Petri Mäntysaari

The Law of Corporate Finance: General Principles and EU Law

Volume I: Cash Flow, Risk, Agency, Information

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Table of Contents

1 Introduction

> "Wenn man eine Erkenntnis als Wissenschaft darstellen will, so muß man zuvor das Unterscheidende, was sie mit keiner andern gemein hat, und was ihr also eigentümlich ist, genau bestimmen können; widrigenfalls die Grenzen aller Wissenschaften in einander laufen, und keine derselben, ihrer Natur nach, gründlich abgehandelt werden kann."[1]

1.1 What Does Corporate Finance Law Mean?

The law of corporate finance has been defined in a modern and more holistic way in this three-volume book. In this book, corporate finance law is studied from the *perspective of the firm*. Like modern commercial law in general, the law of corporate finance helps the firm to reach its *legal objectives* (management of cash flow and the exchange of goods, management of risk, management of agency relationships, and management of information). When trying to reach its legal objectives, the firm typically applies generic *legal tools and practices* (incorporation and choice of business form, contracts, regulation of internal processes through compliance and otherwise, typical ways to manage agency relationships, and typical ways to manage information problems) and takes into account legal rules that belong to different traditional fields of law (contract law, company law, banking law, tax law, competition law, and so forth).[2] In corporate finance law, these legal tools

[1] Immanuel Kant, Prolegomena (1783), § 1. In English: "If it becomes desirable to formulate any cognition as science, it will be necessary first to determine accurately those peculiar features which no other science has in common with it, constituting its characteristics; otherwise the boundaries of all sciences become confused, and none of them can be treated thoroughly according to its nature."

[2] There is a long list of what this book is not: a book on company law, banking law, English law, German law, the law of any particular country, EU securities markets law, corporate finance, and so forth. The details of English law, EU securities markets laws, and corporate finance have been discussed in specialist books like: Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008); Moloney N, EC Securities Regulation. OUP, Oxford (2008); and Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton (2006).

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and practices are used in the *context* of all decisions that influence the firm's finances (investment, funding, exit, and existential decisions).

The three volumes of this book form a whole, and there are cross-references from one volume to another. The volumes are in the order of generality. The first volume contains the most abstract concepts. The third volume contains applications of concepts discussed in the previous volumes.

The *first volume* introduces certain concepts characteristic of the law of corporate finance: the management of cash flow, risk, agency relationships, and information. Key topics discussed in the first volume include: the definition of corporate finance law as an independent area of law, the management of agency relationships, corporate risk management, corporate governance, and the management of outgoing and incoming information. It will be argued that the management of agency relationships, corporate risk management, information management, and corporate governance are interrelated. The first volume also contains a new theory of corporate governance.

The other volumes deal with transactions that influence the firm's finances. Many investments are based on contracts which contain payment obligations. The *second volume* will therefore focus on contract law. It discusses the general legal aspects of any investment contracts and provides an introduction to the law of payment obligations.

Investment transactions can be somebody else's funding transactions. Particular investment transactions will be discussed in the context of funding in the *third volume*. In addition to funding transactions, the third volume will also discuss questions of exit and corporate takeovers. Corporate takeovers raise questions about the target firm's existence.[3]

A reader who is mainly interested in usual financial transactions can have a look at the third volume first. A practising lawyer can find drafting and risk management tips in the second volume. The first volume might interest academics and corporate governance practitioners. The rather abstract, general or organisational issues discussed in the first volume make more sense when read in the context of the concrete issues discussed in the other two volumes.

1.2 Why Was This Book Written?

This book was written because there is a gap between corporate finance books and books dealing with the legal aspects of corporate finance.

Books dealing with the legal aspects of corporate finance do not address questions which are common to most firms. One can say that they offer a piece-meal or meristic view of corporate finance law. First, the study of rules that apply to corporate finance tends to be limited to the laws of only one country or some countries. Second, those books tend to focus on one or more particular aspects of cor-

[3] Corporate insolvency and restructuring typically raise other existential questions. They will not be discussed in detail in this book.

porate finance. Popular topics include company law, mergers and acquisitions, securities markets laws, and tax. Third, the legal aspects of corporate finance may have been discussed from the perspectives of corporate outsiders rather than the firm. For example, a law book dealing with corporate finance might have been written for practising lawyers who advise banks in the City of London. Fourth, those books often discuss the interpretation of law by the courts rather than study the thinking and behaviour of those who buy legal advice and use legal tools.

This can be contrasted with the universal approach adopted in corporate finance books. Corporate finance is the study of the way firms are financed.[4] Corporate finance books attempt to provide a template for the analysis of any firm. Their subject matter is how firms should make decisions on investment and finance.

Because of different approaches to corporate finance, corporate finance books and law books dealing with corporate finance rarely meet.[5] This is unfortunate because the legal framework influences both return and risk.

From the perspective of legal science, the lack of general principles of corporate finance law is particularly unfortunate because corporate finance law as understood in this book is arguably the economically most important area of commercial law.

The purpose of this book is to complement corporate finance books by discussing the practice of corporate finance at the same level of generality as corporate finance scholarship, albeit from a legal perspective. The book thus contains "a theory of practice" and provides an overview of the legal aspects of corporate finance.

This approach brings obvious benefits to legal practitioners, law professors, and legal science. Practitioners who understand both the thinking of those who buy legal advice and the nature of different legal tools and practices can take a more active role as participants in corporate decision-making. Law professors benefit, because external norms have, to a very large extent, been replaced by self-practices in this area, and the study of the practices of users enables them to catch a wider range of legal phenomena. Legal science can benefit in many ways, because, at a high level of generality, the core interests of firms are the same everywhere and not jurisdiction-specific like laws.

1.3 What Are the Themes of This Book?

This book has six themes. The *first theme* is *the firm*. This book focuses on the interests of a non-financial firm.[6] Most firms in the world are non-financial. The firm can act as an investor, raise funding, and make payments to its own investors. The firm can also become a takeover target or act as an acquirer itself.

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4 Zingales L, In Search for New Foundations, J Fin 55 (2000) p 1624.

5 There are exceptions. See, for example, Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003).

6 For the regulation of providers of investment services, see See Moloney N, EC Securities Law. OUP, Oxford (2008).

The firm is a unique combination of physical and human capital.[7] Its defining characteristic is that it substitutes authority for the price mechanism in determining how decisions are made (Coase).[8] The firm is thus understood as a business organisation, i.e. a group of people carrying out interrelated business activities in a coordinated way under common management and the resources that they have at their disposal.

The firm is not the same thing as its business form. The firm will require a business form (such as a partnership or incorporation as a limited-liability company) and legal personality (its own or that of its owners) in order to operate. The firm can consist of many legal entities or entities with different business forms, and the business form or forms of the firm may change over time. Under German law, a distinction is made between a legal entity acting as the carrier of the firm (Unternehmensträger) and the firm itself (das Unternehmen). The firm may change its business form or the legal entity within which it operates without changing its identity. For example, the public limited-liability company within which the firm operates may reincorporate as an SE. In a reverse takeover, the firm may continue to exist within another legal entity. Of course, the firm itself will be subject to constant change.

The firm is not the same thing as the shareholders of the legal entity within which it operates or its other stakeholders. It is assumed that the firm has its own interests and that its stakeholders have their own interests. Sometimes those interests are aligned, sometimes not (for the interests of the firm, see section 8.2.6).

The starting point in this book is thus not the same as in financial economics. Instead of the more holistic view represented in this book, financial economics tends to offer a narrower and mechanistic view of corporate finance. Financial economists usually ask how people can best spread their money over a range of assets, and their starting point is the investor rather than the firm. In practically all other books on corporate finance or corporate governance, shareholders of a company are regarded both as the firm's "owners" and as the most important principal. The firm is not deemed to have any interests whatsoever.[9] Like many other social theories, it has partly been self-fulfilling, and it has led to path-dependency in research.

In financial economics, the choice of shareholders as principal is a way to simplify the mathematics. It is clearly easier to calculate how the monetary flows of fictive "owners" are maximised on the basis of a number of assumptions than to explain how a real business should be managed in an unpredictable world.

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[7] Zingales L, In Search for New Foundations, J Fin 55 (2000) pp 1626 and 1641–1642.

[8] See *ibid*, p 1644.

[9] For a critique, see Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virg L R 85 (1999) pp 247–328; Zingales L, In Search for New Foundations, J Fin 55 (2000) pp 1623–1653; Aglietta M, Rebérioux A, Corporate Governance Adrift. Edward Elgar Publishing, Cheltenham (2005). See also Wiedemann H, Auf der Suche nach den Strukturen der Aktiengesellschaft: The Anatomy of Corporate Law, ZGR 2/2006 pp 245.

However, there is no reason why the path-dependency of financial research should act as a constraint in law. Company laws and securities markets laws do not have to be aligned with the current research interests of financial economists.

For example, making shareholders rich is not the fundamental reason for the existence of company laws, and it is clearly not true that company laws worldwide would have been designed just to further the interests of shareholders. Laws and the legal framework of the firm are, to a large extent, based on the weighing of different interests.[10]

There can be conflicts between financial theory and the practice of corporate finance.[11] The difference between theory and practice can partly be explained by laws and the existence of competing interests.

The behaviour of firms can also reflect the interests of firms themselves and not just the interests of their shareholders or other stakeholders.

For the purposes of this legal study, the most important "principal" is the firm itself. Needless to say, changing the principal is a paradigm change that changes everything. For example, if short-term shareholders are regarded as the most important principal and managers as their agents, it can make sense to align the interests of managers with those of shareholders. This can make it meaningful to use, say, stock option rights designed to increase the share price in the short term. If the firm is regarded as the most important principal and the managers as their agents, it makes sense to align the interests of the managers with the long-term interests of the firm. In the latter case, the firm can use other legal tools.

The philosophical foundations of this approach can be traced back to Adam Smith, Max Weber, and Ronald Coase. (a) Adam Smith demonstrated that, in a free market, it is beneficial for each individual to promote his own self-interest, because an individual pursuing his own self-interest also tends to promote the good of his community as a whole. (b) According to Max Weber, firms are the most important players in modern capitalist society.[12] (c) It is therefore beneficial to society if each firm promotes its own self-interest. In The Wealth of Nations, Smith wrote: "It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their regard to their own self interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages."[13] In the long run, shareholders and other stakeholders should expect something from the firm provided that that thing is in the self-interest of the firm. (d) Ronald Coase explained how the

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[10] Philipp Heck, the founder of the "jurisprudence of interests", used this concept in his book Gesetzesauslegung und Interessenjurisprudenz (1914).

[11] For example, investors should in theory be indifferent about whether they receive money as dividends or buybacks, and it should make no difference whether a company decides to fund itself with shares or debt. In practice, however, there are differences.

[12] Weber M, Wirtschaft und Gesellschaft. Grundriß der verstehenden Soziologie (1922). See also Hansmann H, Kraakman R, Squire R, Law and the Rise of the Firm, Harv L R 119 (2006) p 1336: "Economic activity in modern societies is dominated not by individuals, but by firms that own assets, enter contracts, and incur liabilities that are legally separate from those of their owners and managers."

[13] Smith A, The Wealth of Nations (1776), Book I, Chapter I.

firm promotes its own self-interest in his 1937 essay The Nature of the Firm. Generally, the firm tends to do something with its resources until it is in the self-interest of the firm not to do any more of it. For example, Coase said that "a firm will tend to expand until the costs of organising an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on the open market or the costs of organising in another firm".[14]

This does not prevent investors from promoting their own self-interest. The firm will take their interests into account like any other relevant interests. The firm will also act as an investor itself, and any investor can act as a "firm".

The second theme. The second theme of the book is the focus on *four decisions*. One can distinguish between investment decisions, funding decisions, decisions on how to return funds to investors, and decisions on the existence of the firm.

Investment decisions are decisions on where to invest the resources or funds that the firm has raised. Funding decisions are decisions on where and how to raise funds to finance these investments. Dividend decisions are one of many alternative ways to return funds to shareholders, and the repayment of a debt is the most usual way to return funds to debt investors.

In practice, the firm may take any one of those decisions separately or combine it with one or more other decisions. For example, a firm that is in the course of planning a venture capital investment may seek a transaction structure that enables its new shareholders to cash in after five years. On the other hand, a firm can decide to buy a new machine without having to think about how to return funds to shareholders.

Business acquisitions can raise a wide range of questions relating to investment, funding, and exit, and even questions about the existence of the target firm. Other typical ways to end the existence of the firm include liquidation and bankruptcy. Such questions will not be discussed in this book in detail as they can better be discussed in specialist books.[15] This book will focus on the activities of firms that act on a going-concern basis.

The third theme. The third theme is the emphasis on the *universality* of the types of legal questions across different types of transactions. For example, the types of legal questions that should be addressed by the firm when the firm acquires a company are no different than the basic legal questions that apply when the firm invests in real estate.

By studying legal problems on the basis of function[16] rather than industry or a narrow transaction category, it is possible to understand how the same problem can have been solved in the same ways across different categories of transactions or different industries. Furthermore, the way to solve a problem in one industry or

[14] Coase R, The Nature of the Firm, Economica, New Series, Vol 4, No 16 (November 1937) pp 386–405 at p 395.

[15] See, for example, Finch V, Corporate Insolvency Law. Perspectives and Principles. Cam U P, Cambridge (2002).

[16] See, for example, McCormick R, Legal Risk in the Financial Markets. OUP, Oxford (2006), para 12.02 on the risk-based approach to the analysis of law and regulation.

in the context of one transaction category can help to solve the same problem in other contexts.

There are of course legal differences between different categories of transactions. Different transactions can require the use of different legal tools due to their special characteristics. These differences can help to illustrate the universality of the applicable legal questions and tools.

This book will not focus on special questions of particular transaction categories in detail. Special questions of, say, aircraft finance or syndicated loans have been discussed in specialist books in the light of a certain governing law. On the other hand, the legal tools discussed in this book will be applied in all financial transactions and therefore also in aircraft finance and syndicated loans governed by the law of a certain country.

The same can be said of other fields of law. For example, special questions of company law have been discussed in company law books focusing on one or more jurisdictions and it is not necessary to discuss all of them here. However, certain questions of company law do influence the financial decision-making of the firm regardless of the governing law and have been included.

The fourth theme. The fourth theme is *commercial practice*. While corporate finance books discuss the template that helps any firm to make decisions affecting its finances, this book also discusses the legal tools and practices normally used by firms. Legal tools and practices are important both to firms and their legal advisers.

The book contains a large number of examples illustrating the practices of real firms.

The fifth theme. The fifth theme is *deconstruction*. In all major financial transactions, the firm needs to manage four things by legal instruments: cash flow, risk, agency relationships, and information. In this book, company law instruments, contract law instruments, and other legal instruments will be deconstructed on the basis of how these four components are managed by the firm.

There is a fine line between the law of corporate finance and commercial law in general. In commercial law, the firm typically manages not only cash flow but also the exchange of goods and services. In corporate finance, the main focus is on monetary flows.

The sixth theme. The last theme of this book is the *European Union*. Corporate finance law does not exist in a legal vacuum. It can only be understood in the context of one or more jurisdictions. For example, US books on corporate finance and corporate finance law tend to assume that the legal framework is that of the US. This means that US textbooks are less useful in Europe.

There is a European body of rules and practices forming the basis of EU law of corporate finance. In addition to the Member States of the EU, Community law applies to Member States of the European Economic Area (EEA) under the EEA Agreement between the Member States of the EU and three EFTA states (Iceland, Liechtenstein and Norway), and to Switzerland under bilateral agreements between Switzerland and the EU.

The approximation of laws in the EU has contributed to further convergence of Member States' laws. There is plenty of legislation adopted by Community institutions affecting the law of corporate finance. For example, there is a piece-meal approximation of contract laws, piece-meal approximation of company laws, and extensive harmonisation of securities market laws. The Financial Services Action Plan (FSAP) played an important role in the development of a common body of rules in European securities markets. EU securities regulation is based on the Treaty objective of constructing a common market.[17]

Community law is not the only reason for the existence of common rules. The company and commercial laws of many Member States share the same roots. A western European legal system belongs to one of four legal families: English (common law), French (civil law), German (civil law), or Nordic (civil law).

In addition, similar commercial practices are being adopted throughout the Community. It is normal to use Anglo-American legal practices and the English language in international commercial transactions. Anglo-American legal practices have therefore become increasingly popular in continental Member States over the years.

This body of rules and practices is highlighted here in order to demonstrate the intercourse between rules and practices and financial decision-making. For the same reason, there will often be references to Member States' national laws. However, this book is not intended as a complete account of all legal rules influencing corporate finance in Europe, because it would not be possible to write such a book.

Although this book will present not only rules adopted by EU institutions but even rules applied by the Member States, this book is not a comparative overview of Member States' laws as such. Rather, the book will focus on some main themes useful in financial decision-making. To achieve this, it is not necessary to discuss the laws of every Member State. There will be references mainly to English,[18] German and sometimes – the author being a Finn – Nordic law, but no complete comparative analysis. There are references to German language materials in addition to English language materials. After English, German is the second most popular foreign language studied in Europe.

1.4 General Principles and the Firm

The book will focus on the *general principles* of corporate finance law. As said above, the book will look at these general principles from the perspective of the firm rather than from the perspective of the legislator or the perspective of the established internal conventions of other fields of law.

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[17] Article 2 of the EC Treaty.

[18] In most cases, the same rules apply in the United Kingdom (UK). However, Scots law is a separate legal system. According to the Scotland Act, the Scottish Parliament has devolved powers within the UK. Any powers which remain with the UK Parliament at Westminster are reserved. Reserved matters were set out in Schedule 5 of the Scotland Act.

This approach is rare. It can be hard to find a book on the general principles of any field of law written from the perspective of the users of law. Practices have nevertheless been studied in social sciences.[19]

The choice of the perspective of the firm brings clear benefits. Each country has its own laws and its own terminology, and all laws can influence the behaviour and financial decision-making of firms in one way or another in a market economy. It would therefore be impossible to write a book on corporate finance law, if the purpose of the book were to describe the contents of all those laws, and just as impossible to write a book on the general principles of corporate finance law, because the general principles of all those other areas of law are different. In any case, the result would be local and hardly relevant outside the context of one jurisdiction. The choice of the perspective of the firm means that it is possible to identify a number of key questions that are identical, regardless of the jurisdiction. Firms must address the same key questions everywhere. The most important objectives of the firm and processes that the firm can employ to address those questions are not limited to one jurisdiction but are shared by most firms.

Although the focus is on the decision-making of the firm, the same general principles can be applied by other entities and individuals who participate in trade and finance as suppliers, buyers, contract parties or consumers.

Legal practices, general principles, behaviour, and legal policy. The usual legal practices of firms reflect the behaviour of a large number of market participants trying to act in a rational way. Like financial theory, the legal practices of market participants can therefore help to understand both the market and what is regarded as rational market behaviour.

In principle, such behavioural theories can also be useful for legal policy if they "predict (with reasonable success) the likely responses to legal rules of the particular classes of actors to whom the rules are geared, whether or not the responses of other classes of actors would likely be identical".[20]

One of the theories in this book that may or may not influence legal policy and may or may not be self-fulfilling is the recognition of the interests of the firm and the choice of the firm as the principal for the purposes of company law.

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[19] For example, Bourdieu P, Outline of a Theory of Practice. Cambridge Studies in Social and Cultural Anthropology (No 16). Cam U P, Cambridge (1977). Michel Foucault studied self-practices.

[20] Korobkin RB, Ulen TS, Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics. Cal L R 88(4) (2000) p 1072.