

# **SOURCES OF CORPORATE LAW**

## ***AD HOC CORPORATE LAWS:***

Corporate law in most jurisdictions is not a single unified body of rules but a constellation of **statutory forms**, each tailored to specific economic and governance needs.

# Statutes for Public Corporations

- Apply to companies with **freely tradable shares** listed on public markets.
- Typically impose **robust disclosure duties**, strict governance structures (board composition, committees), and **enhanced investor protection** because shareholder bases are dispersed and agency problems are significant.
- Ex: U.S. Model Business Corporation Act (MBCA) and Delaware General Corporation Law (DGCL); UK Companies Act 2006.

# Statutes for Closely Held Corporations

- Shares are **not freely tradable**; ownership is often concentrated among founders, families, or private investors.
- Statutes recognize the higher relevance of **contractual freedom** and permit:
  - *direct shareholder management,*
  - *shareholder agreements overriding default rules,*
  - *restrictions on transferability.*
- Fewer mandatory protections because agency problems differ (majority–minority conflicts rather than manager–shareholder conflict).

# Quasi-Corporate Statutory Forms

- Hybrid forms balancing limited liability with contractual flexibility.
- Used to accommodate innovative business structures (venture capital, investment funds, start-ups).
- Examples:
  - *U.S. LLP, LLC, business trust;*
  - *European SAS, GmbH, S.r.l. semplificata.*
- Reflect a broader trend toward **functional convergence**: jurisdictions innovate to remain competitive in corporate chartering.

# **OTHER BODIES OF LAW:**

**Corporate law does not operate in isolation; firms are shaped by parallel regulatory frameworks.**

# Group Law (Konzernrecht)

- Particularly developed in Germany.
- Governs **intra-group control**, preventing the extraction of private benefits by parent companies at the expense of subsidiaries.
- Protects **creditors and minority shareholders** in groups where economic control exceeds formal ownership.

# Securities Law & Stock Exchange Rules

- Central to the governance of public corporations.
- Ensure market integrity, investor protection, and mandatory disclosure.
- Example: U.S. Securities Act 1933 and Exchange Act 1934; EU Market Abuse Regulation.
- Important interface with corporate law: disclosure obligations shape board accountability.

# Bankruptcy (Insolvency) Law

- Determines how value is allocated when the firm cannot meet obligations.
- Can result in a **shift of control** from shareholders to creditors.
- Encourages efficient continuation or orderly liquidation, depending on jurisdiction.

# Tax Law

- Influences corporate choices on **capital structure, payout policy, executive compensation**, and choice of legal form.
- Example: limits on deductibility of certain executive compensations or interest deductions (e.g., thin capitalization rules).

# Labor Law

- Shapes corporate governance through employee participation mechanisms.
- Europe: **co-determination** in Germany; worker councils; information and consultation duties.
- Reflects a more stakeholder-oriented corporate model.

## **LAW vs. CONTRACT**

Private autonomy allows shareholders to shape their relationship through charters, bylaws and shareholders' agreements, but these contracts are necessarily incomplete and cannot fully address agency problems or protect non-consenting stakeholders.

Corporate law therefore supplements and constrains private ordering through mandatory rules and public-interest standards that ensure transparency, fairness and the proper functioning of the corporate form.

At the same time, corporate statutes provide a wide range of default rules designed to facilitate private ordering by reducing negotiation costs, filling contractual gaps and offering standard solutions that parties may freely opt out of.

## A) Default Rules

- Form the bulk of corporate statutes.
- Reduce transaction costs by **simplifying contracting** and providing **majoritarian defaults**, i.e., rules most parties would agree upon.
- Types:
  - ***Opt-in defaults*** → *parties choose to adopt them.*
  - ***Opt-out defaults*** → *automatically apply unless parties modify or waive them.*
- Alteration may require:
  - ***supermajority approval,***
  - ***minority veto,***
  - ***or specific formalities, reflecting the need to protect vulnerable parties.***

## B) Mandatory Rules

- Justified by:
  - ***Contracting failures*** (*asymmetric information, bounded rationality*).
  - ***Standardization*** (*accounting rules, fiduciary duties, capital maintenance rules*).
- Corporate law becomes progressively more flexible moving from corporations → LLCs → partnerships.
- Mandatory rules preserve **market credibility** of the corporate form.

# Choice of Jurisdiction

- Parties often engage in **jurisdictional arbitrage** to select the most favorable corporate statute (e.g., Delaware for predictability and expertise).

# BENEFITS OF LEGAL RULES

## — Incompleteness of Charters

- Charters rarely anticipate every contingency.
- Default rules offer a **gap-filling mechanism** through legislation, judicial interpretation, and administrative guidelines.

## — Networking Effect

- Standard form charters facilitate governance because courts and practitioners interpret them consistently.
- Reduces legal uncertainty and strengthens precedential value.

# BENEFITS OF LEGAL RULES

## – Evolution of Defaults

- Adopting statutory default rules allows firms to benefit from **future improvements** in the law without amending their charter.
- Example:
  - *Delaware’s “rolling default regime”, where changes in case law dynamically redefine governance standards.*
  - *UK model articles do not automatically apply to pre-existing companies, limiting automatic updating.*

## – Forum Shopping

- Jurisdictions compete for incorporations, leading to **regulatory competition**.
- Debate: “race to the top” (efficiency) vs “race to the bottom” (managerial opportunism).

# REGULATORY COMPETITION CHOICE OF JURISDICTION CHOICE OF LAW RULES

## — U.S.: Place of Incorporation Rule

- The law of the state of incorporation governs internal corporate affairs.
- Explains Delaware's dominance.

## — EU Evolution

- Historically: **Real Seat Doctrine** → corporate law of the state where the firm's central administration is located.
- Now increasingly replaced by **incorporation theory**, following Court of Justice decisions (Centros, Überseering, Inspire Art).
- Insolvency determined by **Centre of Main Interests (COMI)**, promoting cross-border coordination.

# GOAL OF CORPORATE LAW (IN THE ESG ERA)

## ◆ Core economic goal

Efficient and *sustainable* creation and allocation of wealth: firms as devices to organise risk-bearing, investment and control in the long term, not only to maximise short-term shareholder payouts.

## ◆ From pure shareholder value to management of externalities

Corporate law increasingly requires boards to *identify, manage and disclose* significant **environmental and social externalities** affecting workers, communities, the environment and other stakeholders, and not merely financial returns to shareholders.

# GOAL OF CORPORATE LAW (IN THE ESG ERA)

## ◆ European ESG framework: “hard-law” stakeholder orientation

- **Corporate Sustainability Reporting Directive (CSRD)** – replaces the NFRD and greatly expands mandatory sustainability reporting (double materiality, detailed ESRS standards, assurance duties) for large and listed companies, including certain non-EU groups.
- **Corporate Sustainability Due Diligence Directive (CSDDD / CS3D)** – imposes due-diligence obligations on very large companies to identify, prevent and mitigate adverse human-rights and environmental impacts in their own operations and global value chains; currently subject to “simplification” and delayed implementation, but still signals a move toward legally enforceable sustainability duties.
- **Whistleblowing Directive (EU) 2019/1937** – requires companies (generally  $\geq 250$  employees, then 50–249) to establish secure internal reporting channels, protect confidentiality and prohibit retaliation, thereby empowering insiders to reveal breaches of EU law (including many ESG-related rules).

# GOAL OF CORPORATE LAW (IN THE ESG ERA)

## ◆ Effect on large and very large enterprises

These instruments primarily target **large and very large undertakings and groups**, effectively turning them into *regulatory transmission belts*: they must cascade ESG expectations down the supply chain, collect non-financial data from business partners and enforce minimum standards on human rights, climate and governance.

## ◆ Comparative note: EU vs Delaware

While EU law increasingly embeds *explicit* sustainability and stakeholder obligations into corporate statutes and securities law (“Brussels effect”, including extraterritorial reach to non-EU multinationals), Delaware still formally adheres to shareholder primacy but gives directors broad discretion, under the business-judgment rule, to pursue ESG-aligned strategies where they can be framed as promoting long-term shareholder value.

# GOAL OF CORPORATE LAW (IN THE ESG ERA)

## ◆ Overall goal today

Corporate law seeks not only to **protect investors and ensure efficient capital markets**, but also to **internalise key social and environmental costs**, using disclosure, due diligence and whistleblower protection so that powerful corporations are accountable toward a wider circle of stakeholders.

# PATTERNS OF SHAREHOLDING

## ◆ Dispersed Ownership (US–UK–Japan)

- Public markets with many small shareholders.
- Stronger need for:
  - *disclosure,*
  - *independent directors,*
  - *shareholder voting rights,*
  - *protections against managerial opportunism.*

## ◆ Concentrated Ownership (Italy–France–Germany)

- Presence of controlling shareholders (families, the State, industrial groups).
- Main concern: **majority–minority conflicts.**
- Corporate law focuses on:
  - *related-party transactions,*
  - *self-dealing limitation,*
  - *withdrawal rights,*
  - *stronger judicial review.*

## THE RISE OF INSTITUTIONAL INVESTORS

- Over the past 30 years, equity ownership in major markets has shifted from retail shareholders to **large institutional intermediaries**.
- This “*institutionalisation of shareholding*” is particularly visible in the **US, UK, Germany and Japan**, where pension funds, insurance companies and asset managers now hold substantial portions of listed-company equity.

# Typology of Institutional Investors

## US

- **Mutual funds** (e.g., Fidelity, Vanguard, BlackRock) dominate equity markets through diversified portfolios.
- **Pension funds** (CalPERS, CalSTRS) historically drove the first wave of governance activism.
- **Index funds/ETFs** are now the most influential owners in large-cap firms.

# Typology of Institutional Investors

## UK

- **Pension funds** (defined-benefit plans historically central but now shifting to defined-contribution schemes).
- **Insurance companies** traditionally held large stable blocks.
- **Strong stewardship culture** reinforced by regulatory expectations.

# Typology of Institutional Investors

## Global

- **Sovereign Wealth Funds** (e.g., Norway's NBIM, Singapore's GIC) — often long-term, governance-oriented investors with ESG mandates.
- **Hedge funds** — activist funds using concentrated positions to push for strategic, financial, or governance changes.
- **Private equity** — influential but typically outside the public-market governance sphere; relevant when firms go private (“PE governance model”).
- **State-owned investors** — hybrid actors blending financial and political objectives.

# How Institutional Investors Shape Corporate Governance

## Voting Dynamics

- Institutions control large voting blocks, often 20–30% or more of S&P 500 shares, effectively creating “**infrastructure power**”: they can swing say-on-pay results, board elections, and transformational transactions.
- **Proxy advisors** (ISS, Glass Lewis) further amplify this influence through voting recommendations, creating concerns of “outsized quasi-regulatory power”.

# How Institutional Investors Shape Corporate Governance

## Engagement and Stewardship Strategies

- Growing shift from “exit” to “voice”: instead of selling shares, institutions engage boards through stewardship teams.
- Engagement now includes:
  - *board diversity policies,*
  - *climate transition planning,*
  - *human capital management,*
  - *executive compensation alignment,*
  - *supply-chain human rights issues.*
- UK and EU frameworks require *public disclosure* of engagement policies and outcomes.

# How Institutional Investors Shape Corporate Governance

## Regulatory Stewardship Architecture

- **UK Stewardship Code (2010; revised 2020)**

→ sets global benchmark: requires investors to demonstrate effective stewardship, integration of ESG, and active oversight of investee companies.

- **EU Shareholder Rights Directive II (SRD II)**

→ mandates engagement policies, transparency of voting behaviour, and encouragement of long-termism.

- **US**

→ more reliance on market-driven practices; SEC increasingly scrutinises ESG funds' disclosures and greenwashing risks.

# The Scholarly Debate: Benefits and Risks

## A) The Positive Narrative

### 1. Monitoring and Discipline

Institutions, especially active managers and pension funds, can reduce managerial agency costs.

### 2. Professionalisation of Governance

They possess expertise and resources to evaluate governance structures, strategy, and risks.

### 3. Long-term Orientation

Some (e.g., SWFs, pension funds) have multi-decade horizons, encouraging sustainability and risk management.

### 4. Universal Ownership Theory

Large diversified investors internalise system-wide externalities: climate risk, labour practices, and systemic governance failures affect the *entire portfolio*, not just one firm.

# The Scholarly Debate: Benefits and Risks

## B) The Critical Narrative

### 1. Passivity of Index Funds

Index funds cannot sell underperforming firms (they must replicate the index), creating incentives for *minimal-cost stewardship*, potentially leading to:

- *reluctance to challenge management,*
- *free-riding on activist hedge funds.*

### 2. Conflicts of Interest

Asset managers may face:

- *business incentives (selling 401(k)/pension products to corporate clients),*
- *political pressures (e.g., anti-ESG movements in some US states),*
- *fee-based incentives that dilute stewardship quality.*

# The Scholarly Debate: Benefits and Risks

## B) The Critical Narrative

### 3. Concentration of Private Power

Vanguard, BlackRock, and State Street — the “**Big Three**” — collectively vote 20–25% of shares in many top US firms, raising concerns about:

- *democratic legitimacy,*
- *market concentration,*
- *the risk of “behind-the-scenes” influence without adequate accountability.*

### 4. Short-term activist pressure

Hedge funds sometimes push for rapid restructuring, buybacks, or divestitures, which may:

- *increase short-term share prices,*
- *but reduce long-term investment, innovation, and employee security.*

# Institutional Investors and ESG Governance

- Institutions—especially European and global ones—now act as key ESG drivers:
  - *demanding climate transition plans,*
  - *requiring human rights due diligence,*
  - *integrating sustainability in voting policies,*
  - *using escalation tools (votes against directors, public letters, divestment).*
- **Climate Action 100+**, a coalition of over 700 investors managing \$68 trillion, shows the rise of **collective stewardship**.
- Yet in the US, the **anti-ESG backlash** has politicised institutional investor behaviour, producing divergent regional and ideological approaches.

# Overall Assessment

Institutional investors have become **central governance actors**, with the power to influence strategy, board composition, and ESG practices across global capital markets. Their impact is neither uniformly beneficial nor harmful: it depends on the type of investor, the regulatory environment, and the quality of stewardship.

They now act as **quasi-regulators**, often determining how sustainability and governance norms are implemented on the ground.