

## Principles of Corporation Law HS 2022

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### Exam Question 1 (20 %; 20 points)

Discuss the theories of the firm with regard to the question ‘to whom the Board of Directors (BoD) owes a duty?’ In your view, what theory of the firm best explains the BoD duties? Describe what type of duties the BoD owes? Discuss the challenges of applying BoD duties in the corporate group context?

	Points
The answer to this question involves a general description of the main theories of the firm to answer the question ‘to whom the Board of Directors (BoD) owes a duty?’ Then the answer should address the theory of the firm that best explains the BoD duties. Then describe these duties and discuss the challenges of applying these duties in the corporate group context.	
<b>Main issues:</b>	
In considering to whom the board owes a duty, must consider the main theories of the firm/company. Review the main theories – ‘ <b>nexus of contracts</b> ’/Coase where company as entity is less important relative to shareholders, and duty measured in terms of whether shareholders benefit. It is also known as ‘law and economics’ theory or approach to analysing corporate law in which the firm is created ‘to organise what would otherwise be market transactions whenever their costs were less than the costs of carrying out the transactions through the market’. ‘The limit to the size of the firm is set where its costs of organising a transaction become equal to the cost of carrying it out through the market’. Private contracting around externalities	2
<b>concession theory</b> – company created as a contract with state to ensure that the corporate purpose is fulfilled, can be interpreted as an agency issue, for example, whether corporate purpose fulfilled or not is responsibility of the board to ensure that company fulfils that purpose. In recent times, whether purpose fulfilled or not is a matter of shareholder wealth maximisation,	2
The board’s duty is owed to the company, not the shareholders directly, but often the duty can be assessed in terms of whether most shareholders have benefitted from the board’s oversight company performance. Performance measured in terms of profits (short-term v longer-term) which relates to sustainability of the company.	1
<b>Communautaire theory</b> measured by whether company fulfilling the state’s best interest; in addition to making profits, does company achieve state objectives (society, economy, employees and purpose), some overlap with concession theory but not primacy of shareholders as can be defined in nexus of contracts or concession theory	2
Concession enjoys most adherence - duty fulfilled if principal’s interest are fulfilled ; the duties are measured in terms of the benefit to the company (sometimes determined by whether most shareholders’ interests are served) over the medium to longer term.	1

Extra credit	
Legal contractualism – aggregate theory of the company – shareholders/members contracting between themselves and management	1
Economic contractualism – neo-classical liberalism view to reduce transaction costs – greatest economic benefit to society justifies transaction even if some parties lose.	1
<i>Corporate social responsibility alters the analysis by modifying primacy of shareholders and extending to other stakeholders (defined by contract, ie., employees and creditors</i>	1
<b>Fiduciary/duty of loyalty principle - rationale</b>	
- Board’s duties defined in terms of the company’s best interest – question for whom is he/she a fiduciary? To the company?, to the shareholders or duty to both, or to other third parties?	1 1
- often measured in terms of shareholder value or wealth maximisation.	1
- Duty of loyalty – to measure duty fulfilment to company, board to maximize the investors’ wealth over short or medium to long term? Which investors wealth to maximise: all or majority?	1
- Fiduciary principles are meant to be rules for completing “incomplete contracts”. Overcome high costs of contracting (the overarching fiduciary principle replaces detailed contracts on agency problems)	1
- Distinction between management practices that harm investors’ interests, and practices that at the same time benefit managers and investors	1
<b>Duty of care and duty of disclosure – rationale</b>	
- Duty of care – to act as a prudent person does in the management of his own affairs of equal gravity.	1
- Business judgment rule – duty of board to act in good faith.	1
Board duties in context of corporate group – conflicting duties between to manage group in the bests interest of holding company compared to subsidiary within group	1
As the shareholder for the subsidiary(s) may be different than the shareholders for the group head company, the interests of the shareholders may ot be in alignment, they may diverge.	1
Which shareholders’ interest should prevail	1
If different shareholders, Swiss Responsible Business Initiative would apply liability for the board of a corporate group for violations by the subsidiary	1
Board’s duty expanded to take into account international norms/law – human rights/ environmental standards/ labour rights/ child/women etc	1
Mandatory due diligence to identify potential risks, take effective measures, report measures taken and violations – extra credit	1

What can parent company do to align the interests of parent and subsidiary companies.	1
<b>Total</b>	<b>20</b>

**Question 2 (35 %; 35 points)**

	Points
	<b>35</b>
<p><b>The lawyer should sue:</b></p> <ul style="list-style-type: none"> <li>- <b>John Baker, CEO of the company for violation of the duty of care (13 Points) + 2</b></li> </ul> <p>The answer could discuss the violation of the duty of care, and the gross negligence of the John Baker who did not make any in-depth research as a basis for deciding to invest a significant part of the firm's assets.</p> <p>This situation is based on a similar case, Smith vs. Van Gorkom. Van Gorkom who was the chairman of Trans Union, executed a Merger Agreement during a formal social event that he hosted for the Chicago Lyric Opera. Neither he nor any other director read the agreement prior to its signing.</p> <p>According to the Court, Van Gorkom and the directors were grossly negligent because they executed the Merger agreement, without conducting appropriate analysis or confronting an expert.</p> <p><b>(9)</b></p> <p>This answer could further discuss the business judgment rule as a defense for John Baker In Van Gorkom, the business judgment rule was an unavailable defense.</p> <p>However, the answer could also take an alternative view.</p> <p><b>(4)</b></p> <ul style="list-style-type: none"> <li>- <b>Frank Abagnale for violation of his fiduciary duties and fraud (11 Points)</b></li> </ul> <p>Violation of fiduciary duties and/or fraud</p> <p><b>(7)</b></p> <p>This situation is very similar to the FTX scandal.</p> <p>The answer could make parallelisms with Sam Bankman Fried and the role of the FTX management in causing the crash of company.</p> <p>The FTX management failed to implement any corporate-governance arrangements, and did not implement any internal or external control.</p> <p><b>(6)</b></p> <ul style="list-style-type: none"> <li>- <b>The Gatekeeper: No Worries We Won't See for violation of the duty of care (12 Points) + 2</b></li> </ul> <p>It violated its duty of care. No We Won't sue who was negligent and did not provide a truthful analysis of the company.</p> <p><b>(6)</b></p> <p>The answer could explain the role of gatekeepers (in particular auditors), emphasizing their function in the context of the principal-agent model.</p> <p><b>(4)</b></p>	<p>2</p> <p>2</p> <p>1</p> <p>2</p> <p>2</p> <p>2</p> <p>2</p> <p>2</p> <p>2</p> <p>4</p> <p>2</p> <p>2</p> <p>2</p> <p>2</p> <p>3</p> <p>2</p> <p>3</p>

It could also make hypothesis on the reasons why the gatekeeper failed in this case and make a parallelisms with the major scandals analyzed in class, including Arthur Andersen in the Enron.	3
<b>Fi discuss other scandals from the course, give 1-2 extra credit</b>	1-2
<b>Total</b>	<b>35</b>

**Question 3 (25 %; 25 points)**

Exam Question Fall Semester 2022 (total 30 points)

Alpha S.A. is incorporated and stock marked listed in Spain. Alpha’s BoD is in the midst of revising its remuneration policy.

- a) Assist Alpha’s BoD. On the EU level, which principles do apply? Is there an obligation under EU law to take into account sustainability criteria? (10 pts)

Alpha, being a global player, is also active in Sub-Saharan Africa. A recent data leak has exposed that some employees of Alpha’s local branches pay officials for favourable conditions.

- b) Assess the applicability of the relevant UK corruption legislation. (5 pts)

Shortly after, Germany-based Beta AG makes an offer for the acquisition of all Alpha shares. Alpha’s BoD opposes the transaction and promptly approaches Gamma Ltd., a much smaller competitor domiciled in Ireland to evaluate options.

- c) What could be the intention of Alpha’s BoD? Discuss. (10 pts)

	<b>Points</b>
<b><i>a) 10 points total</i></b>	<b>10</b>
a) (subtotal 10 points)	
<u>Applicable to all listed companies:</u>	
Shareholders must have a vote on the remuneration policy (1)	1
Spanish legislation demands for a binding vote (1 extra)	1
Remuneration policy should contain criteria for fixed and variable pay (1)	1
Shareholders also have an advisory vote on remuneration reports (1)	1
Applicable EU provisions: art. 9a ff Shareholder Rights Directive II (1)	1
To date no obligation to link executive pay to the achievement of sustainability objectives (1)	1
But: Proposed art. 15 para. 3 Directive on Corporate Sustainability Due Diligence (1)	1
<u>If Alpha S.A is a financial service firm:</u>	
Disclosure of variable pay to staff with “material risk” (1)	1
Limitations on guaranteed variable pay: (2)	2
<ul style="list-style-type: none"> <li>- capped ratios</li> <li>- deferral of pay,</li> <li>- malus and clawback arrangements</li> </ul>	
Applicable EU provisions: Capital Rights Directives and Regulations (1)	1
<b><i>b) 5 points total</i></b>	<b>5</b>

b) (subtotal 7 points)	
Alpha defines as a multinational corporation (1)	1
Payments may qualify as bribery under UK Bribery Act of 2010 (1)	1
- Personal applicability: Applies to natural as well as legal persons (1)	1
- (Extra-)Territorial applicability: Prosecution is possible for actions in third countries if foreign organisations carry on part of their business in the UK; Alpha is active globally and hence probably also in the UK (2)	1
- Material applicability: Payments may be active bribery by local branches' employees that is attributable to Alpha (2)	1
<b>c) 10 points total</b>	<b>10</b>
c) (subtotal 13 points)	
Beta makes a takeover offer in the sense that it intends to acquire Alpha without prior agreement (1)	1
Alpha's BoD apparently attempts to frustrate the takeover by negotiating for an "inverse merger"/"corporate inversion" (2)	2
Definition: Strategic merger with a typically smaller party (1)	1
Further potential benefit (apart from frustrating Beta's plans): Change of residence for tax reasons since Ireland has low corporate taxes (1)	1
Gamma could act as a "white knight" (friendly acquirer) in the sense that it may have deep pockets and is willing to pay a higher price per share than Beta (2)	1
Discussion of quasi mergers (1 extra)	1
Need to act fast for Alpha's BoD since procedural requirements of security regulation apply, i.e. (short) cooling and offer periods in order to limit uncertainty (2)	1
Admissibility of Alpha's BoD's reaction:	
- Applicability of EU Takeover Directive (TD)/Spanish company law regarding defense tactics since Alpha has its registered office in Spain (2)	1
- Applicability of Board Neutrality Rule (art. 9 EU TD): Discussion of Bebchuk/Lipton Debate (2)	1
-	
<b>Total</b>	<b>25</b>

**Question 4 ( 20%; 20 points)**

Discuss the pros and cons of the principle of limited liability? Do you think all companies should qualify for limited liability? Why or why not?

	<b>Points</b>
Limited liability arises from the principle of separate legal personality. That shareholders cannot be held personally liable for the debts or liabilities of a company which is a separate legal entity from the shareholder.	1
Pros – incentivises shareholders to invest more capital when they know that they are only liable to lose the capital invested in the company and not have to pay more debts/liabilities of the company from the shareholders’ personal assets	1
Also, companies are protected from the creditors of shareholders by the principle of asset piercing.	2
Limited liability facilitates efficient management of business by focusing only on holding company responsibility for debts of company. It is an enabling basis for the company’s operations.	1
Limited liability facilitates separation of ownership and control – positive or negative for the economy/society.	2
Extra credit – Hirschman – how does limited liability affect exit, voice and loyalty	1-2
Cons – companies only exist because of the charters issued by governments/states – charters confer valuable privileges such as limited liability for owners (protecting against personal liability for company losses) and also protecting companies against the creditors of shareholders.	2
Salomon case – single shareholder owned company escapes debts incurred in the name of the company.	2
Should limited liability be limited in the case of small or large companies?	1
Should limited liability be limited by the extent of the shareholder’s control over the company	2
What should the corporation’s obligations be to society?	1
Piercing the corporate veil – are the criteria adequate for protecting against abuse of limited liability?	2
Criteria for piercing (or lifting) the veil. Fraud committed by shareholders/directors	1
Negligence/recklessness (Barings case)	1
Piercing the veil in case of corporate groups	1
Conclusion and summing up of overall argument	1
<b>Total</b>	<b>20</b>