Universität Zürich[UZH]

Corporate Personality & Consequences

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Review Lecture 2

- 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

Fiduciary Duties: US Case Law

Duty	Test for Whether Duty is Met	Remedy
Loyalty	Fair Process (approval by noninterested directors) or else burden on directors to show **ENTIRE FAIRNESS**	Injuction or Damages
Care	**BUSINESS JUDGEMENT RULE**	None, except in very extreme cases.
Disclosure	Disclose all material information when seeking shareholder approval, or when a conflict of interest exists.	Corrective disclosure or damages
Extra Care When Selling Company	No Clear Test; careful scrutiny of decision process.	Injuction or Damages

Directors Duties: a Case Study

- Re Barings Plc (No 5)*
  - 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:
    - 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 director's conduct involved serious incompetence in failing to understand and remain informed about the switching business.
    - The deputy group Chairman disqualified for 4 years: his conduct was described as «non- management».
    - Product manager of the trader disqualified for six years and found to have «failed to make any serious attempt to discharge his management responsibilities» & «culpable degree of inactivity»
- *Secretary of State for Trade and Industry v. Baker (No. 5) [1999] 1 BCLC 433

Smith v. Van Gorkom

- Trans Union Corp. (a producer of railcars) merged with a subsidary of the Marom Group, In., controlled by the Pritzker family.
- Trans Union for years had had investment tax credits, which it couldn't use up; the merger with Marmon permitted it finally to cash in on these.
- Every TU shareholder was paid $ 55 per share – a premium of approximately $20 over the market price.
- The board approving the merger consisted of several men with impeccable credentials. The five outside directors were:
  - a former dean of the University of Chicago Business School and chancellor of the University of Rochester, and the chief executives of IC Industries Holding Company, American Steel, U.S. Gypsum, and Swift and Company.
- Nevertheless, some shareholders, who thought the share price too low, brought suit.

Smith v. Van Gorkom

- Trans Union's chairman, Jerome Van Gorkom:
  - Had single-handedly put the deal together, had presented it to the board almost as a fait accompli
  - Had obtained the board's go-ahead in just two hours
  - Had never solicited the advice of an investment banker
  - Had signed the merger documents during a social affair for the benefit of the Chicago Lyric Opera after little more than a cursory reading.

Case Law: Parnes v Bally Entertainment Corp.

- June 6, 1996, Bally and Hilton entered into a stock-for-stock merger agreement pursuant to which Bally was to be merged with and into Hilton.
- On August 29, 1996, Linda Parnes, who was then a stockholder of Bally, filed this action against Bally, all of its directors, and Hilton.

"The complaint alleges that Bally's directors breached their fiduciary duties by entering into a merger agreement that was the product of unfair dealing and provided Bally's stockholders an unfair price. The complaint prays for a temporary and permanent injunction, among other forms of relief, but Parnes never sought judicial intervention to stop the merger".

Case Law: Parnes v Bally Entertainment Corp.

- Parnes (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".

"A **derivative claim** is one that is brought by a stockholder, on behalf of the corporation, to recover for harms done to the corporation. Since a stockholder suing derivatively is bringing a corporate claim, not a personal one, the stockholder must maintain his or her status as a stockholder in order to continue the litigation.

Stockholders may sue **on their own behalf** (and, in appropriate circumstances, as representatives of a class of stockholders) to seek relief for direct injuries that are independent of any injury to the corporation. A stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such a claim even after the merger at issue has been consummated. The problem is that it is often difficult to determine whether a stockholder is challenging the merger itself, or alleged wrongs associated with the merger, such as the award of golden parachute employment contracts."

Controlling Shareholders

- Controlling Stockholder:
  - ➢ controls a majority of the company's voting power:
    - "[C]ontrol exists when a stockholder owns, directly or indirectly, more than half of a corporation's voting power." (Weinstein Enters – 2005)
    - While courts typically frame majority holders as controlling stockholders, it is possible for even a majority holder not to be a controlling stockholder if that individual does not exercise control over a particular matter or the board (Williams v. Geier – 1996)
  - ➢ exercises "a combination of potent voting power and management control such that the stockholder could be deemed to have effective control of the board without actually owning a majority of stock" (Corwin v KKR – 2015)

Why Distinguishing Contr. vs Non-Contr. SHs.

Controlling Shareholders may have idiosyncratic goals beyond maximizing company returns and the ability to act in self-interest or achieve these goals (Often to the detriment of non-controlling stockholders)

Three conflicted behaviours:

- **A transfer-pricing scheme**: controlling stockholder uses artificially inflated or deflated prices to shift value from one company to another capturing the difference.
- **A company issuance of new shares to the controlling stockholder** or to an entity owned by the controlling stockholder at low prices;
- **Asset stripping**: the controlling stockholder sells the company's assets to another company owned by the controlling stockholder at a low price, or the opposite, in which the controlling stockholder forces the company to buy from another company owned by the stockholder at an inflated price.

Consequences on Controlling Shareholders

- Imposition of fiduciary duties:
  - Duty of Loyalty: A controlling stockholder act in the best interests of the company and its stockholders, not in the controlling stockholder's self-interest to the detriment of the company or other stockholders.
  - Fiduciary duties of disclosure and care
    - *Lynch v. Vickers Energy Corp.* a controlling stockholder violated the duty to disclose material facts by not revealing asset value estimates despite initiating a tender offer for a price that undervalued the assets.
    - In general: the duty of care the duty to make informed business decisions.
- Enhanced Transaction Scrutiny
  - Entire Fairness as a standard review (rather than Business Judgement Rule):
    - fair price (economic and financial considerations)
    - Fair dealing (timing, structure, negotiations, disclosures, processes, and consents).

The Sources

- National
- Supranational
- Self-Regulatory bodies
- International Principles:
  - **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.

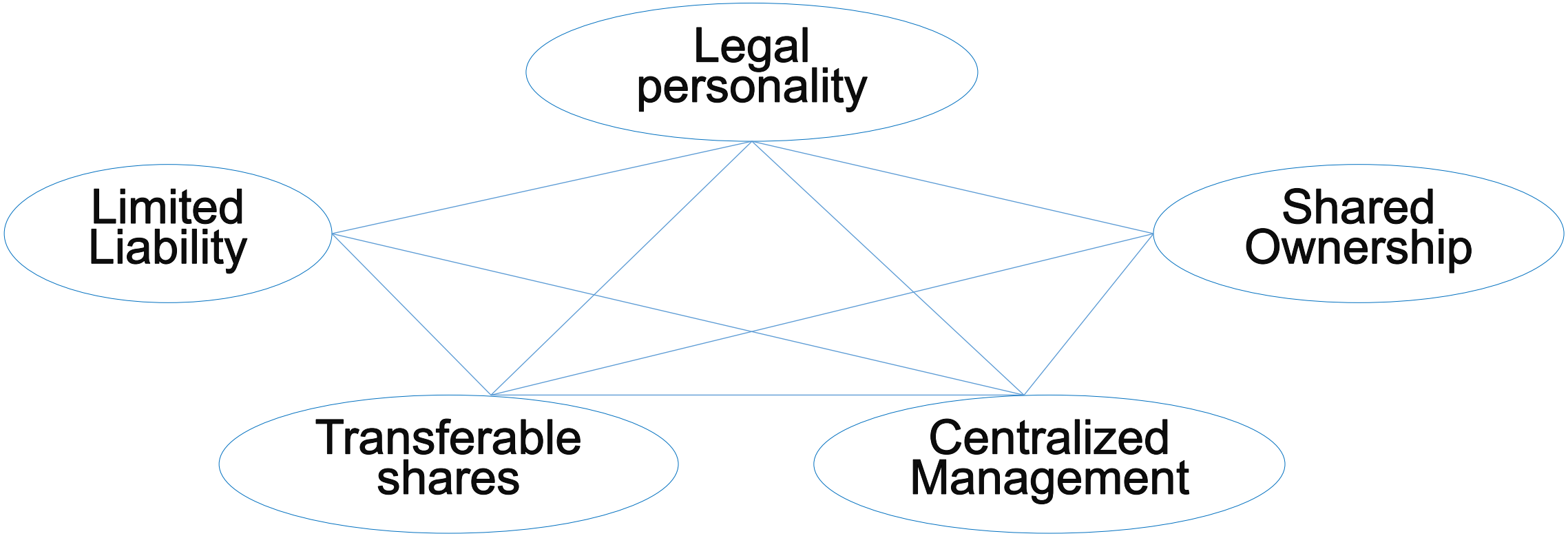
Conclusion

- Who are shareholders and their relationship to the board
- The role of the Board
- How to align incentives between Principal and 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

Corporate Personality & Consequences

- Limited Liability & Legal Personality
  - Emphasis on case Law
  - Salomon Principle & Piercing the Corporate Veil
  - Extension of this principle to Groups

What is a Corporation



Legal Personality

- Nexus of contracts? Better a nexus *«for»* contracts?
- The core element: Separate Patrimony
- 3 sets of rules:
  1) Separation of patrimony: **Entity shielding**
     - **a. Priority Rule:**
       - **i. Creditors of the firm, as security for the firm's debts, have a claim on the firm's assets that is prior to the claims of the personal creditors of the firm's owners.** (This rule is shared by modern legal forms for enterprise organization, including partnerships).
       - ii. Consequence:
         - a firm's assets are, as a default rule of law, automatically made available for the enforcement of contractual liabilities entered into in the name of the firm.
         - By thus bonding the firm's contractual commitments, the rule makes these commitments credible.
     - **b. Liquidation Protection (only for corporations and not for partnerships)**
       - i. The individual owners of the corporation (the shareholders) cannot withdraw their share of firm assets at will, nor can the personal creditors of an individual owner foreclose on the owner's share of firm assets.
       - ii. Such withdrawal or foreclosure would force partial or complete liquidation of the firm.
       - iii. Function**: to protect the going concern value of the firm against destruction by individual shareholders or their creditors**.
     - Legal entities characterized by both these rules have **"strong-form" entity shielding**, as opposed to the "weak-form" entity shielding found in partnerships (only priority rule)
     - By isolating the value of the firm from the personal financial affairs of the firm's owners, strong-form entity shielding facilitates tradability of the firm's shares

Legal Personality

1) Separate Patrimony
2) Rules specifying to third parties the individuals who have authority to buy and sell assets in the name of the firm, and to enter into contracts are bonded by those assets
3) Rules specifying the procedures by which both the firm and its counterparties can bring lawsuits on the contracts entered into in the name of the firm.

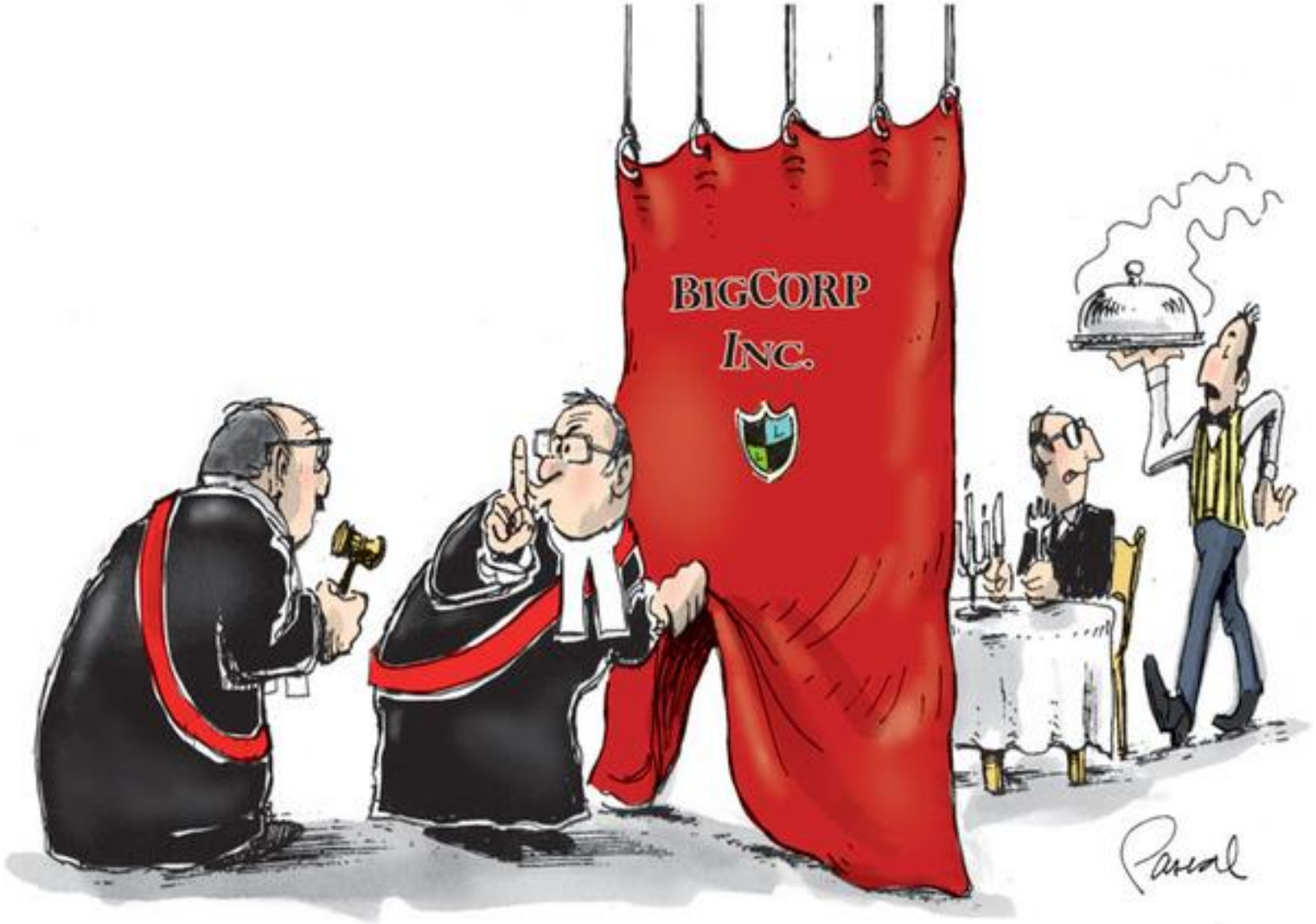
REDUCE THE COSTS OF DOING BUSINESS

Limited Liability

- Limited liability shields firm's owners from creditors claims
  - Economic consequences: ***favoring diversification***
- «Owner shielding» vs «Entity shielding»
  - ***Complementarity*** of the two:
    - Entity shielding protects the assets of the firm from the creditors of the firm's owners
    - Limited liability protects the assets of the firm's owners from the claims of the firm's creditors.

⇒ Ensure that business assets are pledged as security to business creditors, while the personal assets of the business's owners are reserved for the owners' personal creditors.

Lifting the corporate veil



Salomon v. Salomon: Facts (i)

- Salomon ran a boot making business as a sole proprietor.
- Due to a bad economy, his business started suffering.
- Salomon incorporated a company compromising of himself and his family, named Salomon Ltd, and transferred his sole proprietorship to the company for a sum of £39,000.
- Out of the £39,000, the company retained £20,000 and instead gave Mr. Salomon 20,001, out of 20,007(nominal value of £1 per share), of shares in the company. The remaining six shares were held by Salomon's family members.
- Additionally, Mr. Salomon further also received a floating security debenture of £10,000.
- The company, ran by Mr. Salomon as managing director, still couldn't pick up business and fell upon hard times.
- Mr. Salomon attempted to save the business by selling his debentures to Mr. Edmund for £5,000 and subsequently lending the £5,000 to the business and charging an interest rate of 10%.

Salomon v. Salomon: Facts (ii)

- The company still went into liquidation.
- The company was valued at £6,000.
- This amount was just enough to pay off Mr. Edmund (£5,000), who was a secured creditor.
- At the same time, Mr. Salomon intended to rely on his equitable interest in the debentures to claim the remaining £1,000:
  - he should be treated as a secured creditor and be paid ahead of the unsecured creditors who were owed by the company.
- Unsecured creditors argued that Mr. Salomon and the company were the same person and as a result, Salomon should not have priority over them.

Salomon v. Salomon

- **Was Mr. Salomon, who was the majority shareholder of Salomon Ltd, personally liable to pay off the debts the company owed to the unsecured creditors?**
- High Court and the Court of Appeal:
  - The company was a myth and Salmon had incorporated the company contrary to the intent of the Companies Act 1862.
  - The company was an agent of Mr. Salomon and as a result, concluded that Mr. Salomon should be liable to pay the debt incurred by the company during the course of its agency.
- House of Lords:
  - As long as a company was duly and properly incorporated, it should be seen as an independent person under the eyes of law.
  - Mr. Salomon was not personally liable to pay the debts of the company and also established the "corporate veil" between the company and its owners/shareholders
- Corporate veil: A separation between the identity of the company (separate legal identity) and the identity of the owners/shareholders.

“The unsecured creditors of Salomon and Company, Limited, may be entitled to sympathy, but they have only themselves to blame for their misfortunes. They trusted the company, I suppose, because they had long dealt with Mr. Salomon, and he had always paid his way; but they had full notice that they were no longer dealing with an individual, and they must be taken to have been cognizant of the memorandum and of the articles of association.”

Lord Macnaghten

Exceptions to the corporate veil

- Preventing those with fraudulent tendencies from hiding behind the corporate veil
- Exceptions:
  - Wrongful Trading: a director knew or should have reasonably known that the company is insolvent/likely to be insolvent and did not take appropriate measures for minimizing creditor's losses
  - Fraud: Standard Chartered Bank v. Pakistan National Shipping Corporation
    - A company director accused of fraudulent misrepresentation could not escape liability on the basis that the fraud was not committed on behalf of himself personally but on behalf of his company. In addition, there was no common law defence of contributory negligence available to him in circumstances where the claimant acted upon the false representation.
  - Evasion of legal duty: Petrodel Resources Ltd. V. Prest
  - Agency:
    - A company can act act as an agent if its members i.e. directors/SHs authorize the company to do so.
    - Individual members are bound by the acts of the company (agent) as long as those actions are within the scope of authority.
    - Directors/shareholders may potentially become personally liable for the acts of the agent company

where a director or a company:

(1) are in **control** of a company or **group of companies**, and

(2) are

(i) guilty of a crime, domestic or international as defined in the relevant law,

(ii) a corporate or personal tort, or

(iii) use the company as a sham, facade or to perpetrate fraud, or

(iv) use the corporate structure to avoid existing legal liabilities and obligations that will foreseeably become legally enforceable (like prospective contract, enforceable labour rights, payments, foreseeable litigation etc), or

(v), for any other reason which the courts have deemed appropriate to lift the corporate veil, and

(3) have done so with **male fides or in bad faith**, capriciously and without legitimate commercial interests

The director or company are liable and should not be permitted to hide behind the artificial corporate structure to escape accountability.

Case Law

- *Macaura v. Northern Assurance Co.* [1925] – House of Lords refused to lift the veil

- «Abuse of the Corporate Form» :
  - *Jones v. Lipman* [1962] – Court lifted the veil because company was a sham
  - Gilford Motor Company LTD v. Horne

Macaura v. Northern Assurance Co. [1925]

- Mr Macaura sold all timber to a company (Irish Canadian Saw Mills Ltd) in which he and his nominees held all the shares.
- Mr Macaura insured the timber against fire on policies in his own name.
- After two weeks, a fire broke out and he claimed the insurance.
- The insurance company Northern Assurance Co Ltd:
  - Mr Macaura did not have an insurable interest as a shareholder in the company. They argued that the company is a separate legal entity.
- Lord Sumner: “His relation was to the company, not to its goods”
- Lord Wrenbury: “The corporator, even if he holds all the shares, is not the Corporation, and neither he nor any creditor of the company has any property legal or equitable in the assets of the corporation”
- Lord Buckmaster: “The shareholders’ interest is limited to a share in the profits while the company continues to carry on business and a share in the distribution of the surplus aassets when it is wound up – whereas the interest of the Company is in the property which it owns”

Jones v. Lipman

- Mr. Lipman had agreed to sell a freehold property to the plaintiffs.
- Prior to completion he:
  - set up a limited company (in his absolute control)
  - sold the property to that company: the sole intention to deny the plaintiffs the remedy of specific performance against both Mr. Lipman and the comp.
- The Company was a “mask which [Mr. Lipman] holds before his face in an attempt to avoid recognition by the eye of equity”
- Specific performance against Mr. Lipman and the company

Gilford Motor Company LTD v. Horne

- Horne was an ex-employee of the Gilford Motor.
- A clause in his contract of employment with them prevented him from setting up in competition with the company following the termination of his contract.
- Mr. Horne was concerned to avoid contraveining his agreement and so incorporated a limited company in his wife's name in order to carry on such a competing business.
- The Court of Appeal: "the company was formed as a device, a stratagem, in order to mask the effective carrying on of business of Mr. Horne.
- In view of this sham, the Court of Appeal declined to recognize separate legal personality of the limited company and granted Gilford the injunction which it sought, against both Mr. Horne and the defendant company

Daimler Co Ltd v Continental Tyre & Rubber

- Continental Tyre & Rubber was incorporated in England however all the shareholders and directors except one were German Nationals.
- In 1914 there was an outbreak of war between the two nations.
- Continental Tyre & Rubber sued Daimler Co Ltd for an unpaid debt.
- The argument of Daimler Co Ltd:
  - Continental Tyre & Rubber was an alien enemy and it was illegal to trade with an enemy, and further wanted to avoid funds going towards the Germans war effort.
- The court had to consider whether they would lift the corporate veil and inquire as to the nationality of the shareholders and consider the ownership of the company.
- As a matter of national emergency, the corporate veil could be lifted, and was. Daimler Co Ltd did not have to pay Continental Tyre & Rubber the debt due.

Corporate Groups

- Group: an aggregation of enterprises that form a business unit, with entities retaining their legal independence.
- Common law countries
  - UK: Statutory rules or court principles
    - Adams v. Cape Industries [1990] = strict application of the Salomon principle even though the group had been restructured so as to avoid liability
- Civil law countries
  - Germany: “Konzernrecht” = law of groups
- EU law does not regulate veil piercing in context of corp groups
  - Draft EC Ninth Company Law Directive on the conduct of groups was withdrawn

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Adams v. Cape Industries

- Adams worked for an American subsidiary of Cape Industries (an English firm in the business of marketing asbestos).
- Adams became ill due to his exposure to asbestos dust. When he sought to sue the American subsidiary, he discovered that it had no assets to speak of.
- He brought an action against Cape Industries: the two companies should be treated as being part of one and the same economic enterprise.
- The court:
  - the two companies were entirely separate as a matter of law, even though it was accepted that the corporate structure between Cape Industries and its American subsidiary was designed to minimize legal liability and taxation.

Unsuccessfull arguments

- **Purpose: to establish that Cape had been present in the United States.**

1. A single economic unit argument:
   - Cape and its subsidiaries were in reality one economic unit which should be treated by law as such.
2. Corporate veil argument:
   - the corporate form was nothing more than a façade concealing the true facts of a situation and which could be drawn aside if legally expediency dictated such a move appropriate.
3. Agency based argument:
   - The subsidiaries were merely agencies making contracts for their principal, the holding company.

- The Court of Appeal:
  - on grounds of pure legal doctrine, it was not entitled to lift the corporate veil against a defendant company, which was a member of a corporate group, simply on the grounds that the corporate structure had been used so as to ensure that legal liability in regards to the particular future activities of the group would fall on another member of the group rather than on the defendant company.
  - Contention dismissed: a corporate veil should be pierced merely because a group of companies operated as a single economic entity in terms of business reality.