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The Law of Corporate Finance in Europe – An Essay

Theodor Baums
Institute for Law and Finance

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Policy Platform ■ House of Finance ■ Goethe-Universität Frankfurt ■ Grüneburgplatz 1 ■ 60323 Frankfurt am Main
Telefon: +49(0)69 798-30050 ■ Fax: +49(0)69 798-30077 ■ www.hof.uni-frankfurt.de/policy_platform

INSTITUTE FOR LAW AND FINANCE

THEODOR BAUMS

THE LAW OF CORPORATE FINANCE IN EUROPE – AN ESSAY

INSTITUTE FOR LAW AND FINANCE
JOHANN WOLFGANG GOETHE-UNIVERSITÄT FRANKFURT

WORKING PAPER SERIES NO. 63

PROF. DR. THEODOR BAUMS
PROF. DR. ANDREAS CAHN

INSTITUTE FOR LAW AND FINANCE

JOHANN WOLFGANG GOETHE-UNIVERSITÄT

SENCKENBERGANLAGE 31

D-60054 FRANKFURT AM MAIN

TEL: +49 (0)69 / 798-28941

FAX: +49 (0)69 / 798-29018

(INTERNET: HTTP://WWW.ILF-FRANKFURT.DE)

Theodor Baums

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I.

Company law is traditionally understood in Europe as the law of associations, and this is how it is taught in our law schools. Companies, including those listed on stock exchanges, are associations of members. In some cases the relationship of the individual members to the undertaking can be close; for example, the members may manage the company. In other cases, the members might restrict themselves to the role of providers of equity capital. However, even in the latter case – which is typical of the relationship of small investors and institutional investors to a listed company – the shareholders are comparable to members of an association. Each member has the right to vote and influence the direction of the company, the management bodies have fiduciary duties towards the members, etc. This model, which considers even the shareholders of listed companies to be members of an association, has increasingly been called into question. This paradigm shift, which has also influenced the thinking of legal scholars in Continental Europe, was triggered by findings in financial economics, which considers shareholders to be parties to a particular type of financial contract with a particular set of rights. This theory sees a company as a nexus of contracts between individual investors and the company's management. The ideal point of reference for the shareholder is no longer that of a member of an association. Rather, as a mere provider of capital, the shareholder is the last link in a chain of relationships that runs from the providers of credit to the providers of equity capital. There are a number of hybrid forms – developed by modern financial practice – which lie between these two poles.

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What does this paradigm shift mean for legal theory and academic doctrine?

The rights and duties of shareholders must be reconstructed, must be understood and defined anew in the light of their function as financers of the undertaking. The shareholder's voting right does not serve to express the position of an individual member of an association. Shareholders only have voting rights because they have a residual claim rather than a fixed right to receive interest, as in the case of creditors. A creditor's rights to information and to influence the management serve to protect his claim to interest and payment of the principal. They are a result of the contractual provisions or the terms and conditions of loans negotiated between the parties, and are ancillary to the legal instruments through which such rights are enforced. Here, the claim for payment is primary. In contrast, the provider of equity capital receives from the outset open-ended rights to the 'residual' based on his investment. The rights to receive information and influence the direction of the company – including the right to sue the company directly or derivatively – are components of the complex mechanism which is summarised by the concept of 'corporate governance'. This mechanism is designed to ensure that the value of the undertaking and its distributable profits – i.e. its 'residual' – increase. Since shareholders have a right to the residual, they also generally have sufficient incentive to make use of their powers of influence to increase the value of the company. To sum up, both types of providers of capital have control and enforcement rights, each fitting the nature of their particular claims.

Other key concepts of our company law, such as fiduciary duties, must also be oriented towards this new perspective. Does management only have a fiduciary duty towards the providers of equity capital? Why don't they have a comparable duty towards providers of long-term loans or bond capital? And does the majority in a bondholders meeting also have a fiduciary duty towards the minority? If the recognised fiduciary duty which shareholders owe each other rests on the same principle, can minority shareholders really have a fiduciary duty? In other words, is there really a principal-agent relationship? Or should the assumption of such a fiduciary duty rather be understood as a way of addressing 'hold-up' problems, and

does this also apply to minority bondholders?

If, from this perspective, we turn to the legal concept of the corporation, in particular the law governing publicly listed companies, we no longer see an association of members composed of shareholders who have concomitant powers to govern the association. In this traditional model, providers of bond or loan capital are only taken into consideration in the context of all the association's creditors – who are protected by mandatory rules of law. In the new model, the company and its management bodies stand in relation to various groups of investors holding securities with differing characteristics, ranging from equity to bond and loan capital, and the rights and duties of these investors are best explained as a function of the characteristics of the instruments they hold. Classical company law is understood purely as a law of organised associations of providers of equity, with specific rules protecting creditors. In contrast, the law of corporate finance addresses all equity and debt instruments, their characteristics, their rights and duties, and their similarities and differences – including the possibility of exchanging one instrument for another or converting one instrument into another. From this point of view, surprising parallels become apparent. For example, identical collective action problems exist when bondholders as well as shareholders must approve a restructuring. Among other things, this requires a resolution to be approved by the majority of the shareholders, and a similar resolution to be approved by the bondholders. On the question of majority resolutions, we find ourselves right in the centre of a 'company law of bondholders'; here too there will be minority/majority conflicts, questions of voting rights, and judicial review of challenged resolutions, among other problems.

At this point, I would like to turn from these brief observations on shifts in our fundamental understanding of companies and their constituents to some of the newer developments in the law of corporate finance at the EU level.

II.

As is well known, the Second Company Law Directive cemented traditional capital

protection rules – a system in which both the establishment of minimum capital and rules for its maintenance are mandatory – in European law. This is not the right place to go into the pros and cons of this system. We all know, however, that this system hinders or even blocks a number of desirable capital market transactions. The legally required minimum capital bears no relationship whatsoever to the adequate capitalisation of a company. When making a distribution to shareholders, it is not asked whether, despite the distribution, the company will still be able to pay its current debts as they fall due; the question is whether the capital figure fixed at some point in the past and the required reserves are maintained. Under these rules it is difficult to issue and repurchase securities to take advantage of favourable market conditions. Among other things, the provision of 'financial assistance' by the company to shareholders is strictly limited.

In Directive 2006/68/EC, amending the Second Company Law Directive, the EU took a careful step towards deregulating the rigid requirements of the Second Directive. In future, under certain circumstances it will be possible to do without an expert valuation of contributions in kind, and the restrictions on the repurchase of shares and financial assistance to shareholders are to be relaxed.

In parallel with issuing this Directive, the European Commission requested a feasibility study to be prepared. This study should facilitate a decision on whether, in addition to the current system of capital protection, Member States can offer a system of capital protection based on the US model. The basic characteristics of such an alternative system could be:

- Solvency tests and over-indebtedness tests before making distributions; and
- The introduction of stricter duties and liability for board members in connection with distributions.

Another policy choice for the Commission would be to completely revoke the capital requirements of the Second Directive, and leave the protection of creditors essentially to the Member States. Should the EU really concern itself with

introducing pan-European, harmonised rules to establish equal protection for various kinds of company creditors, such as bondholders and banks, employees, trade suppliers, and tort victims? Are all these cross-border issues? Do the requirements of the Second Directive really protect creditors in a way that significantly exceeds the terms and conditions that creditors demand in contracts and bonds, and the accompanying protective legislation of individual Member States? Does standardisation offer any advantages in this area, as it does, for example, in the area of financial disclosure to investors?

It seems to me that we must really dedicate much more serious attention to the pros and cons of harmonising national company laws than has been seen to date.

III.

This brings us to my final point – the research agenda. This agenda flows naturally from the observations I have already made.

First, with regard to the regulation of company law at EU level – we have to engage in much more detailed analysis than we have in the past of the pros and cons of harmonisation and standardisation, compared with simply allowing competition between legal systems. What are the advantages of competition between legal systems, i.e. competition between the Member States to provide the most attractive set of rules? What advantages do we lose when we eliminate competition through harmonisation? In this debate, we should look at the US experience and the scholarly discussion surrounding it. Instead of issuing directives or regulations, we may want to consider developing non-binding model acts like the (now 'Revised') Model Business Corporation Act, which the individual Member States should be free to implement (with or without changes), but need not do so.

Second, and solely regarding Germany, which is the only country I feel qualified to comment on, the findings of financial economics should be integrated into our scholarly work much more than it has been. The matters on which we company

lawyers focus our attention are divided by economists roughly into the areas of corporate governance and corporate finance, naturally with a significant overlap. The analytical tools that we employ under the rubric of 'corporate governance', such as the principal-agent model, were developed to analyse the financial relationships between equity investors and management in order to structure them more efficiently. Likewise, the financial structure of a firm and the characteristics of financial instruments are significant for corporate governance.

I find most interesting – particularly for the law governing publicly listed companies – the paradigm shift implied by the uniform treatment, in modern financial economics, of all contributors of capital as contractual counterparties of the company. This point has already been made at the beginning of this essay. For shareholders, this means reconstructing their rights and duties; for the traditional understanding of company law as a law of associations of equity investors, this means an expansion into the law on financing individual firms and corporate groups. The similarities of the different groups of investors providing capital must be identified, and a company law for bondholders should be developed. It should be made possible to convert debt into equity instruments, and vice versa. Issuers and investors should be given the broadest possible freedom to structure the characteristics of their instruments, as necessary. If this were to be done, company law would not look the same, and the teaching of company law would legitimately include corporate finance together with the law of associations.

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