



**University of
Zurich** ^{UZH}

Institute of Law

The Corporate Personality, Separate Legal Entity, and Agency Problems

Principles of Corporate Law - Gesellschaftsrecht (Master) –
Lecture 3
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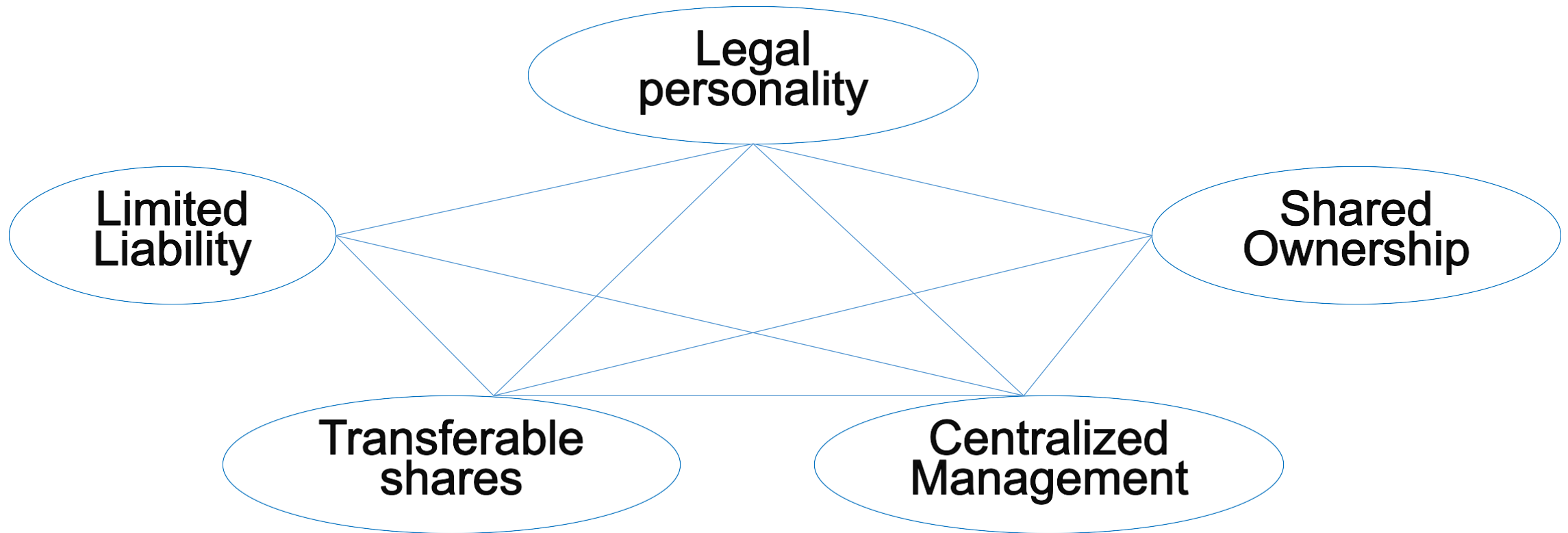
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Review Lecture 2 & 3

- Corporate Governance
 - a system of rules, policies, and practices that dictate how a company's board of directors manages and oversees the operations of a company.
- Shareholders
- Principal-Agent Model
- Board of Directors
 - Centrality of the BofD in modern corporations
 - Separation between Ownership & Control
- Fiduciary Duties
- Business Judgement Rule

What is a Corporation



Theories and Doctrines of the Company

- Public or private purpose?
- **Concession theory**: role of state in creating companies – enticing incorporators to invest
- **Contractualist view (Coase)**: incorporators as ‘economic heroes’ – *laissez faire* view
 - **Limited liability**: enabling & incentive to invest
 - **Legal contractualism**: ‘aggregate theory’ private law contracting between members and between members and management
 - **Economic contractualism**: neo-classical liberalism view to reduce transaction costs – ‘voluntary association between shareholders’, not as much ‘a creation of the state’. ‘[N]et gain must be greater than the net loss’. **Utilitarianism – the greatest gain for the greatest number**

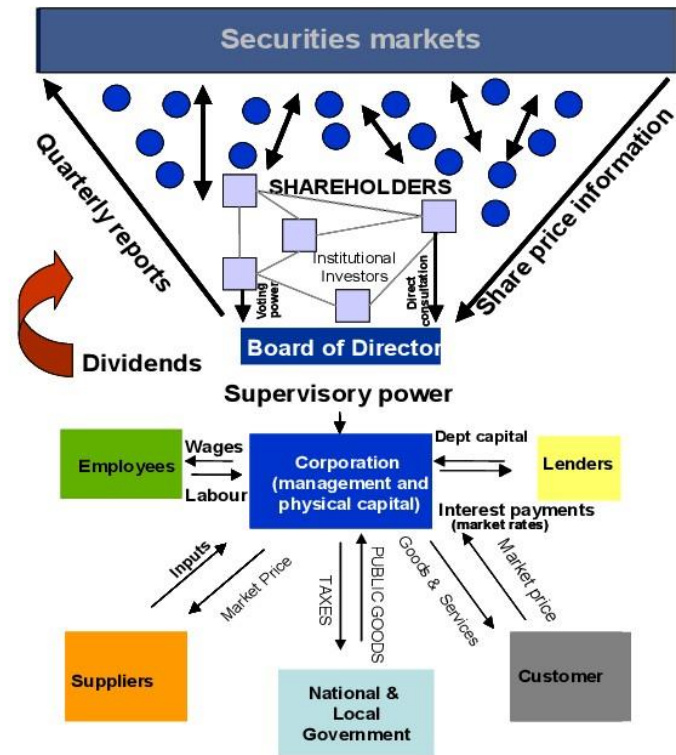
Economic theories of the company

- Economic contractualism – *Kaldor-Hicks efficiency* – *greatest economic benefit to society justifies transaction even if some parties lose*
 - Efficiency, rationality/self-interest, and information. The problem of externalities
- ‘Nexus of contracts’
 - reduce transaction costs
- Limited liability: enabling acts, facilitate efficient management of business
- Principal-agent problem and asymmetric information

Political Theories of Company Law (1)

- *Hayek* – procedural equality & fair dealing, despite the result
- *Kant & Hegel* – political equality & equality of autonomy of individual
- *J.S. Mill* – ‘Where there is an ascendant class, a large proportion of the morality of the country emanates from its class interests’
- *Marx* – individual’s place in world determines actual equality; rejected *Hegel & Kant* for ignoring basic inequalities of birth, occupation & property.
- *Rawls* – just difference principle, ‘justice as fairness’, principles to govern just society derived from ‘behind a veil of ignorance’.

Berle & Means Model of Ownership and Control



Adapted from: M. Blair, Ownership and Control (1995)

Role of Shareholders: Hirschmann



How to bring a company's performance back to full potential:



- “The relation between corporate management and stockholders is a case in point. When the management of a corporation deteriorates, the first reaction of the best-informed stockholders is to look around for the stock of better-managed companies. In thus orienting themselves toward exit, rather than voice, investors are said to follow the Wall Street rule that “if you don’t like the management you should sell your stock.” According to a well-known manual this rule “results in perpetuating bad management and bad policies.”
- „Naturally it is not so much the Wall Street rule that is at fault as the ready availability of alternative investment opportunities in the stock market which makes any resort to voice rather than to exit unthinkable for any but the most committed stockholder”.
- Hirschman

Exit

- Wall Street Rule – If you don't like management, sell your stock
 - Corollary: If you don't sell, vote with management”
 - “Either or Decision”



- New Forms of Exit:
 - Consumer Boycotts
 - Labor Boycotts



- Economists favor 'exit':
 - Market forces presumed to work efficiently
 - Invisible Hand



- Legal intervention 'inefficient' and will fail to achieve shareholder's (the principal) goals

Voice

- Attempt to influence organization
- Remedy problems
- Attend annual meeting and question the Board or Managers
- Vote (or not) for Board members
- Different Votes:
 - Shareholder Voting
 - Engaging through an intermediary (mutual funds)
 - Nonatomistic Investors
 - Voice by Other Stakeholders

Loyalty

- Determines whether shareholder takes a 'voice' or 'exit'
- Loyalty stronger to 'political' or 'social' organizations, than to 'economic' organizations
- How organization structured its strategy to deal with participants' concerns can influence feelings of loyalty, and whether they choose 'exit' or 'voice'.

The Role of Corporate Law and Shareholders

- Corporate law should be assessed in terms of whether it supports ‘exit’ or ‘voice’.
- What are the objectives?
- Should corporate law provide a balance between ‘exit’ and ‘voice’?
 - How should ‘exit’ and ‘voice’ operate?
 - Should the size of the corporation matter? Large, publicly-held v. Small private company (ie., GmbH)
 - Price Signals
 - Disinvestment Campaigns – ‘Occupy Wall Street’

The landscape of shareholders

- Pension Funds
 - Private Pension Funds
 - Public Pension Funds
 - Independent Non-Profit Pension Funds
- Banks
- Investment companies
- Insurance Companies
- Foundations
- Unions
- Hedge Funds
- Private Equity Funds

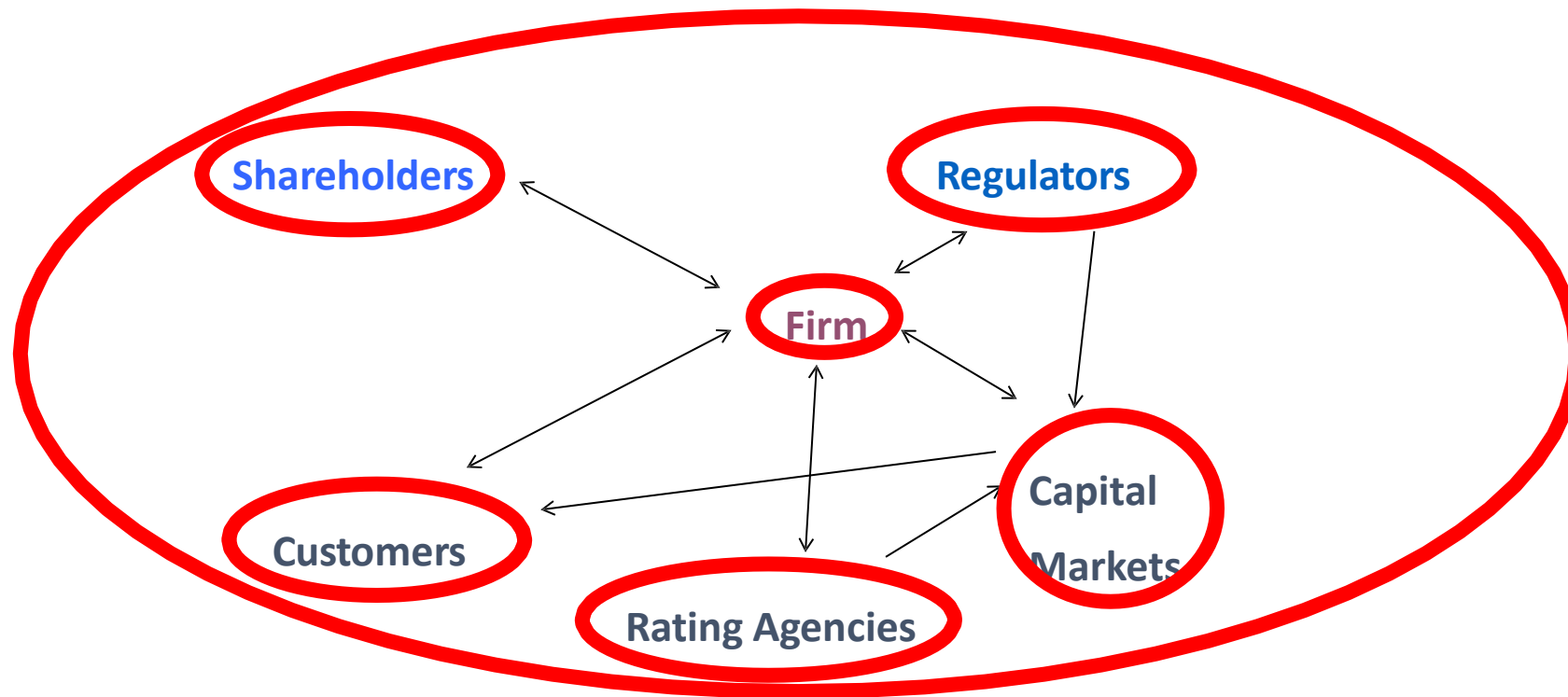
Shareholders

- The principal-agent problem
 - Shareholder – company manager
 - Creditors - Shareholder/managers
 - Shareholder – institutional investor/mutual or pension fund
- Regulator (stakeholders/society) – company

- ***What is the purpose of the company?***

Modern Capital Markets

Complexity of Agency Problem

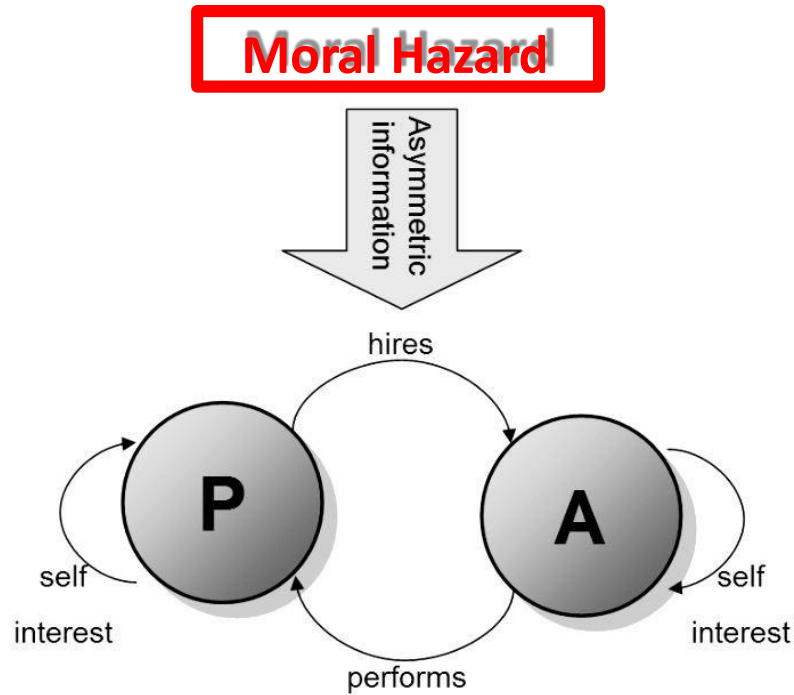


Principal-Agent Model



Shareholders
Shareholders

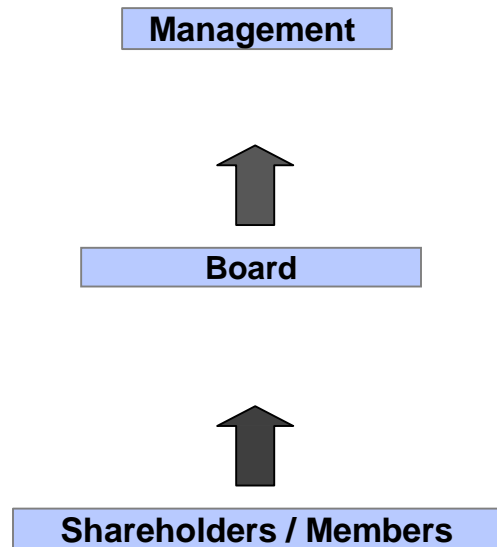
Directors
Directors



**Adverse Selection –
hidden information
&
Moral Hazard –**

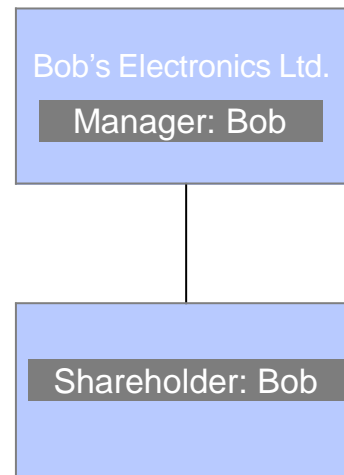
- Investor (principal) / Manager/employee (agent)
- Investors not have information about prospects of company (hidden information). Good companies will retreat from investor (public) markets. Adverse selection
- Agent's incentive to expropriate or steal the principal's assets (hidden action). Moral hazard.
- corporate law – governance structure to provide an appropriate degree of accountability to reduce agency problems.
- To what extent can all stakeholders' interest be taken into account?

The Company's Pyramid Model of Corporate Governance



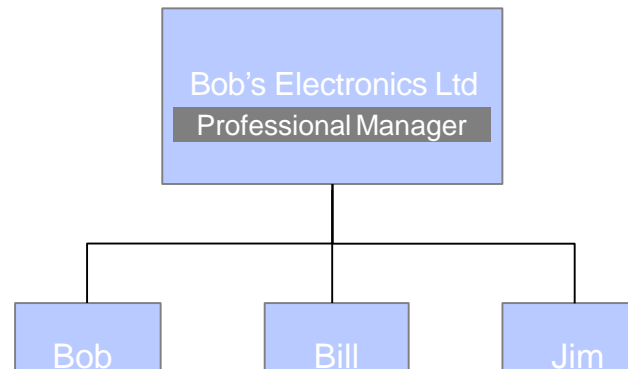
Closely Held Managed by Members

Manager and shareholder incentives completely aligned



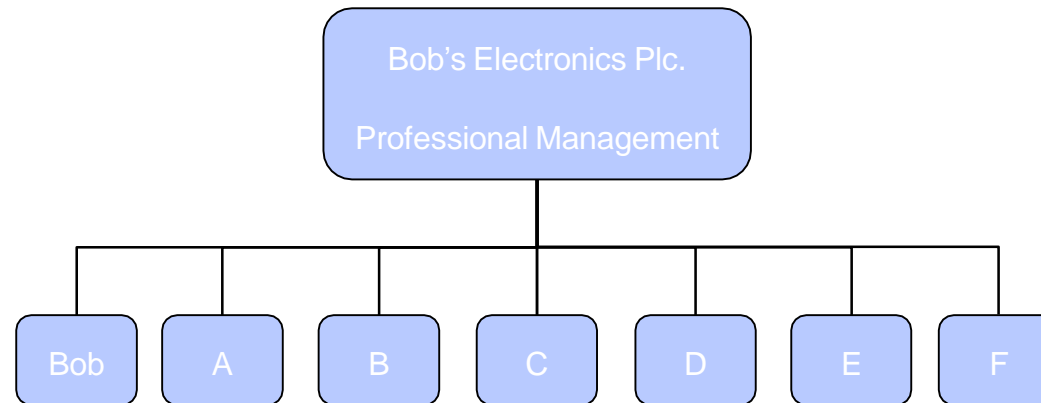
Closely Held Professional Management

- Managerial and member incentives not fully aligned
- Agency costs
- Controlling agency costs: monitoring and member control
 - Power to appoint and remove the board
 - The board's power to appoint and remove management
 - Power to reserve certain matters to the shareholders



Publicly Held Professional Management

- Company managed and controlled by management
- Collective Action Problem: Shareholders have poor incentives to monitor and control



Property Model

- When shareholders invest, they become part owners of the company, or at least of the company's business
- Shareholders have the right to the company's residual income
- This legitimates the shareholders' right to have company run exclusively in their own interest
- Any deviation undermines respect for private property ownership, which requires property be used in the interest of its owners
- Employees = outsiders
- Statutory intervention in the employment bargain = illegitimate intrusion into the private realm of shareholders?

Nexus of Contracts Model

- Company = vehicle for contracting
- Bargaining to reduce transaction costs
- Shareholders provide capital on which they are remunerated
- Ownership right in shares, not company
- Company = 'fiction'
 - legal fiction that serves as a nexus for a set of contracting relations among individual factors of production.
- Ownership of firm = irrelevant concept
- Bargaining and employee consent – no authority relationship between managers and employees
- 'Misleading' to state that 'company owes moral or social responsibilities to employees,' or other third parties.

How to minimize Agency Costs

Property Model

- Commission Payments
- Profit Sharing
- Efficiency Wages
- Performance Measurement
- Fear of Firing
- Enhanced Shareholder rights

Nexus of Contract Model

- View that affording control rights to shareholders is efficient
- Shareholders = group best able to bear risk
- Shareholders have the right to the company's residual income
- Shareholders stand last in line, but enjoy an unlimited right to the surplus
- The group that faces the greatest risk has the most