



**University of  
Zurich** <sup>UZH</sup>

**Institute of Law**

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# **Agency Problems, Role of Board of Directors**

Gesellschaftsrecht (Master) – Lecture 2

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- L1 Introduction, Theory of the Firm, Common Principles of Corporate Law across Jurisdictions, Role of Shareholders (KA)**
- L2 Management & Agency problems, Role of Board of Directors (KA)**
- L3 Corporate Personality, Formation, Separate Legal Entity Principle, Limited Liability (KA)**
- L4 Investor Protection, Shareholder Control Issues, and Minority Shareholders Rights (DR)**
- L5 EU Free Movement (KA)**
- L6 Insider Dealing, Market Abuse and Fraud (KA)**
- L7 Data Law (DR)**
- L8 Corporate Finance, Capital Raising and Maintenance – The Prospectus and related requirements (KA)**
- L9 Compensation and Bonuses (DR)**
- L10 Corporate Governance, Stakeholders and Corporate Social Responsibility (KA)**
- L11 Takeovers and Mergers (KA)**
- L12 Role of Gatekeepers – Accountants, Auditors and Rating Agencies - a 'True and Fair View' (KA)**
- L13 Multinational corporate groups, Ethics, and Corruption (DR)**
- L14 Selected Topics and Exam Review (KA)**



# Review – Lecture 1

- *Coase*: contracts and transaction costs
- *Pigou*: regulation and externalities
- What is a corporation: private property of shareholders used to advance a common interest
- History
  - Royal charters: ecclesiastical, municipal & charitable
  - Merchant guilds (14th c). Colonial (16th c): E. India (1600), South Sea (1702), Commercial: Bank of England (1694)
- Corporate theories – contract, concession & communitaire models
- Attributes of the modern corporation
  - Separate entity with perpetual existence
  - Limited liability for corp obligations limited to corp property
  - Centralised management
  - Transferability of ownership interests



## Main points - Lecture 2

- Agency problems
- Legal and regulatory protections
- How might we explain the development of corporate law and its purpose? And what does this mean for the role of shareholders?
- What is the Board of Directors
- Fiduciary duties
- Business judgment rule
- Role of shareholders - Exit, Voice and Loyalty
- Changing role of shareholders



## Corporate law models

- Contractual model: ‘aggregate theory’ management acts in best interest of company, interests of shrs equated with ‘interests of the company’. But shrs can have different interest
- Berle and Means – separation of ownership and control, and the role of regulation in protecting small shareholders who lack incentive to monitor effectively because of coordination problems.
- Constituency or stakeholder model
- Enterprise model – corporate group management
- How to balance interests of shareholders & stakeholders?
- Management challenge: how to balance objectives & risk?



## Social responsibility and political activity

- Business aims to make money – increase wealth
- Should business engage in philanthropy as well?
- Corporate Social Responsibility (CSR) – *The Halo Effect*
- Large v small companies?
- Corporation as nexus of contracts, concession or communautaire – should the state be able to impose social responsibilities?
- *A.P. Smith manufacturing Co., v Barlow*, court upheld board of directors decision to make charitable contribution to university. Court referred to old notion of incorporation to pursue only a social good, but over time the goal of private business became focused on profit. Today, ‘calls upon the corporations for reasonable philanthropic donations have come to be made with increased public support.’



## What about BERLE AND MEANS? And modern developments – *BEBCHUK V LIPTON DEBATE?*

Separation of ownership and control, but modern markets

- Rise of institutional investors – agency problem within investors, See Strine article.
- Complex trading systems – electronic trading systems & high frequency trading
- Hostile takeovers
- Hedge funds
- Lipton & Rosenblum reject the ‘managerial discipline model’ and promote the ‘5-year plan’

***Institutional shareholders growing influence and potential for unifying ownership and control***



# Are political and economic factors more important than the contractarian model?

Patterns of corporate ownership result of political and economic factors (ie., restrictions on banks owning shares)

- 1) Less influence to market forces and need for shareholders to monitor agents
- 2) Institutional, social and cultural factors
- 3) More than one way to channel investment capital to a company

***Different theories of corporate evolution: evolutionary theory, path dependence, and chaos theory – which most appropriate theory?***



# Shareholders and Agency Problems (1/3)

## The principal-agent problem

- Shareholder – company manager
  - Creditors - Shareholder/managers
  - Shareholder – institutional investor/mutual or pension fund
  - Regulator (stakeholders/society) – company
- *Adverse selection, moral hazard – social costs*

***How best to achieve shareholder objectives  
while limiting other agency costs?***



# Shareholders and Agency Problems (2/3)

## The principal-agent problem

- Investor (principal) / Manager/employee (agent)
  - Agent's incentive to expropriate or steal the principal's assets
  - corporate law – governance structure to provide an appropriate degree of accountability among participants



## Shareholders and Agency Problems (3/3)

How to devise a complete contract to take account of investor's **wealth maximisation objective** while achieving **agent's objectives** (financial & non-financial compensation):

- Reducing information asymmetries - enhance principal's ability to monitor agent.
  - ***But never complete or full information for principal***
- Contract design to align incentives of principal and agent
  - ***How to design a 'complete contract'?***



## Role of shareholder (Hirschman's theory)

- Exit (or Entry)
- Voice
- Loyalty



## Exit

- ‘either or decision’
- economists favour ‘exit’
- market forces presumed to work efficiently

*Legal intervention ‘inefficient’ and will fail to achieve shareholder’s (the principal) goals*



## Voice

- Attempt to influence organisation
  - Remedy problems
  - Attend annual meeting and question the Board or Managers
  - Vote (or not) for Board members
- 
- ***Combination of exit and voice can lead to greater improvement, but . . .***



# Loyalty

- Determines whether shareholder takes a 'voice' or 'exit'
- Loyalty stronger to 'political' or 'social' organisations, than to 'economic' organisations
- How organisation structured and 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 shareholder

- 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'



## Corporate law theories (Common Law)

- Aggregate theory, UK Companies Act 2006 s. 33(1) ‘the provisions of a company's constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions...’ but limits on member enforcing the articles – rule of *Foss v Harbottle* (1843)
- Contractual relationships determinative of obligations/duties of Board
- Majority decision of contractors represents company will. Contractually negotiated rules of company governance by shareholders serves as will of the corporation.
- Corporation entitled to autonomy from state – classical laissez-faire approach – emerges as common western state practice in 19<sup>th</sup> century



## Corporate law models

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- Constituency or stakeholder model
- Enterprise model – corporate group management
- How to balance interests of shareholders & stakeholders?
- Management challenge: how to balance objectives & risk?

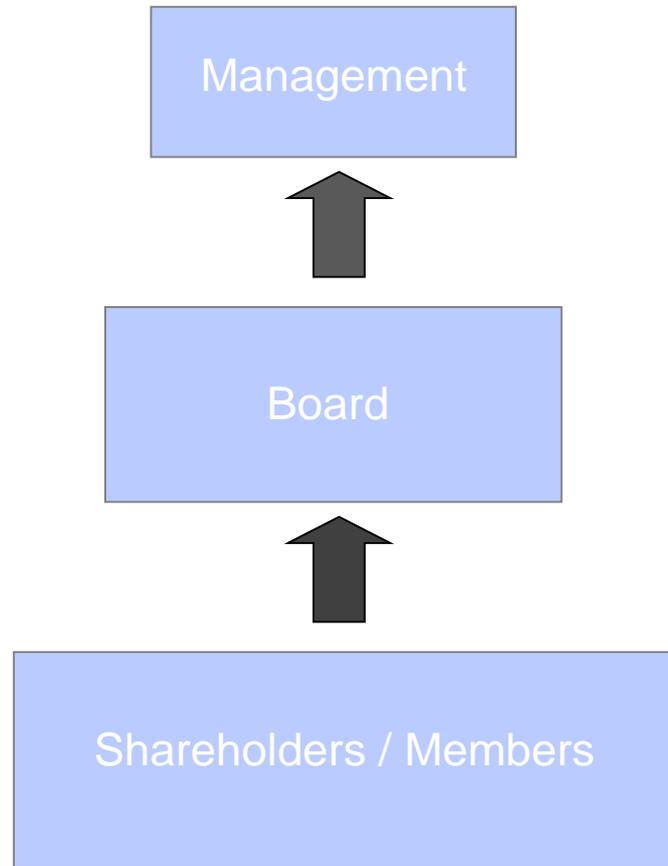


## Which model?

- Traditional view was based on ‘contracting theory’ to achieve ‘complete contracts’ – align incentives of principal & agent and effective (transparency) monitoring of agent
- Different legal doctrines and regimes may make the principal-agent worse - leading to poor resource allocation for society and possibly too much risk in financial markets ie., the credit crisis and corporate governance – the problems of the banks – UBS (2007), Citigroup (2008), Lehman Brothers (2008)



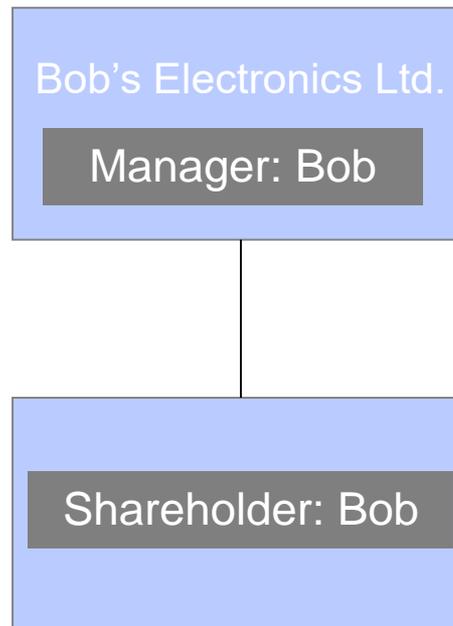
# The Company's Organs





## Closely Held Managed by Members

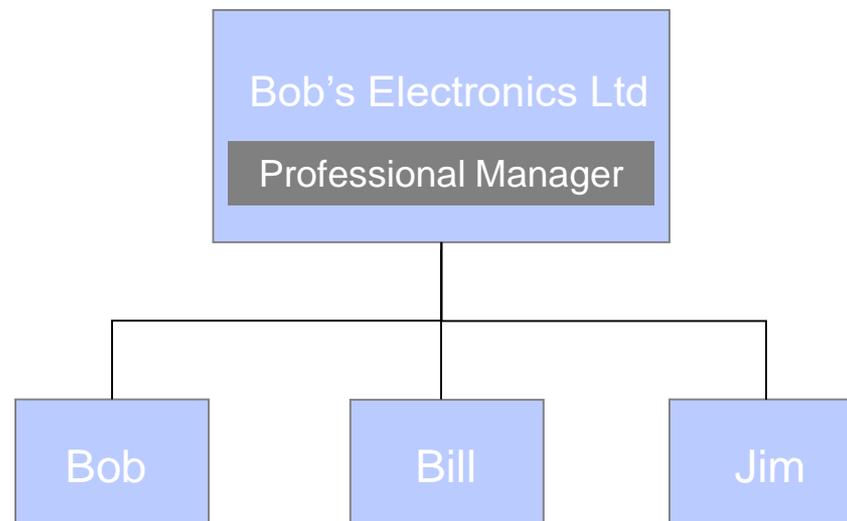
Manager and shareholder incentives completely aligned:





## Closely Held Professional Management

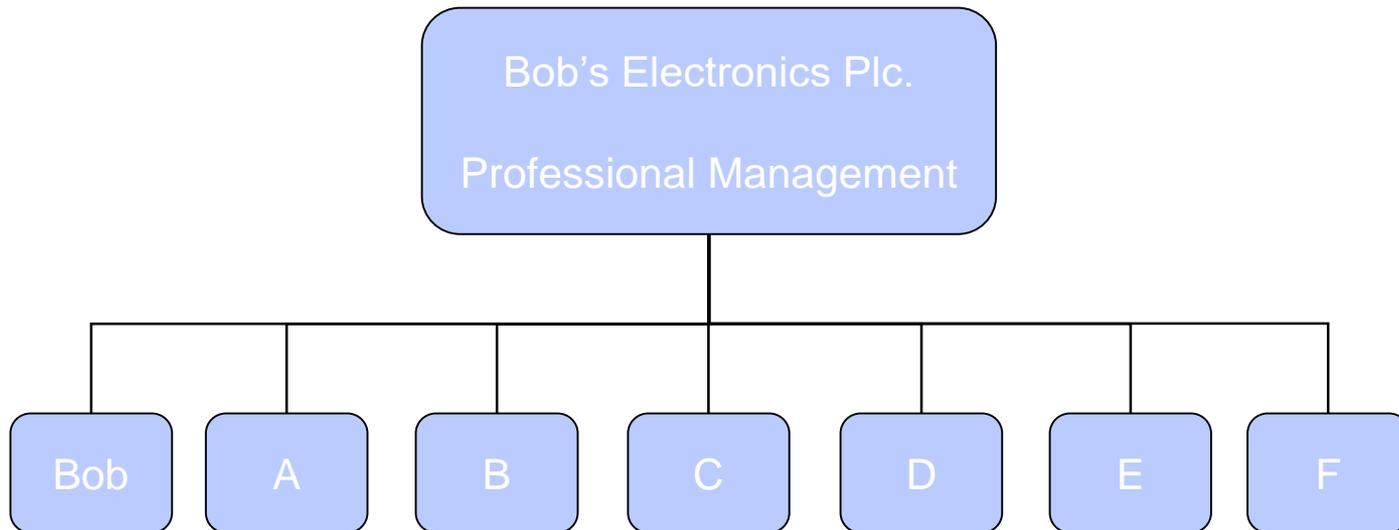
- Managerial and member incentives not fully aligned
- Agency costs
- Controlling agency costs: monitoring and member control
  - Power to appoint and remove the board
  - The board's power to appoint and remove management
  - Power to reserve certain matters to the shareholders





# Publicly Held Professional Management

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





## Legal and regulatory disclosure for investors will lead to...

- 1) Information leads to more efficient pricing of shares – reflecting market value based on available information
- 2) Enhancing quality of publicly-traded companies – through disclosure of information and shareholder pressure for performance



## Legal and regulatory disclosure

For company issuers, investor protection requirements are **conditions** for entering securities markets

- mandatory disclosure
- accounting reports/methodologies (fair value of assets)
- standardisation and comparability of data/information

Is the mandatory information to be disclosed to investors really helpful for investors in making investment decisions – financial crisis 2007/08 showed that information of complex securities were available in prospectuses but investors still made bad decisions

***What about the causes of investor behaviour –  
is it always rational?***



# Changing structure of securities markets and globalisation

- 1) Stock markets – organised exchanges
- 2) Rise of institutional investors who have incentive to ‘churn’ and to seek short-term share price performance
- 3) Deal market – broker to broker
- 4) Multilateral Trading Facility/systems (MTF) – electronic trading systems owned by investors

*Benefits – enhanced liquidity and equity-based compensation, market-based measures of performance (stock & bond prices), and a market for corporate control (ie., merger and acquisition)*



## Role of the Board of Directors

### Board

- Elected by shareholders to oversee the company
  - Executive members – CEO, CFO, other senior management
- Independent members (non-executive). Represent the interest of the company and its shareholders. Elected by shareholders by resolution at corporate meeting

- Fiduciary duties

Fiduciary principles are uncommon in contractual relations: because parties bargain at arms length and enforce their deals to the letter no matter how severe the consequences for the other side

- Investor rights – cannot foresee all future events. Investors contract locates uncertainties in the holders of residual claims. They receive few explicit promises except: right to vote and protection of interests



## Board duties – *Fiduciary Duties*

**‘to say that a man is a fiduciary only begins analysis: it gives direction to further inquiry. To whom is he a fiduciary? What obligation does he owe as a fiduciary?’ *Justice Felix Frankfurter, SEC v Cheney Corp.*, 318 U.S. 80, 85-86**



## Board duties – *Fiduciary* Duties in Swiss Law

### Art. 717 Swiss Code of Obligations (The Company Limited by Shares)

#### IV. Duty of care and loyalty

- 1 The members of the board of directors and third parties engaged in managing the company's business must perform their duties with all due diligence and safeguard the interests of the company in good faith.
- 2 They must afford the shareholders equal treatment in like circumstances.

#### See BGE 139 III 24 (Jurisprudence similar to the Business Judgment Rule)

- Shareholder claim for damage caused to the company due to unnecessary legal proceedings resulting in court and legal costs of about one million CHF
- The misuse of court proceedings can be seen as a breach of Art. 717 I OR (E. 3.3.)
- In the particular case were the court proceedings between the stock company and the minority shareholder not in the interest of the company, but in the mere interest of the majority share holder (E. 3.4,5)
- Breach of the duty of equal treatment (E. 3.4)
- General restraint of the Swiss Courts in the review of decisions of the board of directors



# Liability in Swiss Law

## Art. 754 Swiss Code of Obligations

### III. Liability for administration, business management and liquidation

- 1 The members of the board of directors and all persons engaged in the business management or liquidation of the company are liable both to the company and to the individual shareholders and creditors for any losses or damage arising from any intentional or negligent breach of their duties.
- 2 A person who, as authorised, delegates the performance of a task to another governing officer is liable for any losses caused by such officer unless he can prove that he acted with all due diligence when selecting, instructing and supervising him.

See BGE 139 III 24

- Differentiation between «direct damage» caused directly to the shareholders and «indirect damage» caused directly to the Stock Company but indirectly to the share holders



## Liability in Swiss Law

### BGE 139 III 24

Summary: Board denied shareholders to register their shares.  
The shareholders sued the board in order to be registered.

Direct damage: Damage the appellant had by the litigation.

Indirect damage: Damage the board caused through their decision,  
which reduced the value of the appellants' shares.

Ruling: The denial for registering the shares was not in the  
interest of the company and was in breach of the  
principle of equal treatment of the shareholders.  
Therefore, the board caused unnecessary costs for  
the company.



## To whom is he/she a fiduciary? *in corporate law*

- Board members (both executive and non-executive members)
- Duty to the company?
- Duty to shareholders?
- Or duty to both?

***Fiduciary duties help the shareholders to control divergent interests of managers and shareholders***



## Fiduciary principle

- 1) Optimal fiduciary rules approximate the bargain that investors and managers would have reached if they could have bargained and could enforce their agreements at no cost
- 2) The 'rules preserve the gains resulting from the separation of management from risk bearing, while limiting the ability of managers to give priority to their own interests at the expense of the firm' *Easterbrook & Fischel*
- 3) Distinction between management practices that harm investors' interests, and practices that at the same time benefit managers and investors
- 4) Fiduciary principles are meant to be rules for completing 'incomplete contracts'. Overcome high costs of contracting
- 5) Fiduciary duties have goal of overriding the high cost of expressly specifying things for all contingencies in a contract
- 6) Detailed contracting to address all future contingencies after firm established is almost impossible (ie., raising capital & strategy)



## Business Judgment Rule (US law)

- **Absolving managers of liability if their judgment is negligent. They are protected from making ‘stupid’ decisions**
- **Behind the business judgment rule is recognition that investors’ wealth would be lower if managers’ decisions were routinely subjected to strict judicial review. *Judicial deference***
- Justification: Fear of personal liability will cause corporate managers to be more cautious; the role of judges second-guessing managers
- It is better to insulate all honest (but dumb) decisions from review than to expose managers and directors to review by judges and juries who do not face market pressures.
- S.Ct case *Smith v. Van Gorkom* decided that business judgment rule only applies to decisions that are ‘informed’.



## Case Law: Parnes v Bally Entertainment Corp.

- Stockholder of Bally (plaintiff) challenged Bally/Hilton merger alleging Bally's director failed to exercise the business judgment rule in good faith (breach of fiduciary duties).
  - Chairman of Bally informed potential acquirers that in order to receive his consent to a merger sums of money and Bally assets would have to be transferred to him.
- Court of Chancery dismissed claim because plaintiff stated derivative claims and had no standing after merger, as it was no longer a shareholder.
- The Delaware Supreme Court concluded that the claims were direct as they directly challenged the fairness of the merger process.
- Regarding the breach of fiduciary duties, the Delaware Supreme Court held that the allegation in the complaint, if true, were *“so far beyond the bounds of reasonable business judgment that it seems essentially inexplicable on any ground other than bad faith”*.



## Case Law: Emerald Partners v Berlin

- Plaintiff, stockholder of May Petroleum Inc. (“**May**”) challenged merger of May with other corporation which increased the Chairman’s ownership of May to 73.5%.
- The Delaware Supreme Court rejected motion to dismiss based on the “*Entire Fairness Doctrine*”: Directors must establish to the court’s satisfaction that the transaction was the product of both fair dealing and fair price.
- However, this decision was subsequently not expanded upon and was called into doubt by the Court of Chancery.



## Duty of care, duty of loyalty and duty of disclosure

- Duty of care – to act as a prudent person does in the management of his own affairs of equal gravity.
- Duty of loyalty- to maximize the investors' wealth rather than one's own wealth (Swiss & UK).
- Distinction due to conflict of interest problem – decisions based on conflict of interest receive less judicial deference than general business decisions
- Duty to Disclose Conflicts and Material Interests



## Directors Duties: a Case Study

### Re Barings Plc (No 5)\*

- The collapse of the British bank Barings in February 1995 raised important issues regarding the scope and application of director's duties under the UK Company Directors Disqualification Act 1986 (CDDA)
- The conduct alleged in the claim involved lack of director supervision and monitoring of the dealings of a rogue trader, whose switching business seemed to generate substantial proportion of the Barings group's profits. In fact the business incurred losses in the order of £827 million, which caused the collapse of the bank.
- The court emphasised that even when a director has delegated a function, he remains responsible for the delegated function and retains a residual duty of supervision and control.
- The court found that the director's conduct involved serious incompetence in failing to understand and remain informed about the switching business. The deputy group Chairman was disqualified for 4 years; his conduct was described as «non-management». The product manager of the trader was disqualified for six years and found to have «failed to make any serious attempt to discharge his management responsibilities». Anthony Gamby was disqualified for 5 years and criticised for his «culpable degree of inactivity»

\*Secretary of State for Trade and Industry v. Baker (No. 5) [1999] 1 BCLC 433



## IOSCO encourages strong corporate governance standards

Senior management controls & director duties create a reasonable person standard for determining the duty of care and skill for bank directors & managers.

*A non-binding international standard.*



## Indemnification and insurance – a *Coasean* approach?

- For managers and directors for expenses incurred in litigation and against certain types of judgments.
- Contractual response to risk of liability
- Allow markets to contract around liability rules when markets are cheaper than courts.
- Exclusions for Bad Faith



## Conclusion - Which model?

- Traditional view was based on 'contracting theory'. Coasean and 'aggregate theory' aims to achieve 'complete contracts' – align incentives of principal & agent and effective (transparency) monitoring of agent
- Different legal doctrines and regimes may make the principal-agent problem worse - leading to poor resource allocation for society and possibly too much risk in financial markets ie., the credit crisis and corporate governance – the problems of the banks – UBS, Citigroup, Lehman Brothers



## Conclusion - Duty of Loyalty to company and/or shareholders?

- To whom should the duty be owed?
- Company
- Shareholder
- Combination of shareholder and company – how to assess?
- What about other Stakeholders?