Foundations of Company Law

Companies and company law

Company law has as its object, as one might expect, the regulation of “companies”. Before delving into company law itself, it is thus natural to first ask the question, what is a company?

At its most basic level, a company is a means to facilitate cooperation and to pool assets, in particular money (capital) and skills (human resources). Cooperation and asset pooling can be done in different ways, however. Supply and demand can lead to cooperation and asset pooling on a free market via the price mechanism. Alternatively, cooperation and asset pooling can also be achieved by organized cooperation in a, more or less, integrated structure (i.e., the firm). Put in more legal terms, cooperation and asset pooling can be achieved either through the formation of a contract or the formation of a company.

What explains the choice between contract (price mechanism) and company (firm) as a means for cooperation and asset pooling? In his seminal work, *The Nature of the Firm*, economist Ronald Coase deals with this problem. He suggests transaction costs are the main reason why integrated cooperation via company may supplant the price mechanism.

Read: R.H. Coase, *The Nature of the Firm* (1937)

Do you understand the basic distinction between cooperation via the price mechanism and cooperation in a firm? Do you understand how this translates to contractual cooperation and cooperation through integration in a company?

Do you understand how transaction costs influence the choice between contractual cooperation and cooperation through integration in a company?

Do you understand how transaction costs to the growth of a company and the limits of growth? Do you understand how technological innovation influences these transaction costs?

Other elements may also influence the choice between contractual cooperation and cooperation via company law. Coase mentions fiscal policy. What other elements can you think of?

One way of envisioning company law (and contract law, for that matter) is to see it as attempt to limit transaction costs. In particular, company law offers a preset framework which regulates both the relationships between company insiders (e.g., management, shareholders) and company outsiders (e.g., creditors, clients, governments). Thus, company law regulates both the internal and the external position of the company.

INTERNAL	EXTERNAL
Shareholder rights and protection	Creditor protection
Fiduciary duties of the BoD	Representation of the company

Insofar company law regulates the internal organization of the company, this falls largely under the umbrella term “corporate governance”. As it is the subject of a different course, we will only discuss it incidentally. The main topic of the course will be the external position of the company vis-à-vis creditors and certain complex transactions that change the structure or ownership of the company as a whole.

Of course, company law does not exclusively regulate the internal and external position of the company. Other fields of law come into play as well, including contract law, extracontractual liability law (tort law), environmental law, employment law, securities law, insolvency law and strategic trade law.

Constitutive elements of the company and company law

Characteristics of the company and company law

<u>Introduction</u>

When investing in a company, or any business enterprise, there are basically five questions you could ask yourself[1]:

(1) How much can I expect to gain (return on investment)?
(2) How much can I lose (possible liability)?
(3) Who will manage my investment?
(4) How can I get out?
(5) How is the investment structured?

These five questions correspond to the core characteristics ("hallmark features") of companies as identified by John Armour and his co-authors in their work *The Anatomy of Corporate Law*: (1) residual shareholder ownership, (2) (limited) liability, (3) delegated management, (4) transferability of shares and (5) legal personality. The authors discuss how the way company law determines these core characteristics address three fundamental "agency problems". Attempts at solving these agency problems through rules addressing the five questions (core characteristics) set out above, are the core and *raison d'être* of company law.

Read: J. Armour et al., *The Anatomy of Corporate Law* (2017) – chapter 1

Do you understand the three fundamental agency problems discussed in the chapter? Do you understand how they connect to the notion of transaction costs as discussed in the paper by Coase?

Do you understand how company law seeks to address these agency problems and how this relates to the five core characteristics of the company?

[1] A.R. Palmiter, *Examples & Explanations for Corporations, Ninth Edition* (2021), 4-5.

Can you think of additional agency problems not discussed by Armour and his colleagues that nevertheless impact the functioning of the company?

Legal personality

The first core characteristic under discussion is that of "legal personhood". What does it mean for a company to be a separate legal person? In essence, it means that the company is recognized as existing independently from its economic owners (i.e., the shareholders). This has several consequences. First, it implies that the company is capable of acting on its own in the legal sphere, by acquiring assets, incurring debt and being a party in legal procedures. Second, it implies that – in principle – contracts can be conclude between company insiders (e.g., shareholders, managers) and the company itself. The notion that a company has its own, distinct, existence is the fundamental basis on which most of company law is based.

Read: *Salomon v. A. Salomon* (House of Lords, 1896)

Do you understand the facts of the case, the issue at hand and the holding of the Court?

In his opinion, Lord MacNaghten argues that "[t]he unsecured creditors of A. Salomon and Company, Limited, may be entitled to sympathy, but they have only themselves to blame for their misfortunes." Do you agree with this statement? Could you link this with the statement by Armour et al. that "almost all [fundamental characteristics of a company with the exception of legal personality] could in theory be crafted by contract […]"?

Can you link the previous statement by Lord MacNaghten to agency problems that remain undiscussed or are only hinted at by Armour et al.?

The notion that a company can acquire its own assets is known as "affirmative asset partitioning" (AAP). It implies that the assets of the company are separate from the assets of the shareholders and, consequently, can only be used for the benefit of the company. Shareholders cannot withdraw these assets at will, and shareholder's personal creditors cannot execute their claims on these assets (i.e., entity shielding, in the words of Armour et al.). As a consequence, AAP reduces monitoring costs for company creditors who do not need to keep track of the personal expenses of shareholders. Similarly, the going concern value of the company is better protected through AAP.

However, AAP may also lead (especially in combination with limited liability – see below) to insider opportunism and increase the risk of insolvency. The former problem is addressed by corporate governance rules (e.g., on conflict of interests), securities law (e.g., on insider trading) and special liability rules (e.g., veil piercing – see below). The latter problem is addressed by contractual arrangements that add additional debtors or pledges, or by default rules that do so. When these default rules are part of company law, they generally relate to the (lack of) limited liability of the shareholders.

Limited liability

The term "limited liability" in the context of company law generally refers to the notion that the creditors of the company cannot, in principle, hold shareholders personally liable for the debts of the company. Just as personal creditors cannot execute their claims on the assets of the company, company creditors cannot execute their claims on the assets of the shareholders (i.e., owner shielding). Legally speaking, shareholders are not liable for the debts of the company. Economically speaking, they are only liable for their investment in the company as the company's residual owners and claimants (see below), hence the idea of "limited" liability.

Limited liability is not per se necessary. Indeed, many companies do not know limited liability (e.g., partnerships – see below) or only grant limited liability protection to some shareholders but not to others (e.g., the French *société en commandite*). However, limited liability has clear advantages. Most importantly, limited liability provides investors with a downsize cap, but leaves an unlimited upside potential. As a consequence, it incentivizes investment through equity over debt and facilitates diversification. However, limited liability also increases risks for non-adjusting creditors. Moreover, the case for limited liability relies on the assumption that shareholders have a positive net interest in the company. This assumption, however, is not always correct. For example, when a company is too big to fail, moral hazard may occur. Additionally, the workings of the financial market could lead to shareholders (or constituents exercising shareholder rights) with a negative net interest in the company as is the case when short-selling and share lending are combined.

Liquidity

Liquidity refers to the degree to which participation in a company (i.e., a "share") in the company can be easily turned into liquid assets. Thus, liquidity is closely linked to the transferability of shares. Easily transferrable shares are said to have a higher liquidity than shares that cannot easily be transferred. Liquidity is important for shareholder, e.g., to facilitate investment diversification and for the personal creditors of shareholders (who have a claim against the estate of the shareholder, including the shares).

Formally, a distinction can be made between "closed companies" and "public companies". "Closed" in this context means that there are legal impediments to the transferability of shares. "Public", by contrast, means that shares are legally speaking freely transferable. Public companies may be listed, but this is not necessarily the case.

Note that public (even listed) corporations can still be closely held. Especially in the European context, it is common to have a controlling shareholder (or family of shareholders) of a publicly listed company, as opposed to the United States where a dispersed "free float" is more common. Note also that practical impediments may make it very uninteresting or difficult to sell shares, even though formally these shares are freely transferrable. Under those circumstances, liquidity of shares can be low – and (personal) creditor protection can be frustrated.

Delegated management

Generally speaking, the company is governed by a board of directors that is formally distinct from the shareholders (and shareholder's meeting) and appointed by the shareholders. Of course, shareholders may appoint themselves as directors. Dependent on the size of the firm and the nature of the shareholdership, the board may be a truly separate entity in control of the company (e.g., wide a widely dispersed – uninterested – free float) or be a meeting of (controlling) shareholders by a different name (e.g., in a closed and closely held SME).

Additionally, the board may *de facto* lead the company or may delegate operational management to (hired) administrators (e.g., a "CEO") (see also the distinction between a one-tier and two-tier board). The rules on delegated management fall largely outside of the scope of this course (see *Corporate Governance*).

Investor ownership

Finally, investor ownership implies that control of the firm lies ultimately by those contributing equity in the firm (dependent on the quantity of their contribution). In other words, shareholders (i.e., the company's investors) control the firm. This implies (1) indirect control over the company's management and (2) residual ownership of the company's assets after liquidation.

Investor ownership can be diluted, however. From the corporate governance perspective, legal impediments to investor ownership may exist (e.g., mandatory worker participation in German corporate law). Additionally, practical impediments may give the board of directors a very high degree of autonomy (especially in the United States). From the perspective of residual ownership, recall that the assumption that investors have positive net interest in the well-being of the company is not per se true.

Corporate purpose?

Traditionally, the main "corporate purpose" was to make profit under the assumption that a company is run for the (commercial/financial) benefits of its shareholders (shareholderism). Increasingly, companies are also expected to take into account the interests of other involved parties (stakeholderism). This is the basis of the entire ESG-debate (which is also the subject of a different course). In addition to the (implicit or legally binding) implications of ESG, an increasing number of states have made it either possible to create a company with a mixed "purpose" under a specific corporate form (e.g., a "benefit corporation") or have made it possible to pursue other (social) goals in addition to the traditional goal of profit maximization, regardless of corporate form.

Suggested readings:

- M. Zito et al., *Benefit Corporations System Worldwide: A Comparative Overview* (2024)
- Chapter 17 MBCA
- art. 1.1 Belgian Corporate Code

While an increased interest in ESG seems positive at first, some questions arise concerning legitimacy and accountability, and concerning the potential for abuse.

Read: M. Friedman, *A Friedman doctrine* (1970)
***Dodge v. Ford Motor Co.* (SCOTUS, 1919)**

Do you understand Friedman's argument against the social responsibility of companies? How does his argument compare to later views advocating in favor of stakeholderism?

How does the focus on ESG potentially affect the balance of power in a free and democratic society? Can you provide in favor of, and opposed to the inclusion of ESG from a company law perspective?

Do you understand the facts of the case, the issue at hand and the holding of the Court?

In Dodge, there seems to be a discrepancy between Henry Ford's actions and his statement before the Court. Do you understand this discrepancy and can you explain the ramifications it may have for so-called "benefit corporations"?

In civil law jurisdictions, the law of foundations is often concerned with abuse of the form of the foundation. Do you understand how benefit corporations (or their equivalent) reproduce this problem in a different form? How does this interconnect with the notions of legal personhood, limited liability and liquidity?

Company archetypes

On the basis of the previous characteristics, we can distinguish between two "company archetypes": the partnership model, and the corporation (in the strict sense) model.

PARTNERSHIP	CORPORATION
Identity partner = determinative ⇨ No transferability of shares and low liquidity ⇨ Direct partner involvement in governance	Identity partner $\neq$ determinative ⇨ Transferability of shares and high liquidity

⇨ Unlimited liability ⇨ Inherently fragile construction ⇨ Holdup problem ⇨ High monitoring costs Partnership = group of partners	⇨ Not direct shareholder involvement in governance ⇨ Limited liability ⇨ Robust construction ⇨ No holdup problem ⇨ Lower monitoring costs Corporation = separate entity

As with all archetypes, the above schedule is a gross simplification of reality. First, not all corporations in the strict sense meet all criteria described above. This is especially true for the closed corporate forms often used by SMEs, where liquidity is low and shareholder involvement in governance can be (very) high. Additionally, various hybrid forms of partnerships have emerged that possess some characteristics traditionally associated with corporations (e.g., limited liability towards at least some partners).

A more nuanced table, taking these observations into account, may look something like this:

TRUE PARTNERSHIP	HYBRID PARTNERSHIP
⇨ No transferability of shares and low liquidity ⇨ Direct partner involvement in governance ⇨ Unlimited liability ⇨ No legal entity status	⇨ No transferability of shares and low liquidity ⇨ Direct partner involvement in governance *of some partners* ⇨ (Partial) (un)limited liability ⇨ Partial legal entity status
CLOSED CORPORATION	**OPEN CORPORATION**
⇨ Limited transferability of shares and limited liquidity ⇨ Direct partner involvement in governance? ⇨ Limited liability ⇨ Legal entity status	⇨ Full transferability of shares and high liquidity ⇨ No direct partner involvement ⇨ Limited liability ⇨ Legal entity status

Even this more nuanced table, however, remains a simplification. First, it does not account for corporate forms that have a special background or purpose. The most important of these are presumably the “cooperatives”, but other examples exist depending on each jurisdiction (e.g., special agricultural corporate forms).

Second, the archetypes described above make abstraction of the flexibility of company law. Compare this to the menu in a restaurant. In some restaurants (jurisdictions), there is a menu with options to choose from, but no or few alterations are possible. Elsewhere, however, the menu (law) allows for a great deal of personal customization. The more the flexible the law is, the less meaningful the distinction into archetypes.

Read: J. Armour et al., *The Anatomy of Corporate Law* (2017) – chapter 1

Do you understand the distinction between mandatory rules and default rules? Do you understand how this distinction connects back to Coase’s paper discussed above?

“Trop de liberté nuit” (Too much liberty is harmful) – do you agree with this statement? How does this connect to the signal function of the law and the notion of “legitimate expectations?”

Do you understand how the distinction between mandatory and default rules connects company law to other fields of law (e.g., tax law, insolvency law)?

Regulatory theories of company law

Before continuing, it is useful to make a brief detour to discuss the most important regulatory theories of company. These theories seek to define, *in abstracto*, how society should think about companies in general. As a result, these theories also seek to define the boundaries of regulatory action.

Overall, three main theories can be distinguished:

(1) Contractarian theory: according to the contractarian view, a company is a voluntary cooperation between individuals (shareholders). Hence, great deference should be given to the will of the parties (as with any contract) and the company can be perceived as an extension of its shareholders in the public sphere;

(2) Concession theory: according to this view, the government grants the privilege (under certain conditions) to create a legal fiction (i.e., a non-existent entity is recognized as legally existing). Hence, under the concession theory, the government is free to define the limits of the concession it grants;

(3) Legal entity theory: according to this view, companies (with legal personality) are the recognition of the law of a preexisting social entity. While the law is generally free to determine the rights and limitations of legal personality, it cannot arbitrarily deprive an existing legal entity of the logical rights it would have or impose rules that are contrary to the nature of the company is a legal entity.

The importance of corporate theory should not be overstated. US philosopher John Dewey summarized it quite neatly when het stated that "*each theory has been used to serve the same ends, and each theory has been used to serve opposing ends*."[2] Indeed, most jurisdictions have been influenced by all of the aforementioned theories and sometimes it is unclear to pinpoint exactly which theory has been influential at what point.

However, corporate theory remains relevant for several reasons. First, it can help to explain how and why regulatory systems clash (especially when attempts at harmonization are made). Take the example of legal representation of the company. Under a real entity theory, internal limitations cannot be invoked by or against third parties. Under a contractarian theory, however, agency law applies and these limitations do play a role, even in the relationship between third parties. Arguably, this is one of the reasons why integration between German law (real entity theory – *Prokura*) and English law (contractarian theory – agency law) in the context of EU reforms was particularly difficult.[3] Second, company law theory provides the tools for thinking about and advocating legal reform. Hence, it allows for the construction of a (hopefully convincing) narrative to shape the law.

Suggested reading: J. Dewey, *The historic background of corporate legal personality* (1925)

Read: *Browning Ferris Industries v. Kelco* (SCOTUS, 1989), only the dissent by Justice O'Connor

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[2] J. Dewey, "The historic background of corporate legal personality" *Yale L.J.* (1925), 669.
[3] C. Gerner-Beuerle and M. Schillig, *Comparative Company Law* (2019), 74.

***Burwell v. Hobby Lobby Stores Inc.* (SCOTUS, 2014), only the majority opinion by Justice Alito**

Do you understand the difference in corporate theory in the opinions issued by Justice O'Connor and Justice Alito. Do you see how the choice of corporate theory implies different regulatory effects?

Sources of company law

In this course, we will mainly discuss European (EU) company law and United States (US) company law. Occasionally, we will also discuss other legal systems, dependent on the needs of the class.

Sources of company law in the European Union

Company law in the European Union remains, in principle, within the competences of the individual Member States. It follows that each Member State has its own set of company law rules in the absence of a unified body of EU company law. However, this does not mean that EU law is irrelevant; far from it. (Partial) harmonization of company law has been an important feature of EU law and has occurred in various stages.

A constitutional foundation for this harmonization project can be found in article 49 TFEU on the freedom of establishment. This freedom of establishment implies "*the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms*" and extends to "*the setting-up of agencies, branches or subsidiaries*" (i.e., the primary and secondary freedom of establishment; art. 49 TFEU). Freedom of establishment, however, carries certain risks of a race to the bottom and regulatory competition (see below).

To mitigate this, article 50 (2) g TFEU grants the EU institutions the competence to coordinate "*to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 54 with a view to making such safeguards equivalent throughout the Union*." In other words, the EU has a competence to adopt measures for harmonization with the aim of creating a level playing field in the EU (although certain exceptions apply – see below).

The competence of the EU in this regard, has led to various “waves” of harmonization leading to rules on the protection of creditors and shareholders (‘60s-‘80s), on corporate mobility and securities law (‘90s-‘00s) and on corporate governance (‘10s onwards). The main tool to do so, is via directives which are binding as to the results to be achieved but need to be implemented in Member State law and leave Member States some leeway in the choice of means. By way of exception, binding and directly applicable regulations are used instead.

Hence, EU law greatly influences Member State company law. Depending on the topic, Member States have more or less leeway. As a result, Member State law may differ greatly or be relatively homogenous throughout the European Union.

Throughout this course, we will mostly focus on the tools of harmonization to highlight the principles underlying these tools. Occasionally, we will look how these tools have found their way into specific Member State law or how Member States deal with issues that have not (yet) been the subject of EU harmonization. The most important tools of harmonization for company law in the European Union are the following:

- **Directive 2017/1139 (Company Law Package):** this Directive harmonizes and codifies several earlier Directives and now forms the backbone of “EU company law”. It has been revised and amended by Directive 2019/1151 and Directive 2025/25 (both on the use of digital tools and processes) and Directive 2019/2121 (on cross-border conversions, divisions and mergers);
- **Directive 2004/25/EC (Takeover Directive)**: this Directive sets out minimum rules for takeover bids;
- Regulation 2157/2001 and Regulation 2137/85: these Regulations set out the framework for EU legal entities, the Societas Europaea (SE) and European Economic Interest Grouping (EEIG) respectively;
- Directive 2012/17: this Directive creates a framework for a system of interconnection of business registers (‘BRIS’) and has been implemented by Implementing Regulation 2021/1042;
- Directive 2009/102 (Single-Member Company Directive): this Directive sets out rules for creating a single-member company;
- Directive 2007/36/ EC (Shareholders Rights’ Directive): this Directive sets out minimum standards for shareholder’s rights. It was amended by Directive 2017/828

and is further implemented by Implementing Regulation 2018/1212. It is important, but is discussed in the course on *Corporate Governance and ESG*:

- Directive 2024/1760 (Corporate Sustainability Due Diligence Directive: this Directive sets out minimum sustainability duties. It is discussed in the course on *Corporate Governance and ESG*.

In addition to these harmonizing tools (and their implementation in national Member State law), there is of course also a vast body of EU case law and Member State case law and soft law involved in shaping company law in the EU.

Suggested reading (only if you are unfamiliar with the tools of EU law): R. Geiger et al., *'Art. 288' in TFEU Commentary* (2015)

Sources of company law in the United States

Company law in the United States is state law, meaning there are in principle 50 different company law (codes or statutes) in the country. However, there has been a considerable trend towards unification. In 1950, the American Bar Association created the Model Business Corporation Act (MBCA) which has been revised several times since. As of 2023, 36 US states have adopted laws modelled after the MBCA. Important exceptions, however, include Delaware, Texas, New York and California. Occasionally, we will look into the law of these (influential) states as well.

To this state-created company law (in the strict sense), federal law adds a set of rules that is mostly relevant for listed companies: the Securities Act (1933, on disclosure duties when raising capital), the Securities Exchange Act (1934, on reporting requirements and proxy disclosure duties), the Sarbanes-Oxley Act and Dodd-Frank Act (2002 and 2010, respectively, both on corporate governance).

To this, one could add a vast body of case law, and corporate governance principles (e.g., the ALI Corporate Governance Code).