Spring Semester 2011 - Gesellschaftsrecht II (10 June 2011)
Exam by Prof. Alexander / Prof. Vogt

Duration: 180 minutes
General Remarks:
- The examination includes 1 page and a total of 4 questions. Please check the number of pages as soon as you receive the exam as well as when you are turning in your answers.
- The examination is designed as "Open Book".

Grading:
- For grading purposes, each question will be valued equally:

Question 1, 2, 3 and 4 25% each Total 100%
Good luck!

Question 1 (25%)
The Lorry Group ('LG') was a freight company whose main business involved transporting goods by road and rail throughout the European Union. LG's equity shares were listed on the European Union Stock Exchange (EU stock exchange). LG's chief operating officer was Nigel Finger and one of LG's non-executive board members was Sir Malcolm Broadbent. In 2006, Broadbent and Finger both together personally invested 100 million euros in a property investment company called 'Westland Estates', which was controlled and managed by Broadbent. This investment was disclosed to the LG Board of Directors in 2006. In late 2007, the commercial property market dropped sharply in value. The value of Broadbent's and Finger's investment dropped from 100 million to 50 million euros. In 2008, Finger proposed to the LG Board that it buys the investment in Westland Estates from Broadbent and Finger for 50 million.

Before deciding whether to accept the offer, the LG Board has asked you to write a short memo about the legal issues raised by this proposed transaction.

Model Answer:
Main questions to address? (other questions may be relevant as well based on readings and lectures and will be considered)

- Did the initial investment transactions by Finger and Broadbent constitute corporate opportunities?
- Were the investment transactions by Finger and Broadbent related-party transactions?
- Are Finger and Broadbent permitted under general principles of corporate law and/or EU law to propose a sale of their investment to the LG board and if so what type of disclosure should occur?

Statement of relevant facts and issues

F and B are members of the management and board of LG. They may invest in other companies, but only under certain conditions involving disclosure to, and approval by, the board. In order to assess whether their joint investment in 2006 constituted a violation of corporate law and any related financial market regulation, it is necessary to examine their duties as corporate officers.

Insiders of a firm often possess specific information that may be relevant for determining the firm's value. Insiders are in position to divert firm value from shareholders to themselves by self-dealing. This could involve collusion to gain higher compensation, taking corporate opportunities available to the firm, and insider trading. As those transactions divert value from the firm and its shareholders to the corporate insiders, they are restricted – and sometimes prohibited – by corporate and capital market regulation. The rules regulating such transactions vary by jurisdiction: in the US fiduciary duties or the duties of care and loyalty owed by management to the firm are used as a general strategy to ensure ex post court review of such activity. Company law can also require board or shareholder approval of these activities. In the EU, prevention and control require robust disclosure obligations.

F and B invested in a company engaged in business separate from LG. The investment per se may have been an appropriate attempt to further their private wealth. However, if the individuals in question learned of the potential investment through their activity at LG and thus made use of a business opportunity that could have been taken by LG to its benefit, they may have used corporate information in violation of their legal duties as officers and directors..

Related party transactions

The investments taken by F and B were related-party transactions, which are not forbidden per se. However, to a degree, they may be reconcilable with or even necessary for profit maximisation. For example in a corporate group structure, an opportunity may be allocated to a subsidiary or other group member better able to take advantage of it. Managers may take certain opportunities because they can appropriate more of the marginal gains that accrue to the company; this incentivises the managers to make such gains in the first place. This may result in their accepting a lower salary or bonus, thereby saving money for the company. When such transactions reduce agency costs they may therefore be permissible. Conversely, where they exploit the company and expropriate shareholders, thereby increasing agency costs, a series of legal strategies should be used to limit or prevent this type of activity. Civil and criminal liability may used to reduce agency costs.

In the EU, where this case takes place, management is often encouraged to obtain board approval before taking a corporate opportunity. In this case, this was not done. To proceed, it is necessary to separate F and B. As a member of management, F is obligated to enhance shareholder value and may be liable for taking a corporate opportunity to the disadvantage of LG. As a board member B may also incur liability for certain behaviour, but is less likely even than F (whose risk of liability is low in the EU) to be liable.

Does the investment constitute a corporate opportunity? or whether the two individuals in question learned of it by virtue of their responsibilities at LG.

Does it matter that the 2 companies are engaged in different business sectors? These questions should be discussed in light of corporate law principles below.

Corporate opportunity

If it is established that a corporate opportunity was taken, it has to be determine whether this was permissible because it was in the interest of the company and its shareholders were expropriated. Through disclosure of the transaction to LG's board of directors who did not take action, there may be a presumption of legitimacy that the board had approved the transaction.

If a corporate opportunity, what type of remedy for shareholders?

If the opposite were true the board or in case it is conflicted or otherwise unable – the shareholder (via a derivative suit for damages to the company) could sue the two individuals in question for damages because of loss of corporate opportunity. They may also be civilly liable for failing to disclose such transactions under securities regulation, and possibly criminally liable for insider dealing.

Buying the company – discuss the advantages and disadvantages

Regardless of whether the investment by F and B was permissible, the company must consider the potential advantages and disadvantages of acquiring Westland at the present time. The shares in Westland have been devalued by a drop in the market. It is the interest of F and B to cut their losses and sell their share. If LG buys them it may incur a financial loss. However, the shares may also rise in values as the market recovers. This is supported by the fact the shares are being offered to LG at market value, a presumably accurate estimate of their worth. If this were the case F and B would presumably not want to sell their stake for such a large loss unless they were in need of liquidity. The company must act in its own best interest; the interest of shareholder value maximisation. In order to determine whether the investment would be good for LG, the company board should obtain independent advice on the matter. This cannot come from F and B as they may be conflicted cannot be permitted to decide on the acquisition. They may be tempted to engage in self-dealing or in transacting with LG on terms less favourable to the company than those that could be obtained at arm's length. Such transactions if overvalued can be challenged as disguised in some EU jurisdictions.

Generally, EU company law requirements on disclosure of related party transactions

Disinterested board approval required along with potentially ex-post shareholder ratification. Because it is a publicly traded company, the requirements on LG will be stricter regarding disclosure of the transaction and shareholder rights ability to be provided information about F and B engaging in such transactions.

EU directives on company law apply to publicly-traded companies and require disclosure of such related party transactions.

EU accounting regulation requires adherence to the International Financial Reporting Standards (IFRS), which requires disclosure annually on transactions with directors and executives.

Also, member state company law requires rules provide minority shareholders with the right to request and obtain a special independent auditor or expert investigation of the specific transaction.