. The Working Group also considered at its previous session⁴⁴ means alternative to minimum capital requirements through which creditors and third parties dealing with the business entity could be protected. These techniques, several of which are included in existing simplified legal regimes for closely held businesses, include providing for:

(a) The liability of members of the business entity for improper distributions and the obligation to repay the entity for any improper distributions;⁴⁵

(b) Standards of conduct including good faith and fiduciary responsibilities;⁴⁶

(c) Limited liability to be lifted in certain circumstances (“piercing the corporate veil”);⁴⁷

(d) Transparency in accounting⁴⁸ and auditing of financial statements;

(e) The establishment of credit bureaus;

(f) A supervisory role to be established for commercial registries or specialized agencies; and

(g) Corporate governance oversight.

Name reservation

33. Some States require entrepreneurs to reserve a name for the business entity they are forming prior to its formation. In such circumstances, it would be appropriate to include reference to that requirement in the introductory section of the legal text.

B. Formation of the business entity**Number of members**

34. The next broad group of issues that a legal text in respect of simplified business entities could include would relate to the formation of the business entity. An initial matter likely to be considered would be the number of members required for formation of the entity. Although historically the minimum number of members required for the formation of a closely held business entity has been the subject of some debate,⁴⁹ the more recent trend in most legal systems is to permit the formation of a single member enterprise with limited liability.⁵⁰ Another issue that

⁴⁴ See Report of Working Group I, A/CN.9/800, paras. 52, 55-57, 59.

⁴⁵ Such a provision may be found in article 8 of the MLSBE.

⁴⁶ See also Working Paper A/CN.9/WG.I/WP.82, paras. 24 to 25, and an example of such a provision in article 42 of the MASC.

⁴⁷ See, for example, section 41 of the MASC.

⁴⁸ See, for example, article 16 of the MLSBE and section 37 of the MASC.

⁴⁹ IECL, *supra* note 10, pp. 25-29.

⁵⁰ See, for example, the membership requirements of the business entities compared in Working Paper A/CN.9/WG.I/WP.82, pp. 7-9, as well as MLSBE article 5 and MASC section 5. See, also, Directive 2009/102/EC of the European Parliament and of the Council of 16 September 2009, in

could be considered in this section would be whether a rule on the maximum number of members permitted to form a simplified business entity should be imposed, but that could be a matter best considered on a State-by-State basis as part of a State's MSME policy framework.

Business registration

35. Registration of the business entity would also be included in a discussion on formation. As noted in other documents before the Working Group,⁵¹ establishing a declaratory system for business registration is also seen as one of the important legal reforms necessary to establish best practices in business registration, in order to increase efficiency and to reduce the potential for corruption in the system.⁵² Both the MLSBE (article 5) and the MASC (section 5) contemplate declaratory systems for the registration and formation of the respective business entities.

36. Taking into consideration issues discussed in more detail in A/CN.9/WG.I/WP.85, the optimal means of registration would be exclusively electronic, so as to reduce the cost and time of registering the entity and to provide more efficient means of information-sharing. Although many business registration systems aspire to a completely electronic standard, it is likely that any legal text would need to accommodate both paper-based and electronic means of registration.⁵³ The Working Group may also wish to note that electronic filing of business entities would permit them to be created without the intervention of intermediaries, and that there has been concern that this possibility could create a means for the abuse of such entities. As previously discussed in the Working Group,⁵⁴ potential solutions for this problem could include the broad sharing of information provided upon the registration of an entity (within the parameters of applicable confidentiality and data protection laws) on both a domestic and international level, as well as adherence to international standards created for the purpose of combating money-laundering, terrorist financing and other related threats.⁵⁵

Information required in the formation document

37. Other matters to be considered in a discussion of formation of the business entity would be the information that is required to be submitted to authorities for valid formation of the entity (for example, the name of the entity and members and board members, the mailing address and domicile of the entity and any dissolution date). Additional optional information could also be included in the formation document submitted by founding members (such as any specific provision for management or conduct of affairs of the entity or any provision in respect of authority to represent the business entity and to legally bind it). In order to achieve

the area of company law on single-member private limited liability companies (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:258:0020:0025:EN:PDF>).

⁵¹ See Working Paper A/CN.9/WG.I/WP.85, para. 54 and Toolkit (2013), supra note 22, pp. 18-19.

⁵² Toolkit (2013), supra note 22, pp. 18-19.

⁵³ Both the MLSBE (article 6) and the MASC (section 5) accommodate both paper-based and fully electronic registration systems.

⁵⁴ See Report of Working Group I, A/CN.9/800, paras. 27 and 41.

⁵⁵ For a more detailed discussion of the potential for misuse of simplified business forms, see Working Paper A/CN.9/WG.I/WP.82, paras. 26-32.

additional flexibility, a legal text could also permit the formation document to create a business entity at a future date, perhaps stating a finite period of time within which the creation of a prospective entity formation would be allowed.⁵⁶ The requirements for amendment of the formation document should also be set out in the section relating to formation of the entity.⁵⁷ In States where a certificate of existence or authorization must be issued for legal formation of the business entity, a provision in this regard could be inserted in this section of the legal text.⁵⁸

C. Relations of members to each other and to the business entity

38. The next main topic that might logically be considered in a legal text in respect of simplified business entities for MSMEs would be the issue of internal governance, i.e. the rules governing relations between members of the business entity and establishing the management of the business entity.

Contributions and liability to make contributions

39. The first issue to be dealt with in this section could be how to become a member of the business entity. This process is usually begun by making the contribution agreed by the prospective member to the business entity, who then becomes a member of the business entity upon its formation. The Working Group may wish to consider what type of contributions to the entity should be permitted; usually, contributions can consist of tangible or intangible property or other benefits provided to the business entity, and may include future services. Each member of a business entity has an obligation to make the contribution promised to the capital of the entity and the member's liability to do so is not excused by death, disability or inability to perform. Rules on contribution are found in article 7 of the MLSBE and section 9 and 10 of the MASC deal with capital subscription and payment.

Distributions to members and liability for improper distributions

40. A related matter for consideration in terms of internal governance is the establishment of rules in respect of distributions to members. Rather than establishing provisions for the allocation of profits and losses among members of the business entity, this issue can be managed by establishing rules for the entitlement of members to distributions. Restrictions are usually placed on distributions to members of the business entity in order to ensure that the entity can continue to operate, such that no distribution may be made unless it passes the insolvency test (i.e. that the entity can continue to pay its debts after the distribution) or the balance sheet test (in respect of which the entity's total assets must exceed its total liabilities after the distribution). Members receiving a distribution in violation of these rules would normally be held liable to the business entity for the amount of the improper distribution if the member had actual or constructive knowledge that the distribution was in violation of the rules. Rules on

⁵⁶ See, for example, article 5 of the MLSBE. Provision for the future formation of the simplified stock corporation does not currently appear in the MASC, but could easily be added.

⁵⁷ See, for example, MLSBE, article 6 and MASC, section 5.

⁵⁸ See, for example, MASC, section 8.

distribution and liability for improper distribution appear in articles 8 and 9 of the MLSBE.

Shares, voting rights, rights to information, shareholder agreements and meetings, notice and quorums

41. Rules regulating the shares of the business entity or setting out specific rules governing the relations between the members of the business entity (if there is more than one member) would most likely be agreed by members in the operating document. However, it would also be possible to establish gap-filling rules on certain issues in the legal text in the event that the members fail to address them in the operating document. Such rules could include provisions on classes of shares, voting rights, rights to information, shareholder meetings and notice thereof, quorums and majorities, and shareholder agreements.⁵⁹

Management of the business entity and appointment, removal and resignation of managers

42. The Working Group may also wish to consider establishing gap-filling provisions pertaining to the management of the business entity, in the event that members do not address these issues in the operating document. While privately held business entities, and MSMEs in particular, may be more likely to be member-managed than manager-managed, for maximum flexibility, it may be prudent to include rules such as those governing how managers are appointed and removed or resign, the scope of their authority and their standard of conduct in managing the business entity.⁶⁰ Examples of how these issues are dealt with may be found in article 10 of the MLSBE and sections 17, 25 and 27 of the MASC.

Protection of minority members

43. In addition, rules governing conflict between members and remedies for abuse of minority members of a business entity could be addressed either here or in a separate section of the text. As noted in documents previously before the Working Group,⁶¹ protection of the minority members of a business entity may be accomplished through the share structure of the business by establishing different classes of shares with identical voting rights that may vote separately as classes for the election of specified numbers of board members, or through cumulative voting, where the minority may cast all of its board of director votes for a single candidate. However, it may be preferable to deter opportunistic behaviour by the majority

⁵⁹ See, for example, sections 10, 11, 17-22 and 24 of the MASC. Note that the single-member of the MLSBE holds 100 per cent of the ownership of the business entity, and specific rules in respect of shares are unnecessary in that model.

⁶⁰ The Working Group may wish to note that Working Paper A/CN.9/WG.I/WP.82 contains a comparison of fiduciary duty provisions in the simplified legal regimes analyzed therein (tables on p. 12, paras. 24-25). It should also be noted that a provision on abuse of rights as among members of the business entity may be included in a legal regime as found, for example, in section 42 of the MASC.

⁶¹ See Working Paper A/CN.9/WG.I/WP.82, para. 23.

through the establishment of fiduciary duties, such as the abuse of rights provisions found in section 42 of the MASC.⁶²

Conflict resolution

44. Finally, the matter of conflict resolution between members of a business entity may be considered in this section or, again, as a separate topic. As previously noted in documents before the Working Group,⁶³ conflict resolution among members of a business entity may be dealt with in several different ways. Such mechanisms could include the ability to take a derivative suit, which would permit one or more members to initiate a derivative suit in the name of the business entity and for the benefit of the entity as a whole, or through the establishment of voluntary or involuntary dissociation or exit rules for members.⁶⁴ One final matter that the Working Group may wish to consider in this regard is the possible creation of specialized business courts and procedures for dealing with conflicts arising as a consequence of the establishment of the simplified business entity in order to provide MSMEs with less expensive, faster and more highly-specialized adjudication of issues.⁶⁵

D. Relations of members and managers to persons dealing with the business entity

45. The next set of issues that the Working Group may wish to consider is the matter of the relationship of members and managers to persons dealing with the business entity, in effect, the external organization of the business entity. Provisions should be included in a legal text on simplified business entities that clarify who has the power to bind and to represent the business entity, and what actions may be taken by the member or manager (for example, actions in the ordinary course of business), as well as establishing liability for members and managers that exceed their authority. Examples of such provisions may be found in article 11 of the MLSBE and sections 26, 27 and 41 (piercing the corporate veil) of the MASC.

E. Transferable interests

46. The issue of the transferability of interests in the business entity is of great importance in the context of closely held entities. It may be recalled that previous materials before the Working Group⁶⁶ analysed the transferability of interests in the business entity as one of the points of comparison in its survey of various simplified business entities. Generally speaking, the transferability of interests in a simplified

⁶² See also note 60 above. The issue of conflict between members is not relevant to the MLSBE due to its single-member nature.

⁶³ See Working Paper A/CN.9/WG.I/WP.82, paras. 33 to 40.

⁶⁴ See, for example, section 38 of the MASC. Such rules are not necessary in the case of the single-member business entity context as illustrated by the MLSBE.

⁶⁵ See, for example, section 39 of the MASC, which provides for conflict resolution by way of arbitration, or any other alternative dispute resolution, or by specialized judicial or quasi-judicial tribunals, as well as the discussion in Working Paper A/CN.9/WG.I/WP.82, paras. 38-40 and in the Report of Working Group I, A/CN.9/800, paras. 60-61.

⁶⁶ See Working Paper A/CN.9/WG.I/WP.82, pp. 10-11.

business entity is subject to freedom of contract, and members can agree in the operating document on any restrictions on transfer that they deem necessary or desirable. Such limitations could include a requirement that transferable interests not be transferred for a certain specified time or to certain transferees, or that the transfer of certain interests, such as governance rights, be restricted. Again, gap-filling provisions on the transferability of interests in the business entity could be provided in a legal text for situations in which the members fail to address the issue in the operating document.⁶⁷

F. Restructuring

47. The members of a simplified business entity may wish to convert it into another business form permitted under the applicable laws of its jurisdiction, and consideration should be given to this possibility. Restructuring of the business entity should be achieved in the same way as its original formation, i.e. through the will of its members.⁶⁸ In such circumstances, the operating document of the business entity should be amended in the appropriate manner to reflect the desired change. The Working Group may also wish to consider whether to include provisions on mergers and on any restrictions on such conversions or mergers that ought to be included in a legal text, for example, in situations where a member of the business entity does not give the necessary approval for the conversion or merger.⁶⁹

G. Dissolution and winding up

48. Any legal text in respect of simplified business entities for MSMEs must also take into account the end of the life cycle of the business entity. To that end, the Working Group may wish to consider events that should appropriately result in the dissolution and winding up of the business entity. Given the freedom of contract of founding members of the entity, events of dissolution could be identified in the formation document, the operating document or by decision of the members of the entity. Other events of dissolution could arise as a result of compulsory liquidation proceedings or by way of a decision rendered by a competent public authority. Provisions in respect of dissolution and winding up are found in articles 14 and 15 of the MLSBE and sections 34 to 36 MASC.

H. Miscellaneous

Financial statements, governing law and any additional matters

49. The final category which the Working Group may wish to consider in the context of issues that should be addressed in the context of simplified business entities is a catch-all category for additional issues. The MLSBE and the MASC

⁶⁷ See, for example, sections 12 to 15 of the MASC.

⁶⁸ See, for example, MLSBE, articles 12 and 13 and MASC, sections 29 and 31.

⁶⁹ See, for example, MASC, sections 30 and 33.

include in such a section provisions on financial statements and governing law,⁷⁰ but of course, many other issues could be considered for inclusion in this category.

VI. Issues for possible discussion

50. The Working Group may wish to consider the following non-exhaustive list of issues in its discussion:

(a) Is the Working Group of the view that the possible way forward suggested above in paragraphs 5 to 7 would be appropriate?

(i) If not, what alternative approach should be taken to fulfilling the mandate of the Working Group?

(ii) If so, would the approach taken by the draft MLSBE be an appropriate starting point for discussion?

(iii) If the draft MLSBE would not be an appropriate starting point for discussion, is there another text (such as the MASC contained in the annex to A/CN.9/WG.I/WP.83 or one of the approaches set out in A/CN.9/WG.I/WP.87) in respect of which the Working Group would prefer to initiate its discussion?

(b) What additional issues to those set out in the framework in section V above should be considered by the Working Group in fulfilling its mandate?

(c) Following the exploration of the issues above and its previous discussion,⁷¹ is the Working Group in a position to decide on what form its work on simplified business incorporation should take, i.e. a model law with or without a guide to enactment, a legislative guide, or some other text?

⁷⁰ See, for example, MLSBE, articles 16 and 17 and MASC, sections 37 and 43.

⁷¹ See the Report of Working Group I, A/CN.9/800, paras. 34 to 38.