

# Contract Completeness of Company Bylaws and Entrepreneurial Success

Work In Progress – Feedback Welcome

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## Motivation

- **Theory:** Financial contracting matters for entrepreneurial success
  - Allocation of cash-flow rights and control rights to mitigate agency problems
- **Evidence:** Sophisticated financial contracting in VC (Kaplan-Stromberg 2003)
- However, little evidence:
  1. **Beyond** VC-backed firms
  2. **Causal** impact of sophisticated financial contracting?

## This Paper

- How sophisticated are startups' bylaws?
  - Company bylaws = contract between founders and external shareholders
    - Equity (share categories, selling rights...)
    - Governance (board of directors, voting rights...)
  - Analyze bylaws of the universe of French startups 2003-2013
- What is the impact of improving contract completeness?
  - Reform that reduced the cost of writing more complete bylaws
  - Firms raise more equity, invest more, grow faster

## Outline

1. Do entrepreneurs write sophisticated bylaws?
2. Impact on entrepreneurial success

## Data

- Bylaws and shareholder assembly minutes from government API
  - Universe of new firms in France 2003-2013
  - 2.1 Mns pdfs
  - 3 documents per firm on average
- Extremely rich data, but unstructured
  - Natural language processing + LLM

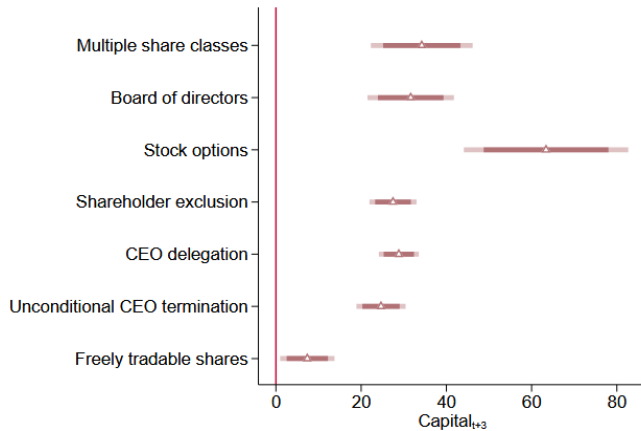
Example

## Stylized Facts – *Work In Progress*

- 0.40% of new firms issue **multiple share classes**
  - $\approx 1/3$  with preferred dividend rights
  - $\approx 1/3$  with preferred cash-out rights
  - $\approx 1/3$  with preferred voting rights
  - $\approx 1/3$  with preferred board/CEO appointment rights
- $\approx 2/3$  of new firms with multiple share classes are not VC-backed

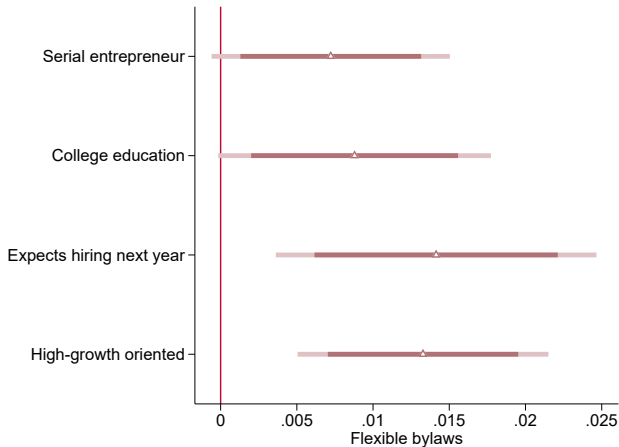
## Stylized Facts – *Work In Progress*

- Sophisticated contractual provisions predict firm performance



## Stylized Facts – *Work In Progress*

- Growth-oriented entrepreneurs use additional contractual provisions





## Outline

1. Do entrepreneurs write complex bylaws?
2. Impact on entrepreneurial success

## Ideal Experiment

- Q: Does the ability to write more complete contracts foster entrepreneurial success?
- Ideal experiment: Compare firms that can optimize contracting to firms that can't
- Our experiment: A reform that reduced the cost of choosing a legal form (SAS) that allows for customized bylaws ("*flexible*") relative to another legal form (SARL) that imposes boilerplate bylaws ("*restricted*")

## The Reform

In 2008, the *Economy Modernization Act* reduced the costs of flexible bylaws and aligned them with restricted bylaws firms

### 1. Minimum equity requirement

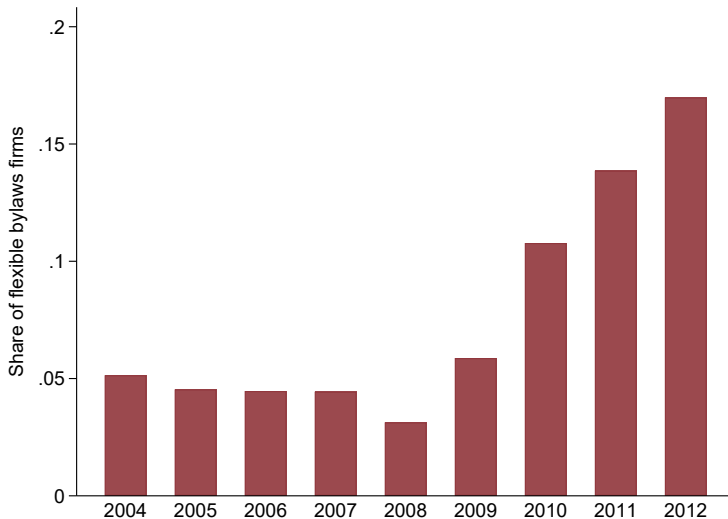
- Until 2008: €37k to start a flexible bylaws firm vs €1 for a restricted bylaws firm
- After 2008: €1 for both
- Pre-reform requirement was binding: 4 years after the reform, 90% of flexible bylaws firms are started with equity < €37k

### 2. Reduced taxes on capital gains for flexible bylaws firms

### 3. Relaxed audit requirements for flexible bylaws firms

## Adoption of Flexible Bylaws

Share of new firms with flexible bylaws legal form



## Data

- Business registry: date of creation, legal form
- Corporate tax filings: annual financial statements
- Universe of French firms

## Empirical Design

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- Difference-in-difference comparing sectors more versus less exposed to the reform
- Our current approach:  $Exposure_j$  = change in industry  $j$ 's share of flexible bylaws firms from before to after the reform
- (In progress: Instrument the change in flexible bylaws share using industry-level equity dependence. Idea: Contractual flexibility is valuable when firms need external equity.)

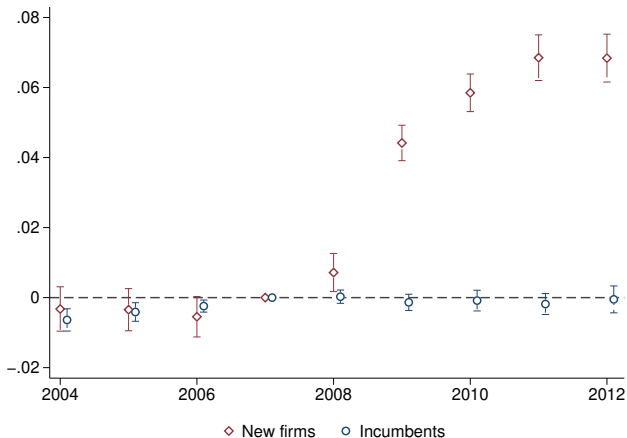
## Empirical Approach

$$Performance_{i,j,t+3}^k = \beta Exposure_j \times Post_t + \text{Industry FE} + \text{Year FE} + \epsilon_{i,j,t}$$

- $Performance_{i,j,t+3}^k = 1$  if firm  $i$ , in industry  $j$ , started in year  $t$ , is in the top  $k\%$  of the distribution in year  $t + 3$
- $Exposure_j$ : change in share of flexible bylaws firms from before to after reform
- $Post_t$ : Year  $\geq 2009$

## First Stage: Flexible Bylaws Adoption

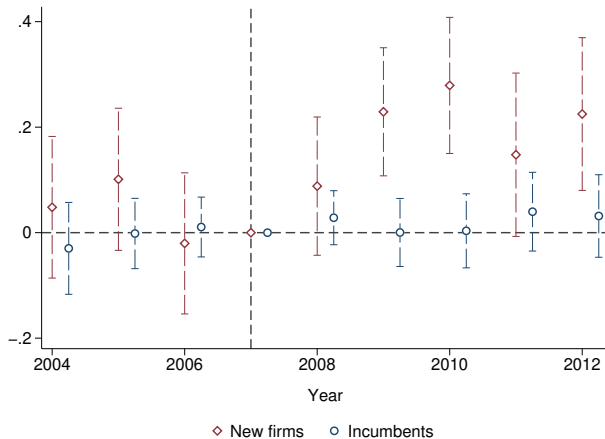
- LHS =1 if firm has flexible bylaws legal form
- IN RED: Higher take-up of flexible bylaws by **new firms** in more exposed sectors
- IN BLUE: Repeat the analysis using **existing firms**  $\Rightarrow$  no effect  $\Rightarrow$  use as **placebo**





## Results: Investment

- LHS =1 if investment is in top 20%
- IN RED: New firms in more exposed sectors **invest more**
- IN BLUE (Placebo): No effect on existing firms



## Other Results

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- Equity issuance increases
- Employment and sales increase
- Robust to controls and fixed effects
- In progress: Sophisticated contractual provisions in bylaws increases

## Conclusion

- Sophisticated contracting at the startup stage:
  1. is used beyond the VC space
  2. fosters entrepreneurial success: equity issuance ↑, investment ↑, growth ↑
- Standardizing contracts to promote entrepreneurship may backfire
- Work in progress: more information about contracts

# Example – Mas de Grille

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## **ARTICLE 1 - Forme**

La Société est une Société par actions simplifiée régie par les dispositions légales applicables et par les présents statuts.

Elle fonctionne indifféremment sous la même forme avec un ou plusieurs associés.

Elle ne peut faire appel public à l'épargne sous sa forme actuelle de Société par actions simplifiée.

Elle peut émettre toutes valeurs mobilières définies à l'article L 211-2 du Code monétaire et financier, donnant accès au capital ou à l'attribution de titres de créances, dans les conditions prévues par la loi et les présents statuts.

## **ARTICLE 2 - Dénomination sociale**

La dénomination sociale est :

### **MAS DE GRILLE**

Sur tous les actes et documents émanant de la Société, la dénomination sociale doit être précédée ou suivie immédiatement des mots «Société par actions simplifiée» ou des initiales «S.A.S.» et de l'énonciation du capital social.

## **ARTICLE 3 - Siège social**

Le siège social est fixé :

Zone Industrielle les Trouyaux 34560 POUSSAN

Il peut être transféré en France métropolitaine par décision du Président qui est habilité à modifier les statuts en conséquence ; et partout ailleurs par décision des associés.

## **ARTICLE 4 - Objet**

La Société a pour objet directement ou indirectement, tant en France qu'à l'étranger :

L'acquisition, la création, la gestion et l'exploitation sous quelle forme que ce soit de tous fonds de commerce d'hôtellerie, de restauration, de débits de boissons, préparations de plats à emporter.

## Example – Mas de Grille

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### Article 1: Legal form

*“The Company is a **SAS [flexible bylaws legal form]** governed by the applicable legal provisions and by these bylaws.*

*It operates indifferently in the same form with one or more shareholders.*

*It may not issue shares to the public in its current form as an SAS.*

*It may issue any securities as defined in Article L 211-2 of the French Monetary and Financial Code, **giving access to capital or the allocation of debt securities**, under the conditions provided for by law and these bylaws.”*

### Article 4: Purpose

*“The purpose of the Company is the acquisition, creation, management and operation, in any form whatsoever, of all **hotel, restaurant, beverage and takeaway businesses**.”*

# The Originals City, Le Mas De Grille, Montpellier Sud



458 reviews

#3 of 9 hotels in Saint-Jean-de-Vedas

📍 93 Rue Theophraste Renaudot, 34430 Saint-Jean-de-Vedas France

✍ Write a review



View all photos (175)

## Example – Mas de Grille

### Multiple share classes

*“The share capital is set at 40,000 euros, divided into:*

- 3,000 Class A shares with a par value of 10 euros allotted to SARL AUBRAC HOTEL*
- 1,000 Class B shares with a par value of 10 euros allotted to Mr Christian Dalle”*

## Example - Mas de Grille

### Differential cash flow rights

*“(...) Class A shares are entitled to a cumulative preferential dividend limited to 100,000 euros. Once the cumulative preferential dividend has been paid, Class A shares and Class B shares will be entitled to the same dividend. (...)”*



## Example – Mas de Grille

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### Cash-out

- Approval:

*“Class A shares are freely transferable.”*

*“Class B shares may only be transferred to third parties with the approval of Class A shareholders.”*

- Preemptive rights:

*“Each shareholder has a preemptive right to the Class B shares to be sold.”*

- Tag-along rights:

*“If one of the shareholders intends to sell all or part of its shares to a third party, thereby reducing its ownership share to less than 5% (...), the selling shareholder must allow the other shareholders, if they so wish, to sell their shares under the same conditions and in the same proportions.”*

## Example – Mas de Grille

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### Deviation from one-share-one-vote

“Quorum: (...) *at least half of the Class A shares* (...)”

“In order to be approved, any decision must receive both *two-thirds of* the votes of the shareholders present or represented and owning *Class A shares*, and *two-thirds of* the votes of the shareholders present or represented and owning *Class B shares*.”

## SARL vs SAS

- French entrepreneurs choose between two legal forms
  - SARL imposes boilerplate bylaws (*"restricted"*)
  - SAS allows for customized bylaws (*"flexible"*)

	SARL (restricted bylaws)	SAS (flexible bylaws)
Multiple share classes	Not allowed.	Allowed.
Sales of shares	Required shareholders approval. Bylaws specify majority rule, but at least 2/3 and less than unanimity.	May be freely tradable or subject to any customized limitations.
Governance	One or several managing directors.	May have board of directors, supervisory board, executive committee, etc. Customizable rules. Only requirement: CEO.
Voting	One share-one vote.	Customized voting rights and majority rules.

## Controlling for the Effect on Inframarginal Firms

- The reform makes some firms choose flexible bylaws (marginal firms)
- It also reduces costs for firms that would have chosen flexible bylaws anyway (inframarginal firms)
- Taking the average firm outcome in sector  $j$ :

$$\Delta \text{FirmOutcome}_{j, Pre \rightarrow Post} =$$

$$\underbrace{\beta \times \Delta \text{Share of flexible bylaws}_{j, Pre \rightarrow Post}}_{\text{Effect of flexible bylaws on marginal firms}} + \underbrace{\gamma \times \text{Share of flexible bylaws}_{j, Pre}}_{\text{Effect of removing requirements on inframarginal firms}}$$

## Firm Creation

- No effect at the extensive margin

	Log(# firms)	
	E-W	# firms
	(1)	(2)
<i>Weights:</i>		
Exposure×Post	-0.0047 (0.026)	0.010 (0.078)
<i>Fixed Effects</i>		
Industry	✓	✓
Industry (2-digit)×Year	✓	✓
<i>Controls</i>		
Pre-reform flexible share×year	✓	✓
Observations	4,635	4,366

## Investment: Regression Table

	New firms	Incumbents	All		
	(1)	(2)	(3)	(4)	(5)
Exposure×Post	0.17*** (0.050)	0.044 (0.029)	0.044 (0.029)		
Exposure×Post×New firm			0.13** (0.059)	0.12* (0.062)	0.14** (0.059)
<i>Fixed Effects</i>					
Industry×New	✓	✓	✓	✓	✓
Industry (2-digit)×New×Year	✓	✓	✓	✓	✓
Industry×Year	—	—	—	✓	✓
County×New×Year	—	—	—	—	✓
CEO demographics×New×Year	—	—	—	—	✓
CEO wage×New×Year	—	—	—	—	✓
<i>Controls</i>					
Pre-reform flexible share×New×Year	✓	✓	✓	✓	✓
Observations	688,846	1,432,548	2,121,394	2,121,394	2,121,394

Back

## Magnitudes

1.  $Exposure_j$  is scaled by first stage coefficient  $\Rightarrow$  IV interpretation

$\Rightarrow$  Flexible bylaws increase the probability of reaching the top 20% of fixed assets by 14 pp

i.e., by 29% given baseline probability of 48 pp for flexible bylaws firms

2. The effect is concentrated in top quantiles

Probability of reaching P50 increases by 5 pp

P66	16** pp
P75	18** pp
P80	14** pp
P90	18*** pp

## Mechanism: Equity Issuance

- Hypothesis: Improved contracting allows firms to raise more equity
- Replace the LHS with equity at  $t = 3$
- To neutralize the effect of retained earnings: (equity at  $t = 1$ ) + (issuance at  $t = 2$ ) + (issuance at  $t = 3$ )



## Mechanism: Equity Issuance

⇒ New firms in exposed sectors are more likely to raise equity

	New firms	Incumbents	All		
	(1)	(2)	(3)	(4)	(5)
Exposure×Post	0.22*** (0.082)	-0.038 (0.032)	-0.038 (0.032)		
Exposure×Post×New firm			0.26*** (0.081)	0.32*** (0.066)	0.39*** (0.060)
<i>Fixed Effects</i>					
Industry×New	✓	✓	✓	✓	✓
Industry (2-digit)×New×Year	✓	✓	✓	✓	✓
Industry×Year	—	—	—	✓	✓
County×New×Year	—	—	—	—	✓
CEO demographics×New×Year	—	—	—	—	✓
CEO wage×New×Year	—	—	—	—	✓
<i>Controls</i>					
Pre-reform flexible share×New×Year	✓	✓	✓	✓	✓
Observations	496,956	995,746	1,492,702	1,492,702	1,492,702

## Effect on Labor

- If labor needs upfront financing, improved financing should increase employment
- If labor is a per-period variable cost, employment should respond less than capital
- Test: replace the LHS with the wage bill (account for both quantity and quality of employment)

## Effect on Labor

- ⇒ New firms in more exposed sectors are more likely to be in the top 20% of labor growth
- ⇒ No effect on incumbents

	New firms	Incumbents	All		
	(1)	(2)	(3)	(4)	(5)
Exposure×Post	0.14*** (0.042)	-0.0018 (0.037)	-0.0018 (0.037)		
Exposure×Post×New firm			0.14*** (0.047)	0.18*** (0.052)	0.24*** (0.045)
<i>Fixed Effects</i>					
Industry×New	✓	✓	✓	✓	✓
Industry (2-digit)×New×Year	✓	✓	✓	✓	✓
Industry×Year	—	—	—	✓	✓
County×New×Year	—	—	—	—	✓
CEO demographics×New×Year	—	—	—	—	✓
CEO wage×New×Year	—	—	—	—	✓
<i>Controls</i>					
Pre-reform flexible share×New×Year	✓	✓	✓	✓	✓
Observations	688,846	1,432,548	2,121,394	2,121,394	2,121,394

## Effect on Revenue

- Capital increases + Labor increases  $\Rightarrow$  Output should increase
- Test: replace the LHS with revenue

## Effect on Revenue

- ⇒ New firms in exposed sectors are more likely to be in the top 20% of revenue growth
- ⇒ No effect on incumbents

	New firms	Incumbents	All		
	(1)	(2)	(3)	(4)	(5)
Exposure×Post	0.15*** (0.046)	-0.024 (0.036)	-0.024 (0.036)		
Exposure×Post×New firm			0.17*** (0.055)	0.21*** (0.055)	0.25*** (0.050)
<i>Fixed Effects</i>					
Industry×New	✓	✓	✓	✓	✓
Industry (2-digit)×New×Year	✓	✓	✓	✓	✓
Industry×Year	—	—	—	✓	✓
County×New×Year	—	—	—	—	✓
CEO demographics×New×Year	—	—	—	—	✓
CEO wage×New×Year	—	—	—	—	✓
<i>Controls</i>					
Pre-reform flexible share×New×Year	✓	✓	✓	✓	✓
Observations	688,846	1,432,548	2,121,394	2,121,394	2,121,394

## Entry Size vs Post-Entry Growth

- At which stage does improved contracting matter most for growth?
- So far, we focused on performance at 3 years
- Decompose into entry size (year 1) and post-entry growth (from year 1 to year 3)

## Entry Size vs Post-Entry Growth

- ⇒ New firms start larger
- ⇒ New firms grow more post-entry (employment not significant → firms frontload hiring)

Panel A: Size at entry.						
	Pr[ $K_{t+1} > p80$ ]		Pr[ $L_{t+1} > p80$ ]		Pr[ $Y_{t+1} > p80$ ]	
	New firms	All	New firms	All	New firms	All
Exposure×Post	0.24*** (0.049)		0.11** (0.047)		0.14*** (0.046)	
Exposure×Post×New firm		0.21*** (0.058)		0.15*** (0.048)		0.19*** (0.053)

Panel B: Post-entry growth.						
	Pr[ $\Delta K_{t+1 \rightarrow t+3} > p80$ ]		Pr[ $\Delta L_{t+1 \rightarrow t+3} > p80$ ]		Pr[ $\Delta Y_{t+1 \rightarrow t+3} > p80$ ]	
	New firms	All	New firms	All	New firms	All
Exposure×Post	0.26*** (0.042)		0.035 (0.041)		0.10** (0.044)	
Exposure×Post×New firm		0.19*** (0.045)		0.061 (0.055)		0.14** (0.056)

## Allocative Efficiency

- Does more flexible contracting allow capital to be better reallocated across firms?
- Test whether post-entry growth (from year 1 to year 3) is correlated with the marginal return to capital in year 1



## Allocative Efficiency

- (1) Capital grows more in new firms with high MRPK  $\Rightarrow$  allocative efficiency improves
- (3) Not true for labor (consistent again with frontloaded hiring)

	New firms (1)	Incumbents (2)	New firms (3)	Incumbents (4)
	<u><math>\Pr[\Delta K_{t+1 \rightarrow t+3} &gt; p80]</math></u>		<u><math>\Pr[\Delta L_{t+1 \rightarrow t+3} &gt; p80]</math></u>	
	(1)	(2)	(3)	(4)
Exposure $\times$ High MRP $\times$ Post	0.29*** (0.062)	0.050 (0.034)	0.027 (0.051)	0.047 (0.031)
<i>Fixed Effects</i>				
Industry $\times$ High MRP	✓	✓	✓	✓
Industry $\times$ Year	✓	✓	✓	✓
High MRP $\times$ Year	✓	✓	✓	✓
Revenues deciles $\times$ Year	✓	✓	✓	✓
Capital deciles $\times$ Year	✓	✓	✓	✓
Labor deciles $\times$ Year	✓	✓	✓	✓
Observations	586,798	1,251,460	605,775	1,218,691