



# University of Zurich

Faculty of Law  
Fall Semester 2012

## **Law & Economics**

### **Economic Analysis of Law**

Business Law

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# Agenda

- **Property rights and corporate law**
- **Economic theories for companies**
  - Principal-Agent relationships
  - Incomplete contracts and transaction costs
- **Regulatory competition in corporate law**
  - United States
  - Switzerland
  - European Union

# Property Rights and corporate law

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- **Property rights and transfer rights**
  - Use (Usus)
  - Change (Absus)
  - Withholding of the profit (Usus fructus)
  - Contracting of the rights above
- **Different (in)corporation types assign property rights**
  - „Dilution“ of property rights among number of right holders
  - Completeness of assignment of property rights

# Property Rights: Classification by assignment and bearer

		Number of right holders	
		Low	high
Completeness of the assignment of property rights	High	Concentrated structure <b>(Sole proprietorship)</b>	Diluted structure <b>(Public corporation)</b>
	Low	Diluted allocation of rights <b>(Foundation)</b>	Diluted allocation of rights with diluted structure <b>(Association, club)</b>

# Company law in Switzerland:

## Classification by assignment and bearer

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- **Partnership – natural person**

- Simple partnerships
- General partnerships
- Limited partnerships

- **Legal persons**

- Joint stock corporation
- Corporation with limited liability
- Cooperative
- Association
- Foundation

# Economic company theories

## I. Principal-Agent relationships

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### ■ Basic assumptions

- Agents can write elaborate contracts
- However: information asymmetry between principal and agent
- Principal as “rational utility maximizer”

### ■ Consequences

- Ex ante incentives in contracts to deal with information asymmetry

### ■ Major proponents

- Berle and Means
- Alchian and Demsetz
- Holmström
- Milgrom

# Economic company theories

## I. Principal-Agent relationships

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- **Separation of ownership and control**
  - Hidden information
  - Hidden action
  - Potential welfare losses by separation of ownership and control
- **Contributions/topics**
  - Ownership structure
  - Shareholder and voting rights
  - Market for corporate control
  - Market for managers
  - Control costs and mechanisms
  - Incentives for managers
  - Incentives within teams

# Economic company theories

## II. Incomplete contracting & transaction costs

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- **Basic assumptions**
  - Transaction costs from writing elaborate contracts
  - Incomplete (market) contracts lead to market failure
- **Consequences**
  - Ex-post governance is needed
  - Organizational theories
  - Implicit contracts
- **Major proponents**
  - Coase, Williamson
  - Grossman, Hart and Moore
  - Simon and March



# Economic company theories

## II. Incomplete contracting & transaction costs

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### ■ Dimensions of analysis

- Market v. firm; „Boundaries of the Firm“
- Vertical range of manufacturing

### ■ Contributions/topics

- Economies of scale
- Economies of scope
- Asset specific investments (remember: long term contracts)
- Hold-up difficulty
- “Repeated games” and reputation effects
- Interdependences



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## **Law & Economics**

### **Business Law – Regulatory Competition**

Business Law

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# Agenda

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- **(Economic) theories for companies**

- Property rights
- Principal-Agent relationships
- Incomplete contracts

- **Regulatory competition in corporate law**

- United States
- Switzerland
- European Union

# Regulatory Competition

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**Definition:** Competition between states to attract businesses by proposing more attractive legal rules:

- Regulatory Competition takes place in all fields of business law.
- Corporate Law is one of these fields.
- At least two forms of regulatory competition exist:
  - **intra-jurisdictional:** between the states of a federation (e.g. the US)
  - **international:** between different states

# Regulatory Competition

- In the US: *Delaware effect*
- 50 % of the publicly traded corporations and 63 % of the Fortune 500 companies have chosen Delaware as their legal home!
  
- **There is a fundamental controversy:**
  - **Race to the bottom?**

The state with the most lenient standards (the most "liberal" regime) is the most attractive.
  - **Race to the top?**

The market mechanism makes sure that the state with the most effective rules wins.

# Regulatory Competition

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- **An advantage of the Delaware effect is:**
  - Delaware's legislature regularly updates the *Delaware General Corporation Law*.
  - There is a specialised court, the *Delaware Court of Chancery* (a court of equity) which has created a whole body of corporate case law.

# Regulatory Competition

- The *Delaware effect* is only possible because of the **internal affairs doctrine**: Corporations which act in more than one US state are – with respect to the internal affairs of the corporations – subject only to the laws of their state of incorporation.
  - This principle applies only to the *internal affairs* of the corporation, not to other fields of law, like e.g. employment or environmental law.
- A Delaware corporation is therefore subject only to Delaware corporate law although it is regularly active throughout the country.

# Regulatory Competition

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- ➔ It is possible to incorporate in Delaware but to move the corporation's seat somewhere else.
- In "Choice of Law" (Private International Law), this is called the **place of incorporation rule**.



# Regulatory Competition

- How is the situation in other countries?
- The law in **Switzerland** is close to US law in this respect.

See Art. 154 of the Federal Code on Private International Law (IPRG):

"<sup>1</sup> Companies shall be governed by the law of the State under which they are organized if they satisfy the publication or registration requirements of that law or, if there are no such requirements, if they are organized according to the law of that State.

<sup>2</sup> A company which fails to meet these conditions shall be governed by the law of the State in which it is administered in fact."

# Regulatory Competition

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- How is the situation in the EU?
- For a long time, EU Member States could decide by themselves about **choice of law** concerning corporations.
- Some countries adopted the **place of incorporation rule** (like in the US or in Switzerland).

# Regulatory Competition

- However, the majority of EU Member States (e.g. Germany) opted for the **real seat doctrine**.
  - According to the real seat doctrine, the laws of the State are applicable in which the company has its *real seat* (seat of the central administration).
  - If the corporation moves to another State, the rules of that State are applicable.
  - This requires a dissolution of the company in the former State and a complete re-establishment in the new state.
  - If these requirements are not satisfied, the corporation becomes a non-existing entity!

# Regulatory Competition

- On the basis of the **freedom of establishment**, the ECJ rejected the real seat doctrine, see e.g. the judgments in the following cases:
  - *Centros*
  - *Überseering*
  - *Inspire Art*
- Therefore, Germany and other EU Member states adhering to the real seat doctrine, had to adopt the **place of incorporation rule**.

But only with respect to companies from other EU Member States, or from countries with which special agreements on the freedom of establishment exist.

# Regulatory Competition

- The English **private limited company** has become very attractive: No special capital requirements exist whereas in Germany the minimum capital requirement for a GmbH ("Company with limited liability") is 25.000 Euro (Switzerland: 20.000 CHF), for an AG 50.000 Euro (Switzerland: 100.000 CHF).
- Regulatory competition works:
  - The German legislature has created a "**Mini-GmbH**" which can be established with a minimum capital of one Euro.
  - The EU has created pan-European corporations, e.g. the **Societas Europaea (SE)**; there are plans for a European GmbH, the **Societas Privata Europaea (SPE)**.

# Regulatory Competition

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- Foreign corporate forms have also disadvantages: There are **transaction costs** caused by registration requirements, the ignorance of foreign law, and hence increased liability risks.
- Therefore, the **attractiveness** of foreign corporate forms seems to be **limited**.
- How frequently are **foreign corporate forms** chosen in Switzerland?