Corporate Law

An introduction to corporate governance under a legal point of view.

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Today's agenda

- Introduction
- Legal Corporation
  - Assessment of key features
- Sources of Corporate Law
- Law vs Contracts
- Mandatory laws vs Default provisions
- Legal Rules vs contracts
- The Goal of Corporate Law
- Patterns of corporate ownership
- Cross jurisdictional coordination

Introduction

- Corporate Law aims at enabling entrepreneurs to transact easily though the medium of the corporate entity, lowering the cost of conducting business.
- Corporate Law facilitates coordination between participants in corporate enterprises.
- Corporate Law reduces the scope for value-reducing form of opportunism among different constituencies.

Introduction

The sources of opportunism may be characterized as what economists call agency problems. They are:

- Conflicts between managers and shareholders;
- Conflicts among shareholders, eg minority vs majority shareholders;
- Conflicts between shareholders and the corporation's other constituencies, eg creditors.

Introduction

- There are two different approach to analyze corporate law:
  - Emphasizing the differences among European, American and Japanese corporation in corporate governance;
  - Identifying a “corporate form”, underlying the similarities of legal characteristics of corporations in all jurisdictions.
- Our analysis pertains to the second strand, trying to depict the key features of a legal corporation (shared by all jurisdictions, at least in part).

Legal Corporations

Legal Corporations are characterized by the following five core elements:

- Legal Personality
- Limited Liability
- Transferable Shares
- Delegated management
- Investor ownership

Legal Corporations

Legal personality

Most of the important relationships within a firm are essentially based on consent.

Law

Nexus of Contracts

Nexus for Contracts

The firm serves as the common counterparty in numerous contracts with suppliers, employees, and customers, coordinating the actions of these multiple parties through the exercise of its contractual rights.

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Legal Corporations

- In this sense the **first** and **most** important contribution of corporate law is to provide firm with a legal personality.
- Doing this, the firm can serve as a single counterparty party.
- The firms is thus distinct from the various individuals who own or manage it.

Legal Corporations

- The core elements for the firm as a “nexus for contracts” is what the civil law calls “separate patrimony”. Such patrimony:
  - Is composed of a pool of assets independent from the ones owned, singly or jointly, by the firm’s owners.
  - Is managed by the firm itself, through its designated managers.
  - Legally is owned by the firm.

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- Since the separate patrimony pertains to the firm, it has:
  - The rights to use these assets;
  - The rights to sell them;
  - The rights to make them available for attachment by the firm's creditors.
- On the other hand, shareholders' personal creditors can't attach the patrimony to satisfy their credits.
- The core function of this separate patrimony has been termed "entity shielding".

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- Entity shielding involves two different rules of law:

  1. **Priority rule**: it grants the creditor of the firm, a security for the firm's debts, a claim on the firm's assets that is prior to the claims of the personal creditors of the firm's owners. Firm's assets are made available for the enforcement of contractual liabilities entered into in the name of the firm.

  2. **Liquidation protection**: shareholders cannot withdraw their share of firm assets at will, thus forcing partial or complete liquidation of the firm.

Legal Corporations

- The presence/absence of such rules determines:
  - Strong form entity shielding: when legal entities are characterized by both priority rule and liquidation rule.
  - Weak form entity shielding: for legal entities characterized by only the priority rule.
- The presence of separate patrimony and entity shielding are <u>necessary but insufficient</u> conditions for a firm to effectively serve as contracting party. Two more rules are needed…

Legal Corporations

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- Firstly, rules specifying to third parties the individuals who have the authority to operate in the name of the firm, an enter into contracts that are bonded by those assets.
- Secondly, there must be rules that specify the procedures by which both the firm and its counterparties can bring lawsuits on the contracts entered into the name of the firm

Legal Corporations

Limited liability

- The corporate form effectively imposes a default term in contracts between a firm and its creditors.
- Creditors are limited to making claims against assets that are owned by the firm itself.
- Creditors have no claim against assets that the firm's shareholders hold in their own names.
- Limited liability is a strong form of **owner shielding**.

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Legal Corporations

Entity shielding and limited liability

- While entity shielding protects the firm's assets from the shareholders' creditors…
- Limited liability protects the assets of the firm's owners from the claim of the firm's creditors.
- Entity and owner shielding set up a regime of asset partitioning: business assets serve guarantee business creditors, while personal assets of the business's owners are reserved for the owner's personal creditors.

Legal Corporations

- Asset partitioning permits to isolate different lines of business for the purpose of obtaining credit.
- Assets associated with each line of business can conveniently be pledged as security just to the creditors who deal with that line.
- Creditors are more likely to monitor “their” line of business than the entire firm or other lines.

Legal Corporations

Transferable shares

- Transferable shares in ownership is another distinguishing feature of legal corporations.
- Transferability permit the firm to conduct business uninterruptedly as the identity of its owners changes.
- In this way, it avoids the complications of number of withdrawal that are common among cooperatives and mutual.

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- Notwithstanding, fully transferable shares do not necessarily mean freely tradable shares.
- For example, even if transferable, shares may not be traded without restrictions on the stock market.
- Rather, share may be transferable among limited groups of individuals, or with the approval of current shareholders. However, free tradability:
  - Maximize the liquidity of shareholdings.
  - Give the firm maximal flexibility in raising capital.

Legal Corporations

With respect to the tradability of its shares we have:

- Private/close firms - limited tradable shares.
- Public/open - freely tradable shares

Moreover we can divide firms into:

- Listed, if shares are traded on the stock market;
- Unlisted.

Finally, firms can be classified into “closely held”, as opposed to “widely held”.

Legal Corporations

Delegated Management

- Standard legal forms for business organizations differ in their allocation of control rights, including:
  - The authority to bind the firms to contracts;
  - The authority to exercise the powers granted to the firm by its contracts;
  - The authority to direct the uses made of the firm's assets.
- Standard legal corporate form delegates principal authorities over corporate affairs to a board of directors (or to a similar committee organ) that is periodically elected by firm's shareholders.

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- The board is **separate** from the operational managers of the corporation.
- The nature of this separation varies according to whether the board has one or two tiers.
  - Two-tier boards: top corporate officers occupy the board's second (managing) tier, but are generally absent from the first (supervisory) tier;
  - Single-tier boards: hired officers may be members of, and even dominate, the board itself.

Legal Corporations

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- The legal distinction between directors and officers divides all corporate decisions (that do not require shareholders approval) into those requiring approval by the board of directors and those that can be made by the firm's officers on their own authority.
- Initiation and execution of business decisions are reserved to the officers, while monitoring and ratification of decisions are reserved to the directors.
- That separation serves as a useful check on the quality of decision-making by hired officers.

Legal Corporation

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- The board is elected by the firm's shareholders.
- The election assure that the board remains responsive to the interest of the firm's owners, who bear the costs and benefits of the firm's decisions.
- Election of the board distinguishes the corporate form from other legal forms, such as the non-profit corporations or business trusts.
- Such entities permit or require a board structure, but do not require election by the firm's owners.

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- The board is distinct from the firm's shareholders, though largely or entirely chosen by them.
- This separation economizes on the cost of decision-making by avoiding the need to:
  - Inform shareholders;
  - Obtain their consent for all but most fundamental decisions regarding the firm.
- It serves also as protection mechanism for minority shareholders.

Legal Corporation

- The board has ordinarily **multiple members**.
- It facilitates mutual monitoring and checks idiosyncratic decision-making.
- Many corporation statues, however, permit to waive the collective board in favour of a single general director or a one-person board. This frequently happens in small corporations where most of the board's legal functions can be discharged effectively by a single elected director who also serves as the firm's principal manager.

Legal Corporations

Investor ownership

- Two key elements are connected to the firm's ownership:
  - The right to control the firm, which generally involves voting in the election of directors and voting to approve major transactions;
  - The right to receive the firm's net earnings.
- In business corporations both elements are tied to the capital: the right to participate in control and the right to receive the firm's residual earnings, as a default rule, are proportional to the amount of capital invested in the firm.

Legal Corporations

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- An investor-owned company reflects several efficiency advantages:
  - Among the various participants in the firm, investors are often the most difficult to protect simply by contractual means;
  - Investors of capital have homogeneous interests among themselves, hence reducing the potential for costly conflict among those who share governance of the firm.

Sources of Corporate Law

- All jurisdictions with a well developed market have at least one core statute establishing a basic corporate form with the 5 characteristics aforementioned.
- Notwithstanding, corporate law generally extends beyond the bounds of this core statute:
  - Special and partial corporate forms;
  - Other bodies of law.

Sources of Corporate Law

- Special corporate forms: major jurisdictions commonly have at least one distinct statutory form specialized for closed corporations (the French SARL, the Italian SRL, the German GmbH, the UK private company, the US close corporation and limited liability company…).
- They differ from open companies because:
  - Their shares, though transferable in principle, are presumed not to be freely tradable in a public market.

…

Sources of Corporate Law

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- Moreover, they differ from open companies because:
  - Sometimes their statutes permit the elimination of the board of directors in favor of direct management by shareholders;
  - Commonly, their statutes permit and facilitate special allocation of control, earnings rights, and rights to employment among shareholders.

Sources of Corporate Law

- Partial corporate forms: some jurisdictions have quasi-corporate statutory forms that can be used to form business corporations with the five core characteristics set above, though some of them must be added by contract.
  - Ex 1: US limited liability partnership – this form reflects the characteristics of the limited liability company onto the traditional partnership. It allows the partnership to have a kind of entity shielding.
  - Ex 2: US statutory business trust – it provides for strong form legal personality and limited liability, but leaves all elements of internal organization to be specified in the organization's charter.

Sources of Corporate Law

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Other bodies of Law

- There are other bodies of law that, even if separate from core corporation statutes, are to be considered functionally as part of corporate law.
- Indeed, they have important effects on corporate structure and conduct.
- These other bodies of law are:

  Law of groups; Security Laws; Bankruptcy Laws

Sources of Corporate Law

- Law of groups: emblematic is the German law of groups, which limits the discretion of directors in corporations that are closely related through cross ownership, in order to protect creditors and minority shareholders of controlled companies.

- Securities laws: they have strong effects on corporate governance through rules demanding disclosures and regulating sale and resale of corporate securities, mergers and acquisitions, and corporate elections.

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Sources of Corporate Law

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- Bankruptcy laws: they affect both the extent to which creditors may need generalized protections in corporate laws and the internal governance of corporation.

Law vs Contracts in corporate affairs

- The relationships among the participants in a corporation are, to an important degree, contractual.
- The principal contract is represented by the “corporation charter” (or “articles of association” or “constitution”).
- The charter sets out the basic terms of relationship among the firm’s shareholders and between them and the firm’s directors and managers.
- The charter can also affects the contents of the contracts between the firm and its employees or creditors.

Law vs Contracts in corporate affairs

- Some or all of a firm's shareholders may, in addition, be bound by one or more shareholders' agreements.
- They regulate the internal relationships amongst the firm's owners.
- Since corporations are subject to a large body of laws and since the defining elements of the corporate form (with the exception of legal personality) could in theory be established simply by contract, the question is "What role do these laws play?"

Law vs Contracts in corporate affairs

- If these rules of law did not exist, the relationships they establish could still be determined by means of contract, just by placing similar provisions in the organization’s charter.
- So, why do we have, in every advanced jurisdiction, elaborate statutes providing numerous detailed rules for the internal governance of corporations?

Mandatory laws vs default provisions

In order to answer the aforementioned question it is necessary to distinguish between:

- legal provision: merely defaults rules, as they govern only if the parties do not explicitly provide for something different;
- mandatory laws: they can't be waived by the parties that have no option and can only conform to them.

A significant part of corporate law consists of default provisions.

Mandatory laws vs default provisions

Corporate law simply offers a standard form that the parties can adopt, at their discretion, in whole or in part.

Advantages of a legally provided standard form:

- It simplifies contracting among the parties involved;
- The parties specify only those elements that deviates from the standard terms.

Corporate law's provisions of such standard terms as default is seen in economic sense as a "public good".

Mandatory laws vs default provisions

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- Default provisions can also serve other functions such as encouraging the revelation of information.
- For example, a default provision may impose a sort of “penalty” to a contracting party when it is more informed that the other (or, as economist say, that party has “private information.
- The purpose is to encourage parties to reveal their private information thus leading to a outcome superior to that which would otherwise be expected.

Mandatory laws vs default provisions

Default provisions can be supplied in a variety of ways:

- A common form of default rule is a statutory provision that will apply unless the parties explicitly provide an alternative.
  - Example: the common US corporate statute requires that a merger is approved by a vote of 50% of all outstanding shares. That rule can be displaced by a charter provision that requires approval by 60% or 70%, or some other numbers.
- …

Mandatory laws vs default provisions

- …
- Sometimes corporate law itself specifies the rule that will govern if the default provision is not chosen (so called "either-or provisions"). The law in this case gives the corporation a choice between two statutory provisions, one of which is the default and the other is the "secondary" provision.
  - Example: the French corporate law allows companies' charters to opt for a two-tier board structure as an alternative to the default single-tier one.

Mandatory provisions

- Some important rules are mandatory. Their presence aims to discourage “contracting failures”:
  - That some parties might be exploited because of information asymmetries.
  - That the interest of third parties might be affected.
  - That collective action problems might otherwise lead to contractual provisions that are inefficient or unfair.

Mandatory provisions

- Mandatory rules may serve also a useful standardizing function, in circumstances where the benefits of compliance increase if everyone adheres to the same rules.
- When used in conjunction with a choice of corporate forms, mandatory provisions can facilitate the freedom of contracts helping corporate actors to signal the terms they offer.
- The law enable this by creating corporate forms that are to some degree inflexible, but then permitting a choice among different corporate forms.

Legal Rules vs Contracts

- Default rules serve another important function that cannot be reached by contract: they provide a means of accommodating, over time, developments that cannot easily be foreseen at the outset.

- A contract that must govern complex relationships over a long period of time is necessarily incomplete, since:
  - situations that were not foreseeable at the time the contract was drafted may arise;
  - situations, thought foreseeable, seemed too unlikely to justify the costs connected to the creation of specific provisions.

Legal Rules vs Contracts

- In this contest, corporation law plays a strategic role, since it serves a “gap-filling” function.
- It provides for such situations as they arise either by adding new rules or by interpreting existing rules.
- A firm will get the greatest advantage from the courts’ interpretative activity if the firm adopts standard charter terms used by many other firms.
- Thus, another advantage is to exploit the constant gap-filling activity of the courts.

Legal Rules vs Contracts

- The problem of contractual incompleteness goes beyond mere gap-filling.
- Corporations usually have a long-term life; the passage of time makes obsolete some of the charter's terms with. Default rules, instead, are altered over time to adapt them to the changes in the economic end legal environment.
- However, the quality and speed by which default rules are supplied, interpreted and updated will depend on a range of variables, such as the legislative system, the civil procedure and the judicial expertise.

The goal of the corporate law

Corporate law serves multiple functions:

- defines a corporate form;
- contains and regulates conflicts among firm's participants;
- pursues the aggregate welfare of all who are affected by a firm's activity, including firm's shareholders, employees, suppliers, customers, as well as third parties.

With reference to the last assumption some scholars and economists assert that the appropriate role of corporate law is simply to assure that the corporation serves the best interests of its shareholders.

The goal of the corporate law

Corporate law is influenced by a series of forces that can vary among different jurisdictions, shaping the features of corporate form.

These forces are mainly:

- Patterns of corporate ownership;
- Cross-jurisdictional coordination.

Patterns of corporate ownership

The number of corporate shareholders differ markedly even among the most developed market economies, having a strong impact on the structure of corporate law.

- Example: in the US and the UK there are a large numbers of public corporations that have dispersed share ownership, such that no single shareholder (or affiliated group of shareholders) can exercise control over the firm. Whereas, in the nations of continental Europe even public companies traditionally have a controlling shareholder.

Patterns of corporate ownership

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Also the nature of shareholders differ substantially from one country to another.

- Example: in the US the majority of stock is owned by institutional investors (mutual funds, pension funds and hedge funds). In Germany large commercial banks traditionally held substantial part of corporate stock.

↑ Protection mechanisms for non-controlling shareholders ↓

↓ Concentrated shareholding

Cross-jurisdictional coordination

Supranational efforts to coordinate the regulation of corporations across jurisdictions constitute another important factor in shaping corporate law.

Sometimes this coordination is undertaken on a global level (i.e. international efforts to develop common accounting standards);

More often it is undertaken within supranational entities, such as the European Union. These efforts generally take two different form: harmonization and regulatory competition.

Cross-jurisdictional coordination

- Harmonization: harmonization is sought through the imposition of uniform, or at least minimum, rules of corporate law upon all member states;
- Regulatory competition: it is the phenomenon by which states compete with one another providing laws that attract business and capitals into the respective jurisdiction.