Family Firms and Closed Companies in Germany and Spain

Edited by
HOLGER FLEISCHER, ANDRÉS RECALDE,
and GERALD SPINDLER

Max-Planck-Institut für ausländisches und internationales Privatrecht

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Mohr Siebeck

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Preface

Family firms and closed companies in general play a crucial role in economic development across the globe. They are the most widespread form of business organization today, and this is particularly true for Germany and Spain. Despite all this, they have been neglected as a research topic for many years. More recently, however, there are signs that the academic tide is turning: Family firms and closed companies are slowly, but steadily receiving more attention in law schools and business schools. This encouraged us to make them the focus of our German-Spanish symposium, to take stock of the current state of legal research in this area and to explore promising avenues for future research.

This volume is based on the updated presentations delivered at the German-Spanish symposium in March 2019 at the Max Planck Institute for Comparative and International Private Law in Hamburg. We would like to thank all participants for their valuable and much appreciated contributions. Janina Jentz, Jennifer Trinks and Ina Freisleben took care of the editing process, and their help is gratefully acknowledged. Last, but not least, our sincere thanks go to Jocasta Godlieb and Michael Friedman for providing valuable language editing service.

Hamburg, Madrid and Göttingen,
November 2020

Holger Fleischer
Andrés Recalde
Gerald Spindler

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Abbreviations

AAMN	Anales de la Academia Matritense del Notariado
AcP	Archiv für die civilistische Praxis
ADC	Anuario de Derecho Civil
AG	Aktiengesellschaft / Die Aktiengesellschaft (Journal)
AktG	Aktiengesetz
Am. J. Comp. L. Supp.	The American Journal of Comparative Law Supplements
AP	Audiencia Provincial
Ariz. L. Rev.	Arizona Law Review
BB	BetriebsBerater
BeckRS	Beck-Online (Rechtsprechung)
BEE	Boletín de estudios económicos
Berkeley Bus. L. J.	Berkeley Business Law Journal
BGB	Bürgerliches Gesetzbuch
BGBl.	Bundesgesetzblatt
BGH	Bundesgerichtshof
BGHZ	Entscheidungen des Bundesgerichtshofes in Zivilsachen
Brook. J. Int'l L.	Brooklyn Journal of International Law
BT-Drs.	Bundestagsdrucksache
CA	United Kingdom Companies Act
Cal. L. Rev.	California Law Review
Cambridge L. J.	Cambridge Law Journal
CC	Código Civil
CCom	Código de Comercio
CDC	Cuadernos de Derecho y Comercio
CEO	Chief Executive Officer
cf.	confer
CFO	Chief Financial Officer
Clev. St. L. Rev.	Cleveland State Law Review
Colum. L. Rev.	Columbia Law Review
CP	Código Penal
CPI	Consumer Price Index
DB	Der Betrieb
DGRN	Dirección General de los Registros y del Notariado
DNotZ	Deutsche Notar-Zeitschrift
DStR	Deutsches Steuerrecht
EBOR	European Business Organization Law Review
ECFR	European Company and Financial Law Review
ECL	European Company Law

ECLE	European Company Law Experts
ed(s).	edition/editor(s)
e.g.	exempli gratia
et al.	et alii/aliae/alia
et seq.	et sequens
EU	European Union
Eur. J. Law Econ.	European Journal of Law and Economics
FBR	Family Business Review
Fordham L. Rev.	Fordham Law Review
FuS	Zeitschrift für Familienunternehmen und Strategie
GDP	Gross Domestic Product
GmbH	Gesellschaft mit beschränkter Haftung
GmbHG	Gesetz betreffend die Gesellschaften mit beschränkter Haftung
GmbHG-E	Entwurf für ein Gesetz betreffend die Gesellschaften mit beschränkter Haftung
GmbHR	GmbH-Rundschau
Harv. Int'l L. J.	Harvard International Law Journal
Harv. L. Rev.	Harvard Law Review
HGB	Handelsgesetzbuch
Hous. Bus. Tax L. J.	Houston Business and Tax Law Journal
i.e.	id est
INE	Instituto Nacional de Estadística
J. Corp. L.	Journal of Corporation Law
J. Econ. Persp.	Journal of Economic Perspectives
JFBS	Journal of Family Business Strategy
J. Finance	The Journal of Finance
J. Fin. Econ.	Journal of Financial Economics
JM	Juzgado de lo Mercantil
JME	Journal of Monetary Economics
JUR	Sentencias y autos de la Audiencia Nacional, Tribunales Superiores de Justicia, Audiencias Provinciales y Juzgados Aranzadi
JZ	JuristenZeitung
KG	Kommanditgesellschaft
LC	Ley Concursal
LEC	Ley de Enjuiciamiento Civil
LLC	Limited Liability Company
LLM	La Ley Mercantil
LMV	Ley de Mercado de Valores
LSA	Ley de Sociedades Anónimas
LSC	Ley de Sociedades de Capital
MAB	Mercado Alternativo Bursátil

marg. no.	margin number
MBCA	Model Business Corporation Act
MittBayNot	Mitteilungen des Bayerischen Notarvereins, der Notarkasse und der Landesnotarkammer Bayern
NJW	Neue Juristische Wochenschrift
NZBLQ	New Zealand Business Law Quarterly
NZG	Neue Zeitschrift für Gesellschaftsrecht
Ohio St. L. J.	Ohio State Law Journal
OLG	Oberlandesgericht
OLGR	OLG-Report
p.	page
para.	paragraph
RabelsZ	Rabels Zeitschrift für ausländisches und internationales Privatrecht
RCDI	Revista Crítica de Derecho Inmobiliario
RD	Real Decreto
RDBB	Revista de Derecho Bancario y Bursátil
RDCyP	Revista de Derecho Concursal y Paraconcursal
RDGRN	Resolución de la Direción General de los Registros y del Notariado
RDLeg	Real Decreto Legislativo
RDM	Revista de Derecho Mercantil
RDP	Revista Aranzadi de Derecho Patrimonial
RdS	Revista de Derecho de Sociedades
REFC	Revista Española de Financiación y Contabilidad
RG	Reichsgericht
RGD	Revista General de Derecho
RGLJ	Revista General de Legislación y Jurisprudencia
Riv. dir. civ.	Rivista di diritto civile
Riv. soc.	Rivista delle società
RIW	Recht der Internationalen Wirtschaft
RJ	Repertorio de Jurisprudencia Aranzadi
RJC	Revista Jurídica de Cataluña
RJN	Revista Jurídica del Notariado
RPT	Related Party Transaction
RQFA	Review of Quantitative Finance and Accounting
RRM	Reglamento del Registro Mercantil
RTDcom.	Revue Trimestrielle de Droit Commercial
RTDF	Revue Trimestrielle de Droit Financier
S.A.	Sociedad Anónima
SE	Societas Europea
sent.	sentence
S.L.	Sociedad de Responsabilidad Limitada
SME	Small and Medium-sized Enterprise
SPE	Societas Privata Europaea

SPV	Special Purpose Vehicle
SRD II	Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (Shareholder Rights Directive II)
Stan. L. Rev.	Stanford Law Review
StGB	Strafgesetzbuch
TS	Tribunal Supremo
UK	United Kingdom
UMAG	Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts
U. Pa. L. Rev.	University of Pennsylvania Law Review
US/USA	United States of America
Va. L. Rev.	Virginia Law Review
vid.	vidit
Vol.	Volume
Wash. & Lee L. Rev.	Washington and Lee Law Review
Yale J. Int'l L.	Yale Journal of International Law
Yale L. J.	Yale Law Journal
ZCG	Zeitschrift für Corporate Governance
ZfB	Zeitschrift für Betriebswirtschaft
ZGR	Zeitschrift für Unternehmens- und Gesellschaftsrecht
ZHR	Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht
ZIP	Zeitschrift für Wirtschaftsrecht

An Introduction to Law and Management of Family Firms

Holger Fleischer

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I. Introduction

Family businesses have long been neglected as a research topic, both from a legal and economic perspective.[1] They share this fate with closed companies

[1] From an economic point of view *I. Lansberg/E. L. Perrow/S. Rogolsky*, Family Business as an Emerging Field, FBR 1 (1988) 1, 3: "Until very recently, neither organiza-

in general, dominating the corporate landscape nearly everywhere in terms of numbers,[2] but nonetheless outweighed by large listed stock corporations in terms of academic attention. From an economic point of view, the scholarly neglect of family firms is partly due to the paucity of readily available data that makes empirical research difficult.[3] From a legal point of view, one of the main reasons lies in the significant dynamics of capital market regulation which have fascinated many business law professors over the last two decades, leaving them little time for supposedly old-fashioned corners of company law. However, there are signs that the academic tide is turning: Family firms are slowly, but steadily receiving more attention in law schools and business schools.[4] This encouraged us to make them the focus of our German-Spanish Symposium, to take stock of the current state of legal research on family businesses and explore promising avenues for future research.

This introductory paper addresses four major topics which will be dealt with one after the other: First, it explains in detail why we should be interested in family firms (II.) Second, it points out what makes family businesses different from other businesses (III.). Third, it takes a closer look at the legal forms in which family firms are organized (IV.). Finally, it analyses the governance framework for family businesses through the lens of company law and contract law (V.).

II. Why Should We be Interested in Family Firms?

As regards the motivation for a closer look at family firms, three points seem to be worth highlighting.

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tional nor family theorists have paid much attention to family businesses."; from a legal point of view *B. Means*, The Contractual Foundation of Family-Business Law, Ohio St. L. J. 75 (2014), 675: "Most U.S. businesses are family owned, and yet the law governing business organizations does not account adequately for family relationships. Nor have legal scholars paid sufficient attention to family businesses."

[2] For a comparative account *H. Fleischer*, The Law of Close Corporations, in: Schauer/Verschraegen (eds.), General Reports of the XIXth Congress of the International Academy of Comparative Law (Cham 2017) 319 et seq.

[3] See also *Lansberg/Perrow/Rogolsky, supra* note 1, 3 et seq., putting forward other important reasons as well: "[R]esearchers find it difficult to study both the family and the business simultaneously. They are trained in one field or the other, and they have gained entry through only one of the two systems."

[4] See *F. W. Kellermann/F. Hoy*, Introduction to the Family Business Companion, in: Kellermann/Hoy (eds.), The Routledge Companion to Family Businesses (New York 2017) 1: "Family firm research has seen an exponential growth in output, quality and topics studies. Despite the youth of the field, growing academic interest has been documented through the publication of annotated bibliographies, reflection pieces, literature reviews, meta-analyses and edited volumes."

1. Family Firms are Fashionable

To begin with, family firms are fashionable. They seem to be everybody's darling these days. Management thinkers like them because family businesses are considered to take a longer-term view than other firms.[5] They are a regarded as a bulwark against short-termism and myopia, under such key terms as patient capital and sustainability.[6] Politicians like family firms as well because they provide lots of relatively secure jobs and hesitate to lay off staff in times of crisis.[7] And the public also likes them because they think family firms are more in touch with local communities than firms owned by anonymous shareholders or foreign institutional investors.[8]

2. Family Businesses as the Backbone of the Economy

Moreover, and more importantly, family firms play a crucial role in economic development across the globe. They are the most widespread form of business organization today,[9] and this is particularly true for Germany. Here, the Foundation for Family Businesses has been investigating the economic significance of family businesses on a regular basis for more than a decade.[10] These are the current figures:

- Family firms account for 90% of all privately-organized firms in Germany,
- they employ 58% of the private sector workforce,
- they generate 52% of the total turnover in the private sector.[11]

In addition to those data, here are some more remarkable facts from a comparative perspective:

Compared to other modern industrialized economies, there is a high percentage of very large family firms in Germany almost all of which are household names. The illustrious list of the 500 largest family businesses in terms of turnover is headed by the *Schwarz*-Group, operating under the brand name

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[5] See "Schumpeter Reluctant Heirs", The Economist, 5 December 2015, 67.

[6] See *S. Sharma/P. Sharma*, Patient Capital. The Role of Family Firms in Sustainable Business (Cambridge 2019).

[7] "Schumpeter Reluctant Heirs", *supra* note 5, 67.

[8] "Schumpeter Reluctant Heirs", *supra* note 5, 67.

[9] See *A. Cahn/D. C. Donald*, Comparative Company Law (2nd ed., Cambridge 2018) 558: "Available data shows family firms to be widespread, if not dominant, in most economies."; *T. Zellweger*, Managing the Family Business (Cheltenham 2017) 24: "Depending on the definition one uses, roughly 70% to 90% of all firms across the globe are family firms. However, given the lack of a shared definition among the studies on this topic, the exact estimates and their international variation should be taken with a grain of salt."

[10] Beginning with *Stiftung Familienunternehmen*, Die volkswirtschaftliche Bedeutung der Familienunternehmen (1st ed., Munich 2007).

[11] Figures taken from *Stiftung Familienunternehmen*, Die volkswirtschaftliche Bedeutung der Familienunternehmen (5th ed., Munich 2019) 7.

"Lidl", the fourth-largest retailer in the world, and *Robert Bosch*, producer of automotive components, followed by the *Aldi-Group*, again a discounter, the *Metro*-Group, the *Phoenix*-Group, *Heraeus*, *Henkel*, *Bertelsmann*, *Boehringer Ingelheim* and *Merck*.[12] Depending on the definition[13] one may also add the carmakers *Volkswagen* and *BMW* to this list, as a leading German newspaper does in its most recent survey of family firms[14]: *Volkswagen* had a workforce of 671,000 employees worldwide and generated a turnover of 252,000 billion Euros in 2019, making it the second largest enterprise in Europe, second only to *Royal Dutch Shell*.

Furthermore, a huge majority of the so-called hidden champions[15] in Germany, highly specialized, unknown world market leaders in niche markets, e.g. in the engineering and automotive industries, are family firms.[16] In fact, two-thirds of those hidden champions are family-owned and managed. Overall, one-third of German family firms are exporters which lies at the root of the often-lamented German trade surplus in Europa and the world. In fact, the 500 largest family firms in Germany are almost all globally oriented and have just expanded their foreign market dealings to amount to more than 50% of their total sales.[17]

Another interesting fact, albeit often overlooked, is the enormous importance of family firms in underdeveloped rural areas; family firms are key figures in the countryside as taxpayers and employers.

Finally, it is worth mentioning that the top 500 family firms in Germany are on average 101 years old; 26 of them were founded before 1800.[18] The median is in the year 1926, meaning that half of this sample of family businesses were founded in or before that year. The oldest German family businesses are the *Coatinc Company Holding GmbH*, a galvanizing company from Siegen in North Rhine-Westphalia (1502), the *William Pry Holding GmbH*, a company for sewing accessories and automotive supplier from Stolberg near Aachen (1530), and *Freiherr von Poschinger Glasmanufaktur*, a glazier from Frauenau

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[12] See *Stiftung Familienunternehmen, supra* note 11, 29.

[13] See *infra* III.1.

[14] See "Die großen deutschen Familienunternehmen", Frankfurter Allgemeine Zeitung, 8 July 2020, 22.

[15] Coining this term *H. Simon*, 'Hidden champions': Speerspitze der deutschen Wirtschaft, ZfB 60 (1990) 9.

[16] Explaining the background in depth *H. Simon*, Hidden Champions, Lessons from 500 of the World's Best Unknown Companies (Boston 1996); more recently *H. Simon*, Hidden Champions of the Twenty-First Century: The Success Strategy of Unknown World Market Leaders (New York 2009).

[17] See *Stiftung Familienunternehmen, supra* note 11, 42.

[18] See *Stiftung Familienunternehmen, supra* note 11, 30.

in Bavaria (1568).[19] This list unequivocally shows that family firms have always been a formative part of Germany's business landscape.[20]

3. Family Business Studies and Family Business Law as Emerging Research Fields

Given the economic importance of family firms, it comes as no surprise that they have increasingly triggered academic interest worldwide, both at business and law schools. Business practitioners took the lead, with the first Family Business Center founded in 1962 in Cleveland, Ohio.[21] The first Chair in family business in the US was established in 1978 at Baylor University, the first European Chair in 1987 at IESE in Spain.[22] A major step forward in creating a new field of research was the establishment of the "Family Business Review" in 1988, the first journal devoted exclusively to publishing research on family firms.[23] Today, we find plenty of evidence that family business studies is a subject in its own right[24] with annual conferences on family enterprises, specialized textbooks[25], handbooks[26] and two other journals, the "Journal of Family Business Strategy" launched in 2010 and the "Journal of Family Business Management" launched in 2011.

Legal scholarship is lagging behind. Family business law, the law of family firms, as a separate field of study is almost non-existent at major US and UK law schools. It is a playground for corporate practitioners, for tax and estate planners,[27] but not, as many scholars seem to think, for serious legal research – many may be reminded of the old joke about the famous 'non-

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[19] According to the list published by the *Stiftung Familienunternehmen*, Die ältesten Familienunternehmen Deutschlands, 6 July 2019.

[20] For more illustrations see the family firms covered in *W. Seidel*, Die ältesten Familienunternehmen Deutschlands (Munich 2019).

[21] See *D. B. Parsons/C. Clarke*, Family Business Centers, in: Kellermann/Hoy (eds.), The Routledge Companion to Family Businesses (New York 2017) 580: "Leon and Katie Danco created the first family business center in 1962 in Cleveland, Ohio. The Danco's Center for Family Businesses was independent of any supporting organization."

[22] See *P. Sharma/L. Melin/M. Nordquist*, Introduction: Scope, Evolution and Future of Family Business Studies, in: Melin/Nordquist/Sharma (eds.), The SAGE Handbook of Family Business (Los Angeles 2014) 1, 12.

[23] Explaining the academic motivation behind this the Editors' Notes by *Lansberg/Perrow/Rogolsky, supra* note 1, 1 et seq.

[24] Emphasizing this point *Sharma/Melin/Nordquist, supra* note 22, 1: "Family business studies is a multidisciplinary field of research that is distinguished from its sister disciplines by its singular focus on the paradoxes caused by the involvement of family in business."

[25] See, e.g., *T. Zellweger*, Managing the Family Business. Theory and Practice (Cheltenham 2017).

[26] See, e.g., L. Melin/M. Nordquist/P. Sharma (eds.), The SAGE Handbook of Family Business (Los Angeles 2014).

book', *Law of the Horse* consisting of five chapters: Chapter 1: Contracting for a Horse, Chapter 2: Owning a Horse, Chapter 3: Torts by a Horse and Chapter 4: Litigating over a Horse.[28] The upshot here is that the horse is not a very useful organizing principle for the study of law.[29]

This is different with family firms which offer the necessary *distinctiveness* for a new field of legal study.[30] Family business law occupies a distinctive factual context at the intersection of different disciplines: company law, family law, and succession law. Family business law therefore merits consideration as a separate field of legal study. Indeed, a couple of German law schools have established Institutes for Family Business Law in recent years, for example in Witten, Bayreuth and Hamburg at Bucerius Law School. At our Institute, we started a research agenda on family firms three years ago. We focus particularly on the comparative legal and interdisciplinary dimensions of family firms, teaming up with our colleagues from the Hamburg School of Business Administration. Our first joint conferences covered topics such as "Family Constitutions" (2017)[31], "Financing the Family Firm" (2018) and "Ownership Management in Family Firms" (2019)[32]. The academic groundwork for much of the ensuing legal scholarship was laid in a pioneering handbook written by two Austrian colleagues[33], and has since been com-

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[27] See *G. Zwick/J. J. Jurinsky*, Tax and Financial Planning for the Closely Held Family Business (Cheltenham 2019).

[28] For the standard version of this joke *H. Koh*, Is There a 'New' New Haven School of International Law? Yale J. Int'l L. 32 (2007) 559, 572 n. 85.

[29] In this sense *D. M. Ibrahim/D. G. Smith*, Entrepreneurs on Horseback: Reflections on the Organization of Law, Ariz. L. Rev. 50 (2008) 71, 72. Elaborating on this argument *F. H. Easterbrook*, Cyberspace and the Law of the Horse, 1996 University of Chicago Legal Forum 207: "Lots of cases deal with sales of horses; others deal with people kicked by horses; still more deal with the licensing and racing of horses, or with the care veterinarians give to horses, or with prizes at horse shows. Any effort to collect these strands into a course in 'The Law of the Horse' is doomed to be shallow and to miss unifying principles."

[30] Stressing the criterion of distinctiveness for creating a coherent field of legal study *Ibrahim/Smith, supra* note 29, 76: "In our view, a new field of legal study is justified when a discrete factual setting generates the need for distinctive legal solutions. This distinctiveness may manifest itself in the creation of a unique set of legal rules or legal practices, in the unique expression or interaction of more generally applicable legal rules, or in unique insights about law."

[31] From this see for example, *H. Fleischer*, Family Firms and Family Constitution: A Legal Primer, ECL 2018, 11.

[32] From this, see, for example, *H. Fleischer*, Organisation der Inhaberfamilie und Ownership Management in Familienunternehmen – eine rechtliche Bestandsaufnahme, BB 2019, 2819.

[33] *S. Kalss/S. Probst*, Familienunternehmen. Gesellschafts- und zivilrechtliche Fragen (Vienna 2013).

plemented by several conference volumes[34] and a comprehensive handbook compiled by practitioners and academics.[35] Meanwhile, a couple of doctoral theses have also been published on different aspects of family business law.[36] A specialized German journal was launched in 2016, "FuS – Zeitschrift für Familienunternehmen und Stiftungen", which sees itself as a platform for research on family businesses, and publishes both legal and economic papers.

III. What's Different about Family Firms?

What's different about banks?, asks a famous paper by *Eugene Fama*.[37] Echoing this title, it is crucial to find out in our context: What's different about family firms? What distinguishes them from non-family firms?

1. Defining Family Firms

Defining family firms is a thorny issue. The definitional debate has troubled family business researchers for years, and seems set to remain a thicket of contention for years to come.[38] We will probably have to accept that there is no consensus definition,[39] no single definite answer to this question, even less so on an international level, where country-specific features and cultural differences add an additional layer of complexity. This is clearly troublesome because until researchers agree on what a family business is, they will find it difficult to build on each other's work and to develop a usable knowledge base.[40]

For business law professors, this is reminiscent of the very similar difficulties in defining the closed corporation.[41] Those difficulties have given rise to the witty but nonetheless accurate remark that a closed corporation is like a spiral staircase, hard to describe but recognizable when you see one.[42] Simi-

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[34] See, e.g., H. U. Vogt/H. Fleischer/S. Kalss (eds.), Recht der Familiengesellschaften (Tübingen 2017).

[35] C. Bochmann/J. Cziupka/J. Prütting (eds.), Münchener Handbuch des Gesellschaftsrechts, Bd. 9: Recht der Familienunternehmen (Munich 2021).

[36] See, e.g., *G. Krämer*, Das Sonderrecht der Familiengesellschaften, Befund eines gesellschaftsrechtlichen Realtyps und ausgewählte Rechtsfragen (Baden-Baden 2019).

[37] *E. Fama*, What's different about banks?, JME 15 (1985) 29.

[38] For an overview of different approaches to the definitional problem *Zellweger, supra* note 9, Chapter 2: Defining the family business, 4 et seq.

[39] Coming to the same conclusion *A. Colli*, The History of Family Business, 1850–2000 (Cambridge 2003) 6: "Despite its relevance, a useful definition of the family firm is elusive."

[40] In this sense *Lansberg/Perrow/Rogolsky, supra* note 1, 2.

[41] See *H. Fleischer*, Internationale Trends im Recht der geschlossenen Kapitalgesellschaft, NZG 2014, 1081 et seq.

larly, a number of definitional proposals for family companies have been made in the corporate law discourse, none of which has prevailed.[43] For our purposes, however, the definitional debate does not need to be gone into here. A working definition is sufficient. Thus, two cumulative criteria are important: (a) the majority of the decision-making rights are in the hands of the family, the *control element*, occasionally reduced to a significant influence-element, and (b) the intention of the family to pass the business on to their descendants, the *intergenerational element*.[44]

2. Coordinating Three Social Subsystems: Family – Business – Ownership

Proceeding further on the basis of this working definition, the easiest way to point out the unique features of family firms is to refer to the Three-Circle Model of the Family Business System (see next page)

This model was developed at Harvard Business School by *Renato Tagiuri* and *John Davies* in 1978,[45] and remains the dominant paradigm today worldwide.[46] It clearly presents three interdependent and overlapping groups, three circles, elements that make up the family business: family, business and ownership. These three social subgroups have their own beliefs and value systems: What counts in a family context, is love, affection, and solidarity. What matters in a business setting is performance. Company owners tend to primarily value return on equity.

The uniqueness of, and challenge for, family firms is the interaction and coordination of all three subsystems. With the help of this model, one can identify different groups of people with different needs and expectations: There are people who are merely family members, others that are family members and employees, and others again that are family members, employees and shareholders. There are also non-family members, employees and shareholders as well.

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[42] In this sense *R. A. Kessler*, With Limited Liability For All: Why Not a Partnership Corporation?, Fordham L. Rev. 36 (1967) 235, 255.

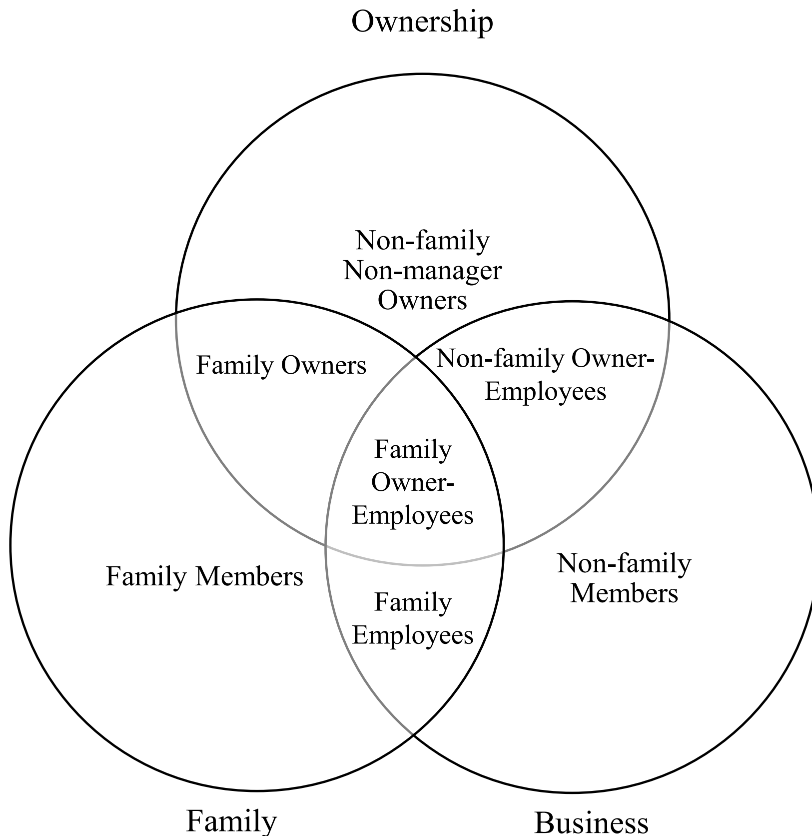
[43] For a comprehensive list of these proposals *Krämer, supra* note 36, § 3: Der Meinungsstand zum Begriff der Familiengesellschaft, 52 et seq.

[44] For a similar family business definition *Zellweger, supra* note 9, 22: "A family firm is a firm dominantly controlled by a family with the vision to potentially sustain family control across generations."

[45] For a refined version *R. Tagiuri/J. Davis*, Bivalent attributes of the family firm, FBR 9 (1996) 199.

[46] Discussing the advantages and disadvantages of circle models *Zellweger, supra* note 9, 18 et seq.

Three-Circle Model of the Family Business System



3. *Taxonomies of Family Firms*

Continuing our classification exercise, one can group family firms according to various criteria: their field of business, the strength of the family influence, whether they are listed or not, their size, their age.[47] These numerous classification features already suggest that the universe of family businesses is more diverse than it may seem at first glance. Therefore, while the fundamental distinction between family and non-family firms remains vital, one must not lose sight of the significant heterogeneity within the population of family firms.

A taxonomy which deserves closer attention in a legal context is one organized around different types of owners in the lifecycle of the family firm. Starting with the founder and sole owner, a typical evolutionary pathway will lead to a sibling company in the second generation and a cousin consortium in the third one, ending up with a true family dynasty at a later stage.[48] As the

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[47] See *A. Davis*, Toward a Typology of Family Business Systems, in: Tàpies/Ward (eds.), Family Values and Value Creation (Basingstoke 2008) 127 et seq.; *P. Sharma/ M. Nordquist*, A Classification Scheme for Family Firms, *ibid.*, 71 et seq.

[48] See *Zellweger, supra* note 9, 59 et seq.

number of family shareholders increases and the business grows in size, more sophisticated governance structures will have to be implemented.

Empirical evidence seems to suggest that, for a variety of reasons, it is rare for a family firm to survive three generations.[49] In fact, many nations and languages have some variant of the American saying: "From shirtsleeves to shirtsleeves in three generations".[50] In England they prefer to say "From clogs to clogs in three generations", the French explain the cycle of wealth and poverty as the 'law of three generations': "La première génération construit, la deuxième développe, quand en s'entend, et la troisième fout la boîte par terre", and the Germans put it like this: "Der Vater erstellt's, der Sohn erhält's, dem Enkel zerfällt's". This widespread phenomenon of the rise and decline of a family firm within three generations is usually referred to as the *Buddenbrooks syndrome*,[51] deriving its name from German Nobel Prize-winner *Thomas Mann's* novel "Buddenbrooks", published in 1901. If one reads the novel carefully, this is actually not fully correct, as Senator *Thomas Buddenbrook* was already a representative of the fourth generation when the trading business was liquidated after his premature death.

It is nonetheless informative and entertaining to analyze a family business in literature from a law and literature perspective.[52] One of my pet projects is to collect older and more recent novels about family firms. By now, we have identified the usual suspects, with *Charles Dickens'* "Dombey and Son" from the UK, France's *Emile Zola's* "The Ladies' Paradise", and from Turkey *Orhan Pamuk's* "Cevdet and his Sons", and a couple of others[53] Along the same lines, a recent paper written by two economists sees great promise in drawing on literary fiction for family business research.[54] They argue convincingly that

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[49] See *T. Zellweger/R. Nason/M. Nordquist*, From longevity of firms to transgenerational entrepreneurship of families, FBR 25 (2012) 136.

[50] Discussing this commonality *S. Rau*, The Riddle of the Three Generations. Why so many family firms around the world don't survive long term, Inaugural lecture, King's College London, 2016; see also *Zellweger, supra* note 9, 322.

[51] See *T. C. Barker/M. Lévy-Leboyer*, An Inquiry into the Buddenbrook Effect in Europe, in: Hannah (ed.), From Family Firms to Professional Management (Budapest 1982) 10; *T. Hilker*, Das Buddenbrook-Syndrom – Ursache des Niedergangs von Familienunternehmen, Familiendynamik. Systemische Praxis und Forschung 26 (2001) 338; *C. Lorandin*, Looking beyond the Buddenbrooks Syndrome: the Salvadori Firm of Trento, 1660s–1880s, Business History 57 (2015) 1005.

[52] See with a broader approach also *V. Chilese*, Die Macht der Familie. Ökonomische Diskurse in Familienromanen, in: Galli/Costagli (eds.), Deutsche Familienromane: Literarische Genealogien und internationaler Kontext (Munich 2010) 121 et seq.

[53] More recently *N. Bossong*, Gesellschaft mit beschränkter Haftung (Munich 2012); *E.-W. Händler*, Fall (Frankfort-on-the-Main 1997); *M. V. Jung*, Phönix oder Suppenhuhn: Ein Roman über Nachfolge in einem Familienunternehmen (Cologne 2018).

[54] See *M. Nordquist/W. B. Gartner*, Literature, Fiction and the Family Business, FBR 33 (2020) 122.

using that kind of literature expands our ability to see more of the details, the complexities, and the richness of families and their businesses.[55]

IV. Family Firms and Legal Forms

Moving on to core legal issues, the choice of legal form by a family enterprise deserves our primary attention. As far as I can see, a family company as such does not exist anywhere, there is no special codified type of business organization solely for family firms. In Germany, a proposal to that effect was discussed in the late 1930s by a committee of the Academy for German Law, but was quickly rejected, not least because of insurmountable definitional difficulties.[56] Instead, family firms have to choose from among the general types of business organizations available in their jurisdiction. How these different legal forms evolved over time, is worth recounting and actually provides a history lesson in the making of business law: family businesses have always been the driving force behind the evolution of partnerships and companies all over the world.[57]

1. Families as Founders of the Roman Societas

The partnership in early Roman law, the societas, developed from a partnership created from an undivided inheritance among heirs who decided, after the death of the paterfamilias, to administer their inheritance jointly rather than distributing it amongst themselves (consortium ercto non cito).[58] This type of partnership was called societas fratrum, i.e. a partnership of brothers.[59] In this sense, one can say, that family firms gave actually birth to partnership law as a separate field of legal study.

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[55] *Nordquist/Gartner, supra* note 54, 126.

[56] See *J. Lieder*, The Corporate Form of Family-Owned Companies, RTDcom. 2016, N° 2, 37, 44: "In the end, the committee dismissed the idea of an independent legal form for family companies. First, members of the committee were at odds with the term and the 'typical criteria' of family companies that made a legal fixation seem highly problematic. Second, the members considered a renewed law of the GmbH to be flexible enough to enable family shareholders to address the specific needs and individual preferences by using the articles of association."

[57] For a more detailed account of the following: *H. Fleischer*, Familiengesellschaften und Familienverfassungen: Eine historisch-vergleichende Standortbestimmung, NZG 2017, 1201 et seq.

[58] See *G. Mousourakis*, Roman Law and the Origins of the Civil Law Tradition (Cham 2015) 139; *R. Zimmermann*, The Law of Obligations (Cape Town 1990) 451 et seq.; in greater detail *F. Wieacker*, Societas. Hausgemeinschaft und Erwerbsgesellschaft – Untersuchungen zur Geschichte des römischen Gesellschaftsrechts (Weimar 1936) 126 et seq.

[59] See *D. Daube*, Societas as Consensual Contract, Cambridge L. J. 6 (1938) 381 et seq.

2. Family Firms as Promoters of the Medieval Compagnia, Accomenda and OHG (Medici, Fugger)

During the Middle Ages, most trading firms were also family businesses.[60] Their names were all family names (*Peruzzi*, *Bardi*, *Medici*, *Welser*, *Fugger*).[61] Their partners were mostly close relatives who founded commercial partnerships with full personal liability.

This new type of business association was developed in the 14th century in northern Italian cities[62] and called *compagnia*, derived from the Latin "cum pane", that is community of those who share their bread, again signaling that this was a legal form primarily for family firms.[63]

A famous example for such a partnership agreement is the *Medici* banking house founded in Florence in 1397.[64] A decade later, the *Medici* made use of a Florentine law from 1408, allowing them to set up an *accomenda* in which some of the partners could limit their liability – the historical prototype of the modern limited partnership[65].

A century later, in 1494, the year, when the *Banco Medici* finally collapsed and the *Medici* family had to leave Florence, three brothers in Southern Germany, *Ulrich*, *Georg* and *Jakob Fugger*, signed a commercial partnership agreement[66] which was actually one of the first of its kind in Germany and came to be known as the "fundamental law of the Fugger dynasty".[67] *Jakob Fugger*, Jakob

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[60] See *E. S. Hunt/J. M. Murray*, A History of Business in Medieval Europe, 1250–1550 (Cambridge 1999) 33: "The intense family orientation of medieval businesses shows up most clearly in the intermingling of the affairs of a business and the extended family of its owners that so often appears in the surviving accounts and letters of medieval businessmen."

[61] See *E. S. Hunt*, The Medieval Super-companies. A Study of The Peruzzi Company of Florence (Cambridge 1994) Chapter 1: "The Company and the Family", 6 et seq.

[62] The *locus classicus* still is: *M. Weber*, The History of Commercial Partnerships in the Middle Ages, 1889, translated by *L. Kaelber* (Lanham et al. 2003).

[63] See *B. Hawk*, Law and Commerce in Pre-Industrial Societies (Leiden/Boston 2016) 9.210: "[T]he medieval Italian compagnia originally reflected small family relationships between father and son or among several brothers – men who lived in the same house, who broke the same bread (as the word compagno implies) and who found it natural to accept unlimited liability, for each other's actions."

[64] For the standard reference on the legal status and economic structure of this institution *R. de Roover*, The Rise and Decline of the Medici Bank, 1397–1494 (Cambridge 1963) 77 et seq.; more recently also *R. A. Goldthwaite*, The Economy of Renaissance Florence (Baltimore 2009) 64 et seq.

[65] See *de Roover, supra* note 64, 89; *Goldthwaite, supra* note 64, 67: "In any event, Florence seems to have been far ahead of the other Italian centers in devising this kind of limited-liability contract, although the instrument never realized its potential for evolving into something like a joint-stock company."

[66] Reprinted in *M. Jansen*, Die Anfänge der Fugger bis 1494 (Leipzig 1907) Vol. I, Appendix, 263–268.

the Rich, as he was called, was the richest man who ever lived on earth,[68] head of a merchant family and leading banker with direct trading relationships to the Pope and the Emperor, *Maximilian I.* A closer analysis of the partnership contract concluded by him and his two brothers in 1494 is highly instructive as it already contained many clauses which were later incorporated into the modern Commercial Codes, e.g. a strict prohibition of competition.[69]

Generally, the *Medici* and *Fugger* examples show that family firms were the main promoters of the medieval types of commercial partnerships in Italy, Germany and elsewhere.

3. Family Firms in the 19th Century between Partnership and Company (Siemens, Sal. Oppenheim)

The next major leap did not occur before the 19th century, when the demand for new legal forms with limited liability had become more pressing than ever. Key legislative developments in Germany included the Prussian Stock Corporation Act of 1843 (Preußisches Aktiengesetz), and, even more importantly for smaller enterprises and family firms, fifty years later, the introduction of the Limited Liabilities Companies Act of 1892 (GmbH-Gesetz).

A nice illustration how family firms made use of the different types of business organization over the course of time, is the history of *Siemens*, the electrical and engineering company, now a conglomerate company.[70] *Werner von Siemens*, the inventor of the pointer telegraph, started the business as a commercial partnership (Offene Handelsgesellschaft, OHG) ("Siemens & Halske Telegraph Construction") together with his business partner *Johann Georg Halske*, in 1847 in a Berlin back courtyard. Throughout his business life, *Werner von Siemens* strongly opposed any conversion into a capital company. In 1890, he at least agreed to convert the business into a limited partnership (Kommanditgesellschaft, KG), with him becoming a limited partner, and two of his sons as general partners. It was only after his death that *Siemens* finally became a stock corporation (Aktiengesellschaft, AG) in 1897. The articles of the stock corporation were drafted carefully to preserve the family's influence through a powerful supervisory board.[71] With respect to corporate finance,

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[67] See *H. Fleischer*, Der Gesellschaftsvertrag der Fugger: Frühform des OHG-Rechts, in: Dreher/Drescher et al. (eds.), Festschrift für Alfred Bergmann zum 65. Geburtstag am 13. Juli 2018 (Berlin/Boston 2017) 183.

[68] *G. Steinmetz*, Der reichste Mann der Weltgeschichte. Leben und Werk des Jakob Fugger (Munich 2016).

[69] See *Fleischer, supra* note 67, 190 et seq.

[70] For a richer analysis of all the partnership contracts and articles of association preserved in the *Siemens* archives *H. Fleischer*, Die Siemens AG: Rechtliche Wegmarken von der Familien- zur Publikumsgesellschaft, AG 2019, 481 et seq.

[71] See *Fleischer, supra* note 70, 487 et seq.

Siemens kept the typical financing patterns of family firms: a preference for internal financing, and regular retention of two-third of its profits.

The *Siemens* case is also remarkable in yet another respect: as an early example of family multinationals.[72] *Werner von Siemens* utilized family ties to build his global empire, sending two of his brothers who jointly managed the company with him to London and Saint Petersburg. In that respect, he very much resembled *Jakob Fugger* four centuries ago whom he admired as a founder of a world business.[73]

A similar story can be told about the development of the private bank Sal. Oppenheim jr. & Cie.[74] In 1789, *Salomon Oppenheim junior*, then only 17 years old, founded a money-trading business in Bonn before moving to Cologne in 1794, where the bank retained its principal business seat for the next centuries.[75] When he died in 1828, his wife and her two eldest sons, *Simon* and *Abraham*, took over, forming a commercial partnership (OHG). Three generations later, in 1904, the business was converted into a limited partnership (KG). Finally, in 1989 the partners decided to change the legal form once again, transforming their private bank into a partnership limited by shares (Kommanditgesellschaft auf Aktien, KGaA).

4. Family Firms and Variety of Legal Forms in the 20th and 21st Century (Merck, Bertelsmann)

Today's picture of family firms in Germany is characterized by the huge variety of legal forms and their combinations.[76] This, however, is not a special feature of family companies, but a general characteristic of German company law: The law and life of business organizations in Germany is quite diverse. There is no single dominant form, but different types of business organizations for different purposes.[77] To take some statistics as examples:[78]

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[72] See *C. Lubinski*, A Family's Multinational's Quest for Unity, Siemens's Early Business in India 1847–1914, in: Lubinksi/Fear/Pérez (eds.), Family Multinationals. Entrepreneurship, Governance, and Pathways to Internationalization (New York 2013) 37, 40: "Siemens was one of the earliest and best-known family multinationals in Germany."

[73] See *Fleischer, supra* note 70, 485.

[74] For a richer account of all the partnership contracts and articles of association preserved in the *Sal. Oppenheim* archives, *H. Fleischer/J. Tittel*, Familiengesellschaftsverträge als Forschungsgegenstand: Die Fallstudie Sal. Oppenheim jr. & Cie, FuS 2020, 10 et seq.

[75] See *G. Teichmann*, Private Banks and Industry in the Light of the Archives of Bank Sal. Oppenheim jr. & Cie., Cologne, in: Cassis/Cottrell/Fraser (eds.) The World of Private Banking (Farnham/Burlington 2016) 205 et seq.

[76] For a more detailed account *Lieder, supra* note 56, 37 et seq.

[77] Explaining this feature in greater depth *H. Fleischer*, A Guide to German Company Law for International Lawyers – Distinctive Features, Particularities, Idiosyncrasies, in: Fleischer/Hansen/Ringe (eds.), German and Nordic Perspectives on Company Law and Capital Markets Law (Tübingen 2015) 3, 7 et seq.

As of January 1st 2020, there were 1,329 million limited liability companies (GmbH), among them 152,000 entrepreneurial companies (Unternehmergesellschaft, UG), a subtype of the GmbH introduced in 2008, requiring no capital minimum. In addition, there were 14,200 stock corporations (AG), 650 European companies (SE) and 360 partnerships limited by shares (KGaA). Apart from that, partnerships still play an important role in Germany, with 23,000 commercial partnerships (OHG) and 280,000 limited partnerships (KG), 90% of them hybrid companies with a legal person serving as general partner (GmbH & Co. KG). Finally, there are more than 200,000 civil partnerships (GbR) not registered in the commercial register, but running as a business and obliged to file turnover tax declarations.

Family-owned businesses make use of all these types of business organization. This is also true for less well-known types such as the partnership limited by shares (KGaA) which is becoming increasingly popular among larger family firms. The KGaA is a two-class company, characterized by the difference between a general partner who is fully and personally liable towards creditors, and shareholders with limited liability. It allows family firms to maintain an effective influence on the management without the need for a capital majority or supermajority. One prominent example is the pharmaceutical family giant *Merck*, the world's oldest operating pharmaceutical-chemical company in the world, founded in 1668, and now listed on the Frankfurt stock exchange. The *Merck* family currently holds 70% of the shares as a general partner and the remaining 30% in the hands of external shareholders.[79]

Apart from the basic legal forms, family firms may also consider combinations of them. By far the most popular combination is the GmbH & Co. KG. In this case, a limited liability company serves as a general partner within a limited partnership. This structure combines the advantages of a capital company (limited liability, external management) with those of a partnership (tax transparency, contractual freedom and flexibility).

Even more sophisticated is another hybrid legal form: the SE & Co. KGaA. In this case, a European company serves as a general partner of a partnership limited by shares. This structure has recently been utilized by *Bertelsmann*, Germany's largest media company and one of the largest media conglomerates in the world, offering television and radio (RTL group) as well as books (Penguin Random House) and education services. The SE & Co. KGaA combines the advantages of the KGaA with those of the SE. At the same time however, it suffers from its very complicated organizational struc-

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[78] Figures taken from *U. Kornblum*, Bundesweite Rechtstatsachen zum Unternehmens- und Gesellschaftsrecht (Stand: 1.1.2020), GmbH-Rundschau 2020, 677 et seq.

[79] For more on Merck's corporate history *C. Burhop/M. Kißener et al.*, Merck. Von der Apotheke zum Weltkonzern (2nd ed., Munich 2018).

ture and high founding costs, making it only appealing for large family firms which need access to the capital market.

The takeaway lesson here is, that family firms in Germany can choose from a wide range of options, when picking the suitable legal form for their business.

V. Governance Framework for Family Firms

The governance framework for family firms usually consists of a series of layers that are at times corporate, or contractual or non-normative in nature.[80] These layers together make up the whole, summoning up the image of the layers of an onion.[81]

1. Statutes

Statutes are necessarily the first port of call for regulation in the legal framework for family firms. They offer a governance pattern with varying levels of flexibility depending on the type of company in question. In Germany, the Stock Corporation Act (AktG) provides the least room to maneuver with the iron principle of statute stringency enshrined in § 23 para. 5.[82] This explains, as has already been pointed out[83], why German family firms aiming to access the capital market are increasingly turning from the rigid corset of the stock corporation (AG) to the softer vestments of a partnership limited by shares (KGaA), a European Company (SE) or a hybrid SE & Co. KGaA.

2. Articles of Association

Usually, the most important rules governing family partnerships and limited liability firms are found in the articles of association rather than legislation. According to § 109 German Commercial Code (*Handelsgesetzbuch,* HGB) and § 45 para. 1 German Limited Liability Company Act (*Gesetz betreffend die Gesellschaft mit beschränkter Haftung,* GmbHG), shareholders can set up

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[80] In more detail *Kalss/Probst, supra* note 32, marg. no. 4/1 et seq. Generally on the many layered governance framework for closed corporations *Fleischer, supra* note 2, 319; also, but with some differences *J. A. McCahery/E. P. Vermeulen*, The Corporate Governance Framework of Non-listed Companies, in: McCahery/Vermeuelen (eds.), Corporate Governance of Non-Listed Companies (Oxford 2008) 1, 5 et seq., explaining that the three pillars of the governance framework differentiate between company law, contract and optional guidelines.

[81] On the following see *Fleischer, supra* note 33, 11 et seq.

[82] From a comparative perspective *T. Rothärmel*, Gestaltungsfreiheit der Familiengesellschafter im deutschen und im US-amerikanischen Aktienrecht (Bielefeld 2006).

[83] See *supra* IV.3.

tailor-made organizational structures in family firms and establish ownership rights according to their specific needs. This can be complimented by the creation of additional corporate organs, for example an advisory board made up of non-family members.[84]

3. *Shareholder Agreements*

In addition to the relevant legislation and the articles of association, shareholder agreements may also contain provisions on corporate governance in the family firm. Their most significant regulatory items include voting rights agreements, transfer restrictions, pre-emptory purchase rights and agreements regarding the make-up of the various corporate organs. From a strictly legal perspective, these are independent agreements between some or all shareholders that operate *alongside* the articles of association, something the nomenclature in other languages makes clear, such as the Italian *patti parasociali* and the Spanish *pactos parasociales.* The relationship here is purely contractual, and in contrast to the articles of association, can only be altered with unanimous agreement, rather than a qualified majority. The contents of these agreements, and even their very existence is usually shielded from the curious gaze of the outside world; they remain "the invisible side of the moon"[85].

4. *Codes of Governance for Family Firms*

Codes of corporate governance provide a further layer of regulation that has already reached the privately held limited liability corporation[86] and the family firm.[87] The main instrument in Germany is the "Governance Code for Family Businesses" created in 2004 as the result of a private initiative, with its third edition released in May 2015. In legal terms, it is distinct from the Ger-

[84] See *A. Sanders*, Der Beirat als Instrument der Family Business Governance in der Entwicklung des Familienuternehmens, NZG 2017, 961; with a broader approach also *A. Koeberle-Schmidt/D. Caspersz*, Family Governance Bodies. A Conceptual Typolgy, in: Smyrnios/Potzioris/Goel (eds.), Handbook of Research on Family Business (2nd ed., Cheltenham 2013) 125 et seq.

[85] *P. Forstmoser*, Corporate Governance – eine Aufgabe auch für KMU?, in: Aktuelle Fragen des Bank- und Finanzmarktrechts. Festschrift für Dieter Zobl zum 60. Geburtstag (Zurich 2004) 475, 501 playing on a poem by *Matthias Claudius*.

[86] See *C. Konnertz-Häußler*, Ein Corporate Governance Kodex für die GmbH (Göttingen 2011).

[87] See *R. Hirsch*, Decoding Family Businesses: Are Corporate Guidelines Necessary for Family Business?, NZBLQ 17 (2011) 126–127: "Starting in the early 2000s with just a few countries engaged, the list of corporate governance guidelines including or focusing on family businesses is steadily expanding at national as well as international policy levels."

man Corporate Governance Code for listed companies in that it, *inter alia*, lacks a statutory comply-or-explain mechanism like that of § 161 AktG.[88]

According to its preamble, the Governance Code for Family businesses tries to help families to ask themselves the necessary questions about their own companies. As such, the Code fulfils a heuristic function, assisting families in finding tailor-made solutions rather than issuing generalized provisions. The Code clearly recognizes the great diversity and heterogeneity of family firms. These differences, the Code says, make it impossible to provide 'one size fits all' recommendations for good family governance.

5. Family Constitution

Last, but by no means least, there is the family constitution, also known as the family charter or family protocol. This is a rather novel governance instrument, although one can point to early predecessors in the house laws of the high nobility in continental Europe, the family pacts of the Habsburg and Hohenzollern dynasty.[89] In substance, a family constitution is a written document usually signed by all family members which sets out the family principles, the common values and collective goals for the family enterprise.

a) International developments

Family constitutions have, by now, become a global phenomenon, found in the US as well as in Spain, Germany, and a number of other countries as well.[90]

In the United States, the initial spark that lit the family constitution flame came from recommendations made in management literature: John Ward of the renowned Kellogg School of Management in Chicago was to become the most influential pioneer, first outlining the challenges for strategic planning for family firms at the end of the 1980s.[91] Together with his colleague Miguel Ángel Gallo from Barcelona he coined the term family constitution in its Spanish form *protocolo familiar* in 1992.[92] Numerous further publications resulted in a

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[88] § 161 AktG stipulates: "The management board and the supervisory board of listed companies shall declare annually that the recommendations of the 'Government Commission German Corporate Governance Codex' published by the Federal Ministry of Justice in the official section of the electronic Federal Gazette have been and are complied with or which of the Code's recommendations have not been applied or are not being applied and the reasons therefor. The declaration shall be made available to the shareholders on a permanent basis."

[89] See *Fleischer, supra* note 57, 1205.

[90] For a comparative account *Fleischer, supra* note 31, 12 et seq.

[91] Preparing the way *J. Ward*, Keeping the Family Business Healthy. How to Plan for Continuing Growth, Profitability and Business Leadership (New York 1986).

[92] *J. Ward/M. A. Gallo*, Protocolo Familiar, Nota técnica de la División de Investigación del IESE DGN-448 1992.

2005 handbook compiled together with Daniela Montemerlo on the 'Family Constitution'[93] that covered the experiences of over eighty families.

In Spain, the *protocolo familiar* has been making its way into corporate practice via US management literature since the 1990s,[94] and has even been granted mention in a number of governance codes for non-listed companies and family firms.[95] Based on an authority to issue ordinances from 2003, the *Real Decreto* 171/2007 put a specific legal definition to the family protocol[96] and created the opportunity for non-listed companies to disclose the whole protocol or some of its rules through the commercial register.

In Germany, the Governance Code for Family Businesses[97] recommends that family firms create their own governance code.[98] Moreover, specialized consulting services and law firms have now discovered the family constitution for themselves, and praise its virtues both in providing guidance and creating consensus. As a consequence, the spread of the family constitution in Germany has increased exponentially, although exact figures are lacking. Current studies find some sort of family constitution in more than one third of all investigated family businesses.[99]

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[93] *D. Montemerlo/J. Ward*, The Family Constitution. Agreements to Secure and to Perpetuate Your Family and Your Business (Marietta 2005).

[94] See *A. V. Valmaña Cabanes*, El régimen jurídico del protocolo familiar (Granada 2013) 103 et seq.

[95] See Guía pratica para el gobierno de las empresas familiares, 2012; Guía para la pequeña y mediana empresa familiar, 2008; Principios de Buen Gobierno Corporativo para Empresas No Cotizadas, 2014.

[96] Real Decreto 171/2007 of 9 February 2007, Art. 2 para. 1, which can be translated roughly as follows: "The family protocol laid down in this Royal Decree covers all the agreements between the shareholders with each other and with third parties with whom they have a family relationship and which deals with a non-listed company in which they share a common interest in creating a communication model and achieving consensus in decision making to regulate the relationships between family, ownership and undertaking that affect the company."

[97] *Supra* IV.4.

[98] Para. 8 Governance Code for Family Firms: "Creation and Validity of an Own Governance Code. 8.1: It is recommended that the elements of this Governance Code be incorporated into individual rules. 8.2: These rules should be jointly drawn up and approved by the owner family. The process of joint elaboration and opinion-forming is at least as imporant as the outcome. 8.3. The individual rules should be reviewed by the owner family from time to time and amended if necessary. With this in mind, early on the family should determine the decision-making authorities and majorities required for subsequent amendment of their Code. 8.4.: The family should also determine the legal quality attaching to the Code and its content, particularly as this relates to articles of association and other legal documents."

[99] See *R. Rüsen/M. Hülsbeck*, Die Unternehmerfamilie und ihre Familienstrategie. Einblicke in die gelebte Praxis von Family Governance (Witten 2019) 6, 25; *P. Ulrich/S. Speidel*, Die Familienverfassung als Instrument der Corporate Governance in Familienunternehmen. Aktuelle empirische Befunde, ZCG 2017, 197, 199 et seq.

b) Legal effects of a family constitution in germany

From a legal point of view, family constitutions are largely unexplored territory, although a couple of recent publications have shed some light on them.[100] Management scholars and business consultants emphasize that family constitutions are only moral contracts and never legally binding. Some of them firmly believe in this, others purport it only for strategic reasons, i.e. to keep the lawyers, as potential competitors, out of the consultancy market.

At least from a German perspective, the widely held point of view that family constitutions are never legally binding falls short of the mark, as it fails to recognize that there is no such thing as a 'standard' family constitution.[101] Rather, in practice, one is confronted with a range of forms all with differing levels of obligation, making it far more appropriate to speak of family constitutions as a chameleon-like instrument[102]: They come in different shapes and flavors, varying from a short mission statement to a fully-fledged agreement, and cannot be reduced to a single uniform model. Depending on the context, therefore, they may well produce legal effects of one kind or the other:

Technically, family constitutions can be integrated into the preamble of the articles of association by way of reference. Depending on their wording and function, they may also qualify as ordinary shareholder agreements. In still other cases, they may indeed amount to nothing more than a social agreement that does not cross the threshold of legal materiality.[103]

Apart from that, there are even more nuanced and indirect ways in which a family constitution can create legal effects. Let me briefly explain by way of three examples[104]:

First, it is conceivable that individual rules in a family constitution are validated through intra-shareholder practice. Case law of the German Federal Court of Justice recognizes that many years of a particular practice may constitute a tacit modification of the partnership contract.[105] In fact, there is a

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[100] See, e.g., *H. Fleischer*, Das Rätsel Familienverfasssung: Realbefund – Regelungsnatur – Rechtswirkungen, Zeitschrift für Wirtschaftsrecht 2016, 1513; *S. Bong*, Gesellschaftsrechtliche Wirkungen einer Familienverfassung – Zur rechtlichen Relevanz einer tatsächlichen Willenseinigung mit Rechtsgeschäftsbezug in Familiengesellschaften, doctoral thesis, Bucerius Law School 2012; *T. Hueck*, Die Familienverfassung – Rechtliche Konturen eines Instruments der Governance in Familienunternehmen (Tübingen 2017).

[101] See *Fleischer, supra* note 100, 1515 et seq.

[102] *U. Gläßer*, Die Familienverfassung – zahnlose Absichtserklärung, unzulässiges Disziplinierungsmittel oder integratives Steuerungsmittel – Annäherungen an ein Chamäleon, in: Dauner-Lieb/Freudenberg/Werner (eds.), Familienunternehmen im Fokus von Wirtschaft und Wissenschaft. Festschrift für Mark K. Binz (Munich 2014) 228, 234.

[103] See *Fleischer, supra* note 57, 1209.

[104] For the following already *Fleischer, supra* note 31, 18 et seq.

[105] BGH, 2 February 1978, BGHZ 70, 331, 332; BGH, 29 March 1996, BGHZ 132, 263, 271.

presumption that a sustained deviation from the partnership agreement may be tantamount to a consensual change to its contents.[106] Things are more complicated in incorporated family firms where a tacit derogation from the articles of association through intra-shareholder practice faces unsurmountable problems of form. What is feasible however, is a gap-filling supplementary practice or an interpretive observance where an unclear provision of the articles of association has been constantly construed in a particular way.

Second, a family constitution can be valuable as an interpretative aid for partnership agreements. Take the example[107] that the company statute uses the term 'child', without providing further definition. This may lead to subsequent debate as to whether the children of a patchwork family or adopted children are to be granted the same status as biological children. Were the family constitution to provide an indication, or indeed, a comprehensive definition[108], that definition could (and would) hardly be ignored by the German courts.

Third, the family constitution could and should also play a role in specifying the duty of loyalty between co-partners or co-shareholders in family firms. In a leading 1968 decision, the Federal Court of Justice declared that the family bond could have an impact on the shareholders' duty of loyalty.[109] This must hold true a fortiori when these bonds are expressed in the family constitution. As an example: the family constitution contains a provision limiting dividend distribution to 40% of annual profits after taxes, which is not mentioned in the articles of association. In my opinion, a shareholder, voting on profit distribution resolutions in a manner inconsistent with the family constitution, may, in individual cases be in breach of the duty of loyalty. A second example:[110] the family constitution provides for a reduced compensation where a shareholder leaves the company, with no further details provided in the articles of association. In this case, too, a shareholder demanding full compensation, may, depending on the situation, also be acting in breach of the relevant clause. In the same vein, the German Federal Court decided in favor of an agreement between all shareholders that was not included in the articles of association, but was contained in a contractual side agreement. One of the arguments advanced by the Federal Court for this finding drew on the provision outlining contradictory conduct in § 242 of the German Civil Code (*Bürgerliches Gesetzbuch,* BGB).

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[106] BGH, 29 March 1996, BGHZ 132, 263, 271.

[107] According to Higher Regional Court of Stuttgart, 14 November 2012, BeckRS 2012, 23633.

[108] See para. 7.1.3 Governance Code for Family Firms: "An approach to family governance should also specify who is a member of the owner family."

[109] Explicitly BGH, 9 December 1968, BGHZ 51, 204, 206.

[110] According to *R. Kirchdörfer/R. Lorz*, Corporate Governance in Familienunternehmen. Familienverfassungen und Schnittstellen zum Gesellschaftsvertrag, FuS 2011, 97, 105.

Put more generally, the greatest challenge in doctrinal terms is to explain how all these formal and informal agreements (articles of association, shareholder agreements, governance codes, family constitutions) interact and influence each other in a family business context. This is a very complex story which will have to be told some other place, some other time.[111]

VI. Outlook: Comparative Family Business Law

In recent years, family business law has emerged as a vibrant field for legal research. Given the prevalence of family firms around the world, similar legal issues will sooner or later surface in a number of jurisdictions and have to be resolved either by arbitration proceedings or by national courts. The legal effect of family constitutions briefly discussed in this paper is only one example. In light of this, great promise lies in a comparative approach, seeking to find out how family dynamics are dealt with in company law doctrine in different jurisdictions. This may well open up the doors to a new subdiscipline in the realm of comparative private law: comparative family business law.

[111] First thoughts in *Fleischer, supra* note 31, 17 under the sub-heading "From Nexus of Contracts in Family Firms to the Doctrine of Linked Contracts".

Setting the Scene

Family Firms and Closed Companies in Spain

Paula del Val Talens/Miguel Gimeno Ribes[*]

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I. Introduction

The Spanish business environment shares structural features common to most European continental systems, including an overwhelming dominance of small and medium enterprises (99.8%).[1] Many of them qualify as micro firms

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[1] *Dirección General de Industria y de la Pequeña y Mediana Empresa*, Retrato de la PYME – DIRCE a 1 de enero de 2018 (Madrid 2019) 1.

and 89.8% are family owned businesses.[2] Consistently, most firms formed under Spanish law are closely held and present concentrated ownership structures.[3] The latter is true in the case of both closed and public-listed companies. Family ownership is particularly prevalent among Spanish publicly traded companies, amounting to an average 17.2%.[4] At the same time, partnerships are not widespread in Spain. Partnerships sometimes form hybrid entities and are controlled by foreigners, usually companies formed under the law of another EU Member State.[5] Path dependency and the fact that partnerships are awarded legal personality under Spanish law, which in turn leads to the absence of a favorable tax treatment similar to that enjoyed in other jurisdictions, might explain this reality.[6] As a result, companies (*sociedades de capital*) are the preferred legal form for entrepreneurship, in particular, the private limited liability company (*sociedad de responsabilidad limitada* or S.L.) and the public limited liability company (*sociedad anónima* or S.A.), but not partnerships limited by shares (*sociedad comanditaria por acciones*). Most companies take the form of *sociedades de responsabilidad limitada.*[7]

With regard to the range of available company forms, Spain aligns with other European continental legal systems, such as France or Italy where the public company is frequently designed as a flexible and versatile form, suitable for both large and small enterprises and, therefore, equally appropriate for closed companies.[8] Traditionally, legal scholars have described this regulato-

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[2] *Instituto de la Empresa Familiar, Red de Cátedras de Empresa Familiar,* La empresa familiar en España (2015) (Madrid 2015) 59.

[3] *R. La Porta/F. López-de-Silanes/A. Shleifer*, Corporate Ownership Around the World, J. Finance 54 (1999) 471 et seq.; *L. Enriques/P. Volpin*, Corporate Governance Reforms in Continental Europe, J. Econ. Persp. 21 (2007) 117, 118–122.

[4] *D. García/J. Garrido*, Informe anual sobre la propiedad de las acciones cotizadas (Madrid 2019) 2.

[5] See e. g. the facts in TS, 4 July 1980, Case 260; *A. Rojo Fernández-Río*, S. A., S. en C., RDM 156 (1980) 245, 247–248.

[6] Specifically, for Spain, *C. Schmidt/G. Abegg*, Die spanische GmbH & Co. KG bei der internationalen Steuerplanung (Sociedad Limitada y Compañía, Sociedad Comanditaria), GmbHR 2005, 1602; *E. Röder*, Die Kommanditgesellschaft im Rechtsvergleich – Hintergründe der unterschiedlichen Karriere einer Rechtsform, RabelsZ 2014, 109, *H. Fleischer/T. Wansleben*, Die GmbH & Co. KG in den Auslandsrechten – Zirkulation eines gesellschaftsrechtlichen Regelungsmodells, GmbHR 2017, 633, 637; *M. Gimeno Ribes*, Un modelo societario de éxito en el Derecho alemán: La GmbH & Co. KG y sus variedades, in: Oviedo Albán/Navarro Matamoros/Embid Irujo (eds.), La tipología de las sociedades mercantiles: entre tradición y reforma (Bogotá 2017) 313, 333; in general, *B. Knobbe-Keuk*, Das Steuerrecht – eine unerwünschte Rechtsquelle des Gesellschaftsrechts? (Cologne 1986).

[7] *Instituto Nacional de Estadística*, <https://www.ine.es/jaxiT3/Tabla.htm?t=6293&L=0>.

[8] *A. Rojo Fernández-Río*, La sociedad anónima como problema, RDM 187–188 (1988) 7, 12; *L. Fernández de la Gándara*, El problema tipológico: la consagración del sistema dualista sociedad anónima-sociedad de responsabilidad limitada, RdS Extraordinario

ry approach to public companies, in which the form might be equally suitable for a wider range of undertakings, as "functional equivalence".[9] In this regard, domestic public companies in European jurisdictions present different degrees of equivalence and this feature usually predetermines the relationship between public and private domestic models. In line with other continental jurisdictions, Spain presents a two-fold model – two basic company forms, S.A. and S.L. – with only a moderate equivalence, leading to a high degree of similarity between S.A. and S.L., but not sufficient for them to be considered completely interchangeable. This model is an intermediary one, in between the Anglo-Saxon and the German approach.[10] The former features a highly polyvalent public company and, thus, fosters interchangeability. The latter is known to prefer a more rigid model for public companies.

This paper assesses the general legal framework for Spanish closed companies and family firms. The contribution takes up the well-established polyvalence or equivalence of the Spanish public company, which explains the fact that Spanish S.A. and S.L. are both suitable for closed undertakings.[11] We intend to contribute to the comparative analysis of closed companies in Europe and to test equivalence of company forms as an adequate policy strategy. Should ambivalent public company forms be a path dependent approach on the part of French-oriented jurisdictions, including Spain, two main concerns arise. At a domestic level, the Spanish legislature must approach German-influenced solutions with caution in light of fundamental systemic disparities. At the EU level, awareness on the part of the lawmaker is essential to the advancement of harmonized company forms.

We provide an analytical framework built upon both a conceptual and a historical approach. The first consists of a comparison between the so-called

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(1994) 35, 37; *J. A. Viera González*, Las sociedades de capital cerradas (Cizur Menor 2002) 160.

[9] In Spanish, "polivalencia funcional". See *J. M. Gondra Romero*, La posición de la sociedad de responsabilidad limitada en el marco de la reforma del Derecho de sociedades de capital, in: Alonso Ureba/Alonso Ledesma/Esteban Velasco (eds.), La reforma del derecho español de sociedades de capital (Madrid 1987) 909, 931; *Rojo Fernández-Río, supra* note 8, 25; *L. Fernández del Pozo*, La sociedad de capital de base personalista en el marco de la reforma del Derecho de sociedades de responsabilidad limitada, RGD 596 (1994) 5431, 5447; *G. Esteban Velasco*, Las reformas de la sociedad de responsabilidad limitada en España en el contexto comunitario y comparado de la simplificación de las sociedades cerradas de capital, in: Rodríguez Artigas/Esteban Velasco/Sánchez Alvarez (eds.), Estudios sobre Derecho de Sociedades. Liber Amicorum Profesor Luis Fernández de la Gándara (Cizur Menor 2016) 113, 149.

[10] Similarly, *Rojo Fernández-Río, supra* note 8, 25; *Fernández del Pozo, supra* note 9, 5447.

[11] *L. Fernández de la Gándara*, Derecho de sociedades (Valencia 2010) 146–147. See *S. Hierro Anibarro*, Gobierno corporativo sin mercado de valores, in: Hierro Anibarro (ed.), Gobierno corporativo en sociedades no cotizadas (Madrid 2014) 17, 22–23.

endogenous features of private companies and the rules applicable to Spanish company forms. The historical approach provides reasons for the progressive assimilation of the S.A. and S.L. since the end of the 19th century. We then reflect on the implications of this common policy strategy with regards to party autonomy both in general and at the stage of incorporation. Subsequently we consider shareholders' rights and conflicts arising between them. Thirdly, we tackle finance and creditor protection taking into account both debt and equity and particular features regarding the transfer of shares. Finally, we review fundamental issues concerning corporate governance and directors' fiduciary duties highlighting the high degree of homogenization between S.A. and S.L. We conclude by exploring and economically justifying basic financial and governance characteristics of Spanish family firms.

Two preliminary observations may be drawn from this analysis. First, public company regulations are more flexible in jurisdictions where private and public companies are more homogeneous, since the law leaves room for shareholders to adapt the structure of a public company to the features of closely held firms.[12] Second, from a comparative perspective, the differences between the Spanish and the German models must be considered when importing foreign solutions. This applies, in particular, to initiatives to harmonize EU company models since they tend to refer to national equivalent forms without taking into account structural divergences between domestic models.[13]

Traditionally, regulations for the S.A. and the S.L. followed a two-fold policy model, each of them specifically addressed in a separate act. However, the Consolidated Text of the Spanish Stock Corporation Act (*Texto Refundido de la Ley de Sociedades Anónimas*)[14] and the Spanish Limited Liabilities Companies Act (*Ley de Sociedades de Responsabilidad Limitada,* LSRL 1995)[15] were recast into one single act, the Spanish Corporations Act (*Ley de Sociedades de Capital*, LSC)[16] as a means of rationalizing the system by deleting cross-references between them. However, the recasting process included a number of changes, such as the extension of provisions initially designed for only one model to then apply to both of them.[17] This was strongly criticized

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[12] *J. L. Iglesias Prada*, El Proyecto de Ley de Sociedades de Responsabilidad Limitada y la empresa familiar, RGD 596 (1994) 5417, 5420.

[13] *Rojo Fernández-Río, supra* note 8, 15.

[14] *Real Decreto Legislativo 1564/1989, de 22 de diciembre, por el que se aprueba el texto refundido de la Ley de Sociedades Anónimas*.

[15] *Ley 2/1995, de 23 de marzo, de Sociedades de Responsabilidad Limitada*.

[16] *Real Decreto Legislativo 1/2010, de 2 de julio de 2010, por el que se aprueba el texto refundido de la Ley de Sociedades de Capital*.

[17] See *M. L. Muñoz Paredes*, Los "ultra vires" de la Ley de Sociedades de Capital, in: Piloñeta Alonso/Iribarren Blanco (eds.), Estudios de derecho mercantil en homenaje al profesor José María Muñoz Planas (Madrid 2011) 549.

as regulatory excess[18] and might have contributed to an increasing homogeneity between S.A. and S.L. Since the recast, the Spanish legislation on companies has undergone a number of fundamental reforms: apart from the transposition of the Shareholders' Rights Directive I,[19] the most relevant amendments arose from the *Ley 31/2014, para la mejora del gobierno corporativo*,[20] fundamental to the modernization of Spanish corporate governance. This process led to a progressive homogenization of the Spanish legal forms of public and private companies.[21] This has resulted in a typological framework in which the dichotomy between public and private is no longer the main focus. Instead, legal scholarship focuses on specialties which apply to public listed companies as opposed to non-traded entities.[22]

II. Analytical Review

By means of an analytical review, we further assess closed companies by explaining how Spanish public and private forms may be equally well-suited for them. The conceptual approach builds upon what scholars have described as endogenous features of closed companies.[23] These are common traits that shape the model under scrutiny and to which lawmakers should pay attention. Through it, we try to explain how legal models of private and public company forms can adapt to the endogenous features of closed companies and to what extent this is the case. We then move on to a historical approach in or-

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[18] *Fernández de la Gándara, supra* note 11, 144–145; *Muñoz Paredes, supra* note 17, 560 et seq.; *J. M. Embid Irujo*, Concepto, delimitación y tipología de las sociedades de capital, in: Embid Irujo (ed.), Derecho de sociedades de capital (Madrid 2016) 13, 15, 32.

[19] *Ley 25/2011, de 1 de agosto, de reforma parcial de la Ley de Sociedades de Capital y de incorporación de la Directiva 2007/36/CE, del Parlamento Europeo y del Consejo, de 11 de julio, sobre el ejercicio de determinados derechos de los accionistas de sociedades cotizadas*. See Rodríguez Artigas/Farrando Miguel/González Castilla (eds.), Las Reformas de la Ley de Sociedades de Capital (Cizur Menor 2012).

[20] *Ley 31/2014, de 3 de diciembre, por la que se modifica la Ley de Sociedades de Capital para la mejora del gobierno corporativo*. See Juste Mencía (ed.), Comentario de la reforma del régimen de las sociedades de capital en materia de gobierno corporativo (Ley 31/2014). Sociedades no cotizadas (Cizur Menor 2015); Rodríguez Artigas/Alonso Ureba et al. (eds.) Junta General y Consejo de Administración en la Sociedad cotizada (Cizur Menor 2016).

[21] *Embid Irujo, supra* note 18, 32–33. See also *J. M. Embid Irujo*, El derecho de sociedades ante la crisis económica. Especial referencia a la tipología societaria, CDC 59 (2013) 15.

[22] *Rojo Fernández-Río, supra* note 8, 25.

[23] *G. Bachmann/H. Eidenmüller et al.*, Regulating the Closed Corporation (Berlin 2014) 5–6.

der to retrospectively assess the similarities between them as well as the comparatively unclear choice of legal forms under Spanish law.

1. Conceptual Approach

Previous literature has described closed companies as sharing a number of so-called endogenous features. These are i) legal personality and limited liability; ii) a limited number of shareholders; iii) restricted transferability of shares; iv) delegated management; v) shareholder involvement in company matters, notably, in managerial affairs; and vi) the exclusion of trading shares in secondary markets.[24] These traits reflect the strong and sensitive position shareholders hold and the importance of their interpersonal relationships (*intuitus personae*).[25] In turn, they bear some resemblance to partnership law.[26] This is usually related to the fact that shareholders in closed companies make higher specific investments,[27] including the possibility of being employed by the company itself.[28] An assessment of Spanish company forms to identify these features immediately shows that most of them are also met by the *sociedad anónima*. Legal personality and limited liability, as a legal reflection of entity shielding and asset partitioning,[29] are granted to both forms. Even if this is generally the rule in the comparative framework, the Spanish legal system is generous in conferring legal personality, which shows a French influence.[30]

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[24] *Bachmann/Eidenmüller et al.*, *supra* note 23, 5–6. For the endogenous features of publicly traded corporations see *J. Armour/H. Hansmann et al.*, What is Corporate Law?, in: Kraakman/Armour et al. (eds.), The Anatomy of Corporate Law (Oxford 2017) 1, 5–15. For Spain, *Viera González, supra* note 8, 37–74.

[25] For Germany, *U. Immenga*, Die personalistische Kapitalgesellschaft (Bad Homburg 1970) 15; For Spain, *L. Fernández de la Gándara*, La atipicidad en derecho de sociedades (Zaragoza 1977) 152; *Viera González, supra* note 8, 39; *L. Fernández de la Gándara*, Las pequeñas y medianas empresas (PYMES) en el marco del Derecho Europeo. Una reflexión sobre tipología societaria, in: Fernández Torres/Arias Varona/Martínez Rosado (eds.), Derecho de sociedades y de los mercados financieros: libro homenaje a Carmen Alonso Ledesma (Madrid 2018) 269, 280.

[26] In Spain, they are usually referred as partnership-based (*de base personalista*). See *Fernández del Pozo, supra* note 9, 5432–5433.

[27] See *M. I. Sáez Lacave/N. Bermejo Gutiérrez*, Inversiones específicas, oportunismo y contrato de sociedad (A vueltas con los pactos de tag- y de drag-along), RdS 28 (2007) 133.

[28] *J. Alfaro Águila-Real*, Los problemas contractuales en las sociedades cerradas, InDret 4 (2005) 1, 6.

[29] Generally, see *H. Hansmann/R. Kraakman*, The Essential Role of Organizational Law, Yale L. J. 110 (2000) 387, 394; *H. Hansmann/R. Kraakman et al.*, Law and the rise of the firm, Harv. L. Rev. 119 (2006) 1333, 1337.

[30] Generally, see *H. Coing*, Europäisches Privatrecht (Munich 1989) 345–346; *A. M. Fleckner*, Antike Kapitalvereinigungen (Cologne 2010) 364–367.

A limited number of members together with a restrictive regime regarding the transfer of the company's shares leads to the concentration of property in the hands of a small number of shareholders. Their rationale is simple: they prevent changes of members of the company and, therefore, preserve the balance of power.[31] Provisions establishing a maximum number of shareholders were relatively common in French-oriented jurisdictions.[32] In the past, the first Spanish Act on private companies (*Ley sobre Régimen Jurídico de las Sociedades de Responsabilidad Limitada*, LSRL 1953)[33] established limitations of a maximum of fifty shareholders and a maximum share capital of fifty million *pesetas* (Arts. 1 and 3 LSRL 1953). The system was strongly criticized, as non-compliant S.L.s were arbitrarily forced to convert to S.A., a form that may not have been suitable for them.[34] This was mainly because the threshold was not very high. Provisions like this can only be understood in the context of competition between the domestic forms of. S.A. and S.L.[35] Today, a restriction of this kind only applies to the *sociedad limitada nueva empresa* (S.L.N.E.), a simplified form of private company, where shareholders are limited to a maximum of five, all of whom must be natural persons (Art. 444 para. 1 LSC). This form is irrelevant in practice, as its only competitive advantage was that it could be formed electronically, which is now possible for all forms.[36]

Delegated management refers both to the possibility – even the obligation – of establishing a managerial structure that is different from the shareholders' meeting and to the appointment of directors who are not shareholders themselves. This allows the board to function as a mediating structure for shareholders, but also for increased professionalization of management.[37] Delegated management enables third-party access to the board, which in turn differentiates this model from partnerships, where shareholder management is mandatory.[38] This is however counterbalanced by a high degree of sharehold-

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[31] *Fernández del Pozo, supra* note 9, 5440.

[32] See *J. M. Embid Irujo*, Cuestiones tipológicas en la sociedad de responsabilidad limitada, in: Bonardell Lenzano/Mejías Gómez/Nieto Carol (eds.), La Reforma de la Sociedad de Responsabilidad Limitada (Madrid 1994) 109, 121–122; *F. J. León Sanz*, Anotaciones al Derecho español, in: Ulmer (ed.), Principios fundamentales del Derecho alemán de sociedades de responsabilidad limitada (Madrid 1998) 46–47.

[33] *Ley de 17 de julio de 1953 sobre Régimen Jurídico de las Sociedades de Responsabilidad Limitada*.

[34] *Fernández del Pozo, supra* note 9, 5440; *Viera González, supra* note 8, 46.

[35] *Rojo Fernández-Río, supra* note 8, 19–20.

[36] *Real Decreto-ley 13/2010, de 3 de diciembre, de actuaciones en el ámbito laboral y liberalizadoras para fomentar la inversión y la creación de empleo.*

[37] *Bachmann/Eidenmüller et al.*, *supra* note 23, 86–87.

[38] *Fernández de la Gándara, supra* note 25, 399; *K. Schmidt*, Gesellschaftsrecht (4th ed., Cologne 2002) 410; *J. C. Paz-Ares Rodríguez*, La sociedad colectiva: Introducción y administración, in: Uría/Menéndez (eds.), Curso de Derecho Mercantil I (2nd ed.,

er involvement in decision making, including managerial affairs. Here, shareholder involvement should not be understood in the sense of partnership law, since holding a seat on the board does not stem from the position as shareholder,[39] but rather shows in a series of mechanisms allowing or facilitating direct and indirect shareholder engagement: the power to appoint and remove directors (Arts. 214 and 223 LSC), shareholders' ancillary obligations consisting of the duty to act as directors (Arts. 86–89 LSC) and shareholders' binding instructions (Art. 161 LSC).

The articles of association may include ancillary obligations providing that a specific shareholder should be designated director.[40] This is usually considered an adequate mechanism to facilitate their involvement in management.[41] Yet, the fact that managing the company arises from an ancillary obligation does not alter the formal separation between the legal positions of shareholder and director. Shareholders' instructions in private typically reflect the separation between organs and a strong shareholder position.[42] Nonetheless, in the case of Spain, shareholders might also issue instructions in public companies (Art. 161 LSC).[43] Ideally, the extension of shareholder instructions to public companies was designed to foster shareholder activism.[44] The Spanish legislature tried to enhance it by allowing organized activists to effectively intervene via instructions. Even if the likelihood of this scenario may depend on the ownership structure of each public company,[45] it is a fact that this innovation on the part of the Spanish lawmaker undermines an endogenous

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Madrid 2006) 613, 613–614. For a comparative analysis see *C. Osterloh-Konrad*, Die Selbstorganschaft in der Personengesellschaft – Wesenszug oder Anachronismus?, ZGR 2019, 271, 282–287.

[39] In general, *K. Schmidt, supra* note 38, 415. In particular, *J. Girón Tena*, Derecho de sociedades (Madrid 1976) 429; *Fernández de la Gándara, supra* note 25, 281; *Viera González, supra* note 8, 52.

[40] *J. Barba de Vega*, Las prestaciones accesorias en las sociedades de responsabilidad limitada (Madrid 1984) 338; *M. J. Peñas Moyano*, Las prestaciones accesorias en la Sociedad Anónima (Pamplona 1996) 221–222; *M. Viñuelas Sanz*, Las prestaciones accesorias en la Sociedad de Responsabilidad Limitada (Madrid 2004) 94–95; *S. Sánchez Gimeno*, Las prestaciones de servicios u obra de los administradores de sociedades de capital (Madrid 2004) 36–37.

[41] *Viera González, supra* note 8, 240–241.

[42] *León Sanz, supra* note 32, 52.

[43] See *infra* note 162.

[44] *Comisión de expertos en materia de Gobierno Corporativo*, Estudio sobre propuestas de modificaciones normativas (Madrid 2013) 13. In agreement, *M. I. Sáez Lacave*, Activismo accionarial, Hedge Funds y el artículo 161 de la LSC, InDret 4 (2018) 1.

[45] Generally, see *M. Kahan/E. Rock*, Hedge Funds in Corporate Governance and Corporate Control, U. Pa. L. Rev. 155 (2007) 1021; *R. Gilson/J. N. Gordon*, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, Colum. L. Rev. 113 (2013) 863.

feature of public companies such as limited shareholder involvement in managerial affairs and a higher degree of board autonomy.

The fifth endogenous feature is the impossibility of accessing capital markets via publicly traded stock (Art. 92 para. 2 LSC and Art. 2 para. 1 Law of the Securities Market, *Ley del Mercado de Valores*[46]). This in turn is related to limited transferability of shares. At the same time, the fact that shares are not publicly traded naturally affects the firm's finance. However, this analytical approach does not take into account that in Spain private companies might issue debt securities and these may sometimes be traded (Art. 401 para. 2 LSC).

The extent to which the previous analysis is accurate may vary depending on the degree to which these features are default solutions and thus can be deviated from in the articles of association. In other words, the interchangeability of the S.A. and the S.L. can be nuanced by default and mandatory rules. For instance, limited transferability of shares is mandatory in private companies (Art. 107 LSC), but free transferability of shares is only a default rule in the S.A. (Art. 123 para. 2 LSC). In this regard, public companies may include provisions in their articles of association limiting transferability of shares. This option is limited by a legal standard which prevents shares from being *de facto* non-transferrable (*prácticamente intransmisibles*). As a result, this endogenous feature may be included in a Spanish public company through party autonomy.[47] Delegated management is the default solution for both forms, but can be departed from by providing otherwise in the articles of association (Art. 212 para. 1 LSC). Third, shareholder instructions further illustrate how default rules may affect this model by ensuring versatility of public companies (Art. 161 LSC). Again, this option can be excluded in the articles of association of both the S.A. and the S.L. With regards to trading shares in secondary markets, only listed public companies do not match the relevant endogenous feature: S.L. are banned from such activity by means of a mandatory provision (Art. 92 para. 2 LSC), while going public is an option for S.A.

2. *Historical Approach*

An historical analysis may cast light on which legal form better suits the features of a closed undertaking. For that purpose, we will review the different statutory changes throughout the last one and a half centuries. Those can be considered milestones in the evolution of the two main company forms, the private (*sociedad de responsabilidad limitada*) and the public company (*so-*

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[46] *Real Decreto Legislativo 4/2015, de 23 de octubre, por el que se aprueba el texto refundido de la Ley del Mercado de Valores*.

[47] See generally *A. Madrid Parra*, Representación y transmisión de acciones. Cláusulas limitativas, RDM 203–204 (1992) 147; *A. Perdices Huetos*, Cláusulas restrictivas de la transmisión de acciones y participaciones (Madrid 1997); *D. Rodríguez Ruiz de Villa*, Las cláusulas estatutarias limitativas de la transmisión de acciones (Pamplona 1998).

ciedad anónima). As explained above,[48] despite the fact that private companies are the legal form whose features most resemble the ideal closed company, this is also the case for polyvalent public company forms such as the Spanish one. We will further elaborate on this idea by means of this historical analysis.

The Spanish private company was not statutorily recognized until the 1950s, but it had been previously used as a vehicle of economic activity. Originally, the S.L. was a notarial construct in the 19th century. The legal basis was controversial. The first Spanish Commercial Code of 1829 and today's Commercial Code of 1885 included provisions conceiving business forms as a *numerus apertus*.[49] Indeed both Art. 265 of the Commercial Code of 1829 and Art. 122 of today's Commercial Code of 1885 included a list of example business forms. Both partnerships and public companies were explicitly mentioned. Before the Commercial Code of 1885 was enacted, doubts were raised concerning the fact that the only regulated business form in which no shareholder had unlimited liability was the public company and thus its mandatory rules might have been applied to any form sharing this characteristic.[50] Shareholder's limited liability was at the time a privilege rarely conferred. In fact, the S.L. was somehow conceived as a partnership with limited liability for all shareholders, something which could be interpreted as an unlawful alteration of the nature of the partnership.[51] However, both at that time and during the first half of the 20th century, several attempts to explicitly recognize the S.L. failed.[52]

The first statute on private companies was enacted in 1953. In order to guarantee the closed character of the company, both a maximum number of shareholders (50) and a maximum amount of share capital (5 million *pesetas* and, later, 50 million *pesetas*) were introduced (Arts. 1 and 3 LSRL 1953). Originally, the legal form was barely used in practice. This was due to the limitations and complexities of these rules, especially regarding the transfer of shares.[53] In addition, certain concerns were raised in practice regarding the limited amount of the company's assets guaranteeing the repayment of its

[48] See *supra* VII.1.

[49] Originally *L. Benito y Endara*, Formas que pueden adoptar las sociedades mercantiles, RGLJ 104 (1904) 540. See also *C. Prieto González*, Los orígenes de la sociedad de responsabilidad limitada en España: El proyecto Fabra, RDM 108 (1968) 215, 215–216; *M. Andrino Hernández*, La configuración notarial de la sociedad limitada, in: Paz-Ares Rodríguez (ed.), Tratando de la sociedad limitada (Madrid 1997) 59, 77–90.

[50] *E. Castellar*, Sociedades mercantiles a responsabilidad limitada, RJC 1 (1895) 437.

[51] *Castellar, supra* note 50.

[52] *Prieto González, supra* note 49, 227–229; *J. Girón Tena*, Introducción, RdS Extraordinario (1994) 13, 30; *León Sanz, supra* note 32, 25–27.

[53] Critically *Gondra Romero, supra* note 9, 914–915. See also *León Sanz, supra* note 32, 28–29, 33–34.

debts.[54] At the time, the S.A. had no minimum share capital rule[55] and was governed by quite flexible statutory provisions.[56] It may therefore not come as a surprise that, in contrast to other jurisdictions, the vast majority of companies incorporated in the following decades were S.A.

The transposition of the EEC Company Law Directives took place in 1989. The Second EEC Directive in particular had specific implications. A minimum share capital rule and other statutory provisions on creditor protection were introduced for the public company. Back then, this was a novelty. Although a somewhat similar provision had been included in the Statute on the Public Company of 1848[57] it did not establish a fixed amount of minimum share capital. Art. 5 of this statute simply stated that share capital in this kind of company should be adequate for the business purpose.[58] To some extent, this provision could be understood as a prohibition of nominal undercapitalization.[59] As of 1989, the S.A. became a more rigid company form and this led to a large number of conversions into an S.L. As a result of the Europeanisation of Spanish company law, the S.L. became the most widespread form, and has since gone on to become the preferred form for the incorporation of new businesses.[60]

A new statute on the S.L. was enacted in 1995 (LSRL 1995).[61] The act extended most of the rules of the S.A. to the S.L. To date, the typological justification for this extension remains unclear. Rules abolishing the maximum number of shareholders and the maximum amount of share capital as well as introducing a minimum share capital of half a million *pesetas* (3,000 Euro)

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[54] See *Girón Tena, supra* note 52, 28–29; *León Sanz, supra* note 32, 26.

[55] *I. Quintana Carlo*, El capital social, in: Rojo Fernández-Río (ed.), La reforma de la Ley de Sociedades Anónimas (Madrid 1987) 105, 107–108; *M. García Mandalóniz*, El cuestionado sentido del régimen jurídico del capital social, in: Hierro Anibarro (ed.), Simplificar el derecho de sociedades (Madrid 2010) 253, 277–279.

[56] *Rojo Fernández-Río, supra* note 8, 21; *M. Reckhorn-Hengemühle*, Die spanische Aktiengesellschaft nach der Reform des Aktiengesetzes von 1989 (Munich 1992) 8.

[57] *Ley disponiendo que no se podrá constituir ninguna compañía mercantil, cuyo capital, en todo ó en parte, se divida en acciones, sino en virtus de una ley ó de un Real decreto; y mas que se expresa* (Gaceta de Madrid 18 febrero 1848, 4905, 1). See also *Quintana Carlo, supra* note 55, 107. Monographically, *R. Ansón Peironcely*, La Ley de Sociedades anónimas de 1848 (Valencia 2016).

[58] Art. 5: “Toda compañía por acciones, se constituirá precisamente para objetos determinados y con un capital proporcionado al fin de su establecimiento”.

[59] See *J. C. Paz-Ares Rodríguez*, Sobre la infracapitalización de las sociedades, ADC 36 (1983) 1587, 1618–1620. On the concept generally see *P. Ulmer*, Gesellschafterdarlehen und Unterkapitalisierung bei GmbH und GmbH & Co. KG, in: Pawlowski (ed.), Festschrift für Konrad Duden zum 70. Geburtstag (Munich 1977) 661; *M. Lutter/P. Hommelhoff*, Nachrangiges Haftkapital und Unterkapitalisierung in der GmbH, ZGR 1979, 31.

[60] *León Sanz, supra* note 32, 30, 34.

[61] *Ley 2/1995, de 23 de marzo, de Sociedades de Responsabilidad Limitada.*

showed the transition from partnership-like to a more capitalist nature for the private company. Before the implementation of EEC rules, the public company had originally shared the features of a closed company. After that, both legal forms moved in the same direction, i.e. to more capitalist and open forms. However, the relative distance between them has always remained rather small. These circumstances could still today explain a certain path dependency in the use of the Spanish S.A. as a closed company.[62]

In the last one and a half decades, some distinct trends can be identified. First, in 2003 the legislature opted to favor speed over flexibility in the incorporation process. It introduced a species of S.L., the so-called S.L.N.E., with particular characteristics. In this sub-type of private company, the founders could use sample articles of association (Disposición adicional décima LSRL 1995, today Disposición final primera LSC) and the number of shareholders was restricted to five natural persons (Art. 133 para. 1 LSRL 1995, today Art. 444 para. 1 LSC). These restrictions were not very popular in practice, and founders opted for flexibility instead. Second, concerning creditor protection, Spain has followed the European tendency to relax or eliminate the minimum share capital requirements for private companies (Art. 4 bis LSC).[63] In particular, after a 2013 reform, a private company may be incorporated without initially complying with the minimum share capital rule (*sociedad de responsabilidad limitada de formación sucesiva*).[64] In this regard, the S.L. does distinguish itself from the S.A. Third, in terms of corporate governance, private and public companies tend to converge. Several distinctive features of each form have disappeared as a result of the *Ley 31/2014*.[65]

As for future legislative action with regard to company forms, two main perspectives seem to arise. The first option consists of strengthening the differences between the two forms by widening the scope of private autonomy in the S.L.[66] The other option involves bringing them even closer together and increasing the divergences vis-à-vis public listed companies. Nevertheless,

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[62] Generally, see *L. Bebchuk/M. Roe*, A Theory of Path Dependence in Corporate Ownership and Governance, Stan. L. Rev. 52 (1999) 127, 153.

[63] In Germany, the *Unternehmergesellschaft* is a subtype of the private company with no minimum share capital (§ 5a GmbHG). In Italy, the subtype of the private company is called *società a responsabilità limitata semplificata* and has a minimum share capital of 1 Euro (Art. 2463bis Italian Civil Code, *Codice Civile*). In France, there is no longer a minimum share capital for the *société à responsabilité limitée.*

[64] See *supra* note 36.

[65] See *supra* note 19.

[66] *Esteban Velasco, supra* note 9, 147–148; *L. Fernández de la Gándara*, La dualidad de tipos de sociedades de capital. Análisis y perspectivas, in: Alonso Ledesma/Alonso Ureba/Esteban Velasco (eds.) La modernización del Derecho de sociedades de capital en España (Madrid 2011) 49, 54–55.

the latter option entails narrowing the gap between the S.A. and the S.L. to the extent that it may no longer be justifiable to maintain both forms.[67]

III. Party Autonomy

Against this general background, we now turn to specific aspects of Spanish closed undertakings operating both in the form of private and public companies. Here we consider the morphology of private and public companies as closed firms in detail. We first assess pressing issues regarding initial bargaining as part of the incorporation process. We then explore party autonomy throughout a company's life.

1. Initial Bargaining

Initial bargaining refers to the scope of party autonomy at the stage of incorporation. The key factor in formation process for closely held companies is to strike a balance between flexibility and speed. As already pointed out, there have been legislative attempts to foster the latter.[68] However, this seriously compromised party autonomy at the outset. Indeed, the statutory sample articles of association introduced in 2003 for the S.L.N.E. were extremely rigid. They were winnowed down the organizational options required to minimize the need for legal control by the commercial register (*registro mercantil*).[69] This is the consequence of civil servants in charge of the register interpreting statutory provisions very narrowly. Empirical evidence has shown that this trade-off did not convince founders, and the number of incorporations of S.L.N.E. was relatively low.[70] In 2013, electronic incorporation was allowed for every S.L, removing the need to incorporate under the heavy restrictions of the S.L.N.E. As a result, this form is no longer used in practice.

This does not necessarily mean that sample articles of association are not useful. They are widespread and commonly used in practice. However, they do not follow the one-size-fits-all principle as was the case with the statutory rules for the S.L.N.E. Sample articles of association drafted by lawyers have been standardized to some extent and can hence reduce transaction costs.

[67] *Rojo Fernández-Río, supra* note 8, 28–29.

[68] These attempts have followed the path of the World Bank's Doing Business reports. See e. g. *World Bank*, Doing Business 2019, 2019.

[69] *S. Hierro Anibarro*, La Sociedad Nueva Empresa (Madrid 2006) 62–66.

[70] See *J. M. Embid Irujo*, Eine spanische „Erfindung" im Gesellschaftsrecht: Die „Sociedad limitada nueva empresa" – die neue unternehmerische GmbH, RIW 2004, 760, 762. See the empirical and comparative analysis by *R. Braun/H. Eidenmüller et al.*, Unternehmensgründungen unter dem Einfluss des Wettbewerbs der Gesellschaftsrechte, ZHR 177 (2013) 131, 144.

However, they do not sacrifice at least a certain degree of flexibility. What is more, sample articles of association allow for the modification of clauses.

In Spain, notaries also contribute to reducing transaction costs since they have an additional counselling function.[71] This can play an important role in case of small closed companies whose shareholders are not willing to incur higher expenses.[72] Shareholders may use sample articles of association and deviate from the standard provisions if needed.

In order to be incorporated, every company's articles of association are subject to a rigorous and heavily formalistic control by the commercial register.[73] This reduces party autonomy in the articles of association and enhances the role of shareholders' agreements.[74] If the parties or the notary disagree with the result of the register's check, this decision can be challenged before an administrative authority, the *Dirección General de los Registros y del Notariado* (Arts. 71–74 of the Regulation on the Mercantile Register [*Reglamento del Registro Mercantil*, RRM][75]). Their approach has traditionally been quite restrictive and therefore has fostered the development of shareholders' agreements. Shareholders' agreements do not have to be disclosed except in listed companies. Even in this case (Arts. 530–533 LSC), the rule only affects voting agreements and those regarding restrictions on the transfer of shares. Eventually, such rigorous and formalistic control leading to the need for shareholders' agreements may hamper the protection of minority shareholders. Indeed, minorities will not be aware of the content of those agreements. Should the control be less formalistic, a higher number of those clauses would be part of the articles of association. This intermediary conclusion raises doubts regarding the suitability of this interpretative approach on the part of the *Dirección General de los Registros y del Notariado.* A more flexible design would be more protective of minorities.

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[71] See *J. C. Paz-Ares Rodríguez*, El sistema notarial: una aproximación económica (Madrid 1995); *B. Arruñada*, The economics of notaries, Eur. J. Law Econ. 3 (1996) 5.

[72] *Bachmann/Eidenmüller et al.*, *supra* note 23, 182–183.

[73] The *registradores* are in charge of the commercial register. They are not judges but civil servants who control the legality articles of association of every company at the outset. See *J. Alfaro Águila-Real*, Los acuerdos irregulares y la ideología hipotecarista en la calificación registral mercantil, AAMN 58 (2017–2018) 239.

[74] See *J. Noval Pato*, Los pactos omnilaterales (Cizur Menor 2012) 73–78; *P. del Val Talens*, La prohibición de competencia del socio. ¿Prestación accesoria, deber fiduciario o pacto parasocial?, RJN 95–96 (2015) 629; *D. Pérez Millán*, La inscripción de la prestación accesoria de cumplimiento de un protocolo familiar: Comentario de la Resolución de la Dirección General de los Registros y del Notariado de 26 de junio de 2018 (RJ 2018, 3648), RDM 311 (2019) 12, specifically, note 40.

[75] *Real Decreto 1784/1996, de 19 de julio, por el que se aprueba el Reglamento del Registro Mercantil.*

2. *Party Autonomy in General*

Similar results arise when assessing party autonomy from a broader perspective and not only limited to the moment of incorporation. Under Spanish law, there is a general provision on party autonomy (Art. 28 LSC) that equally applies to S.A. and S.L. In some jurisdictions (mostly continental European), rules governing public companies are usually mandatory.[76] This is paradigmatically the case for the German public company, where provisions in the articles of association can only deviate from the statute when explicitly allowed (*Satzungsstrenge*).[77] This is highlighted as being one of the most important differences between Germany and other continental European legal systems such as Spain, France or Italy.[78] Among other reasons, public companies in the latter grouping are polyvalent as a result of wider room for private autonomy when drafting the articles of association.[79] Spanish law does not contain any general rule on the mandatory nature of the statute on public companies.

Conversely, provisions on private companies are usually default rules.[80] However, when compared to other jurisdictions, the Spanish S.L. is subject to a larger number of mandatory provisions. In fact, enabling provisions usually establish the specific range in which party autonomy is allowed, either positively (through authorization) or negatively (through limitation). This is probably the product of the multiple references to provisions applicable to the S.A. after the LSRL 1995. All the above renders the form relatively less flexible. As a result, in terms of private autonomy, the difference between the Spanish public and private company is very small.

Operating costs are another major difference between public and private companies.[81] Statutory provisions governing public companies require the intervention of independent third parties such as auditors and independent

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[76] See *Armour/Hansmann et al.*, *supra* note 24, 19.

[77] See e.g. *V. Röhricht/A. Schall*, in: Hirte/Mülbert/Roth (eds.), Großkommentar Aktiengesetz (5th ed., Berlin 2016) § 23 marg. no. 173–175; *A. Pentz*, in: Goette/Habersack (eds.), Münchener Kommentar zum Aktiengesetz (5th ed., Munich 2019) § 23 marg. no. 156; *P. Limmer*, in: Spindler/Stilz (eds.), Kommentar zum Aktiengesetz (4th ed., Munich 2019) § 23 marg. no. 28–28a.

[78] *Rojo Fernández-Río, supra* note 8, 11–12; *Fernández del Pozo, supra* note 9, 5450; *Viera González, supra* note 8, 87.

[79] *J. M. Embid Irujo/F. Martínez Sanz*, Libertad de configuración estatutaria en el derecho español de sociedades de capital, RdS 7 (1996) 11, 16–17.

[80] See *J. C. Paz-Ares Rodríguez*, ¿Cómo entendemos y cómo hacemos el derecho de sociedades? Reflexiones a propósito de la libertad contractual en la nueva LSRL, in: Paz-Ares Rodríguez (ed.), Tratando de la sociedad limitada (Madrid 1997) 159.

[81] *Fernández del Pozo, supra* note 9, 5449; *F. de la Vega García*, Formas societarias y empresa familiar, in: Sánchez Ruiz (ed.), Régimen jurídico de la empresa familiar (Madrid 2010) 27, 37–38.

experts. This is for instance the case when contributions in kind are paid by shareholders either at the outset (Art. 67 LSC) or as a consequence of a share capital increase (Art. 300 LSC). On the contrary, private companies are usually not required to incur this kind of cost. Rather, shareholders or directors are subject to personal liability in case of inaccuracy.

IV. Shareholders' Rights and Conflicts among Shareholders

1. Shareholders' Rights

After reviewing the scope of party autonomy, we now evaluate the rights of shareholders. This part contains an analysis of the majority principle, its most characteristic features, and of the rules regarding minority protection in Spanish closed companies.

a) Majority principle

The majority principle governing decisions by the general meeting is one of the most genuinely capitalist features of private companies and has remained unchanged since 1953.[82] In that regard, the Spanish legislature has opted to avoid any personalist components. Therefore, unanimity is not the general rule but rather an exception. What is more, articles of association may deviate from the statutory provision and increase the required majority but are usually not permitted to require unanimity (Art. 200 LSC). However, there are certain exceptions when a risk of abuse is in play,[83] such as is the case when altering exit rights (Arts. 347 and 348 bis LSC). A unanimous decision is also needed when shareholders vote upon amendments to exclude (Art. 351 LSC) or on the alteration of the shares in case of a share capital reduction (Art. 330 and 333 LSC) or in liquidation (Art. 393 LSC). The recognition of the majority principle for private companies differs from the one which applies to public companies. Indeed, in a public company, the majority needed is based on the number of shareholders participating in the general meeting (Art. 201 LSC). In contrast, in a private company, the majority is determined by taking every shareholder into account (Art. 198 LSC). As a result, private companies require a higher threshold of favorable votes in order to make decisions. This

[82] *E. Galán Corona*, La Junta General, in: Bonardell Lenzano/Mejías Gómez/Nieto Carol (eds.), La Reforma de la Sociedad de Responsabilidad Limitada (Madrid 1994) 493, 513–514; *F. Rodríguez Artigas*, La Junta General de socios, RdS Extraordinario (1994) 431, 455–456.

[83] *Galán Corona, supra* note 82, 515; *Rodríguez Artigas, supra* note 82, 456; *J. Juste Mencía*, Los derechos de minoría en la sociedad anónima (Pamplona 1996) 183–185.

is arguably a reflection of the closed nature of private companies.[84] It implies the presence of a higher amount of share capital in the general meeting and, therefore, a more concentrated ownership structure for private companies.

In order to balance the majority principle, Spanish law provides several mechanisms. First, changes in the articles of association may affect the rights of an individual shareholder. Since private companies have a closed character and a slightly higher level of flexibility, there is a risk that the controlling shareholder may unilaterally decide to reduce the rights of a specific shareholder.[85] In order to avoid this, the consent of that shareholder is needed (Art. 292 LSC). A similar rule exists in Germany (§ 53 para. 3 German Limited Liability Companies Act [*Gesetz betreffend die Gesellschaften mit beschränkter Haftung*, GmbHG]). Second, the majority principle is also relativized under Spanish law because of the existence of qualified majorities (Art. 199 LSC). However, qualified majorities are relatively low compared to other continental European jurisdictions such as the German three-fourths majority (§ 53 para. 2 GmbHG).[86] Under Spanish law, an absolute majority (more than half of the shareholders) is needed to amend the articles of association and a two-third majority is required to change the structure of the company (merger, spin-off, etc.). Third, shareholders in private companies have more exit rights than in public companies: shareholders can exit a private company if the transferability of a private company's shares is further restricted (Art. 346 para. 2 LSC).[87]

b) *Minority protection*

Minority shareholders are not only protected by instruments balancing the majority principle, they also enjoy minority rights. Most of these are mechanisms designed to counterbalance the power of the controlling shareholder.[88] They can typically be exercised by an individual or a group of shareholders

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[84] See *F. Pou Ampuero*, Segunda convocatoria en S.L., RJN 53 (2005) 261.

[85] *C. Espín Gutiérrez*, Modificación de estatutos, RdS Extraordinario (1994) 465, 476–478; *J. García de Enterría*, El régimen general de la modificación de estatutos en la nueva Ley de sociedades de responsabilidad limitada, in: E. García de Enterría/Martín-Retortillo et al. (eds.), Estudios de derecho mercantil. Homenaje al profesor Justino F. Duque (Valladolid 1998) 365, 369.

[86] This difference also applies to public companies (§ 179 para. 2 Stock Corporation Act [*Aktiengesetz*, AktG]).

[87] See *J. E. Cachón Blanco*, Modificación de estatutos sociales. Aumento y reducción de capital, in: Bonardell Lenzano/Mejías Gómez/Nieto Carol (eds.), La Reforma de la Sociedad de Responsabilidad Limitada (Madrid 1994) 625, 653–654; *Espín Gutiérrez, supra* note 85, 478–479; *F. Martínez Sanz*, Causas de separación del socio en la LSRL, RdS 6 (1996) 26, 29–30; *J. Brenes Cortés*, El derecho de separación, principales novedades tras las últimas modificaciones operadas en el derecho de sociedades, RdS 37 (2011) 19, 42.

representing a minimum percentage of the share capital. Usually 5% is needed, although some of these rights only require 1% of the shares. For both public and private companies, 5% of the shares is needed in order to call a general meeting (Art. 168 LSC) or to include new items in the meeting agenda (Art. 172 LSC). This is also the case if the minority shareholders request an auditor to verify the accounts of a small-sized company (Art. 265 para. 2 LSC) or do not agree with the auditor appointed by the general meeting (Art. 266 para. 1 LSC). In order to bring a derivative lawsuit against the directors (*actio pro socio*), a minimum 5% of the shares is required as well (Art. 239 para. 2 LSC). This threshold is not necessarily a legal barrier to shareholder litigation.[89]

Special rules for private companies are particularly interesting: 5% of the shares is needed in order to receive the documents used by the directors to prepare the annual accounts (Art. 272 para. 3 LSC). This amount is also required for minority shareholders to request a notary to record the general meeting (Art. 203 para. 1 LSC). In contrast, in public companies, only 1% is needed (Art. 203 para. 1 LSC). However, more important defensive mechanisms have a lower threshold: for both private and public companies, challenging a decision of the general meeting only requires 1% of the shares (Art. 206 para. 1 LSC). This threshold was introduced in the 2014 reform,[90] but cannot be understood as a restriction on the protection of minorities, since shareholders with a lower number of shares can still be compensated (Art. 206 para. 1 LSC). Rather, the property rule has been replaced by a liability rule.[91]

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[88] *Juste Mencía, supra* note 83; *L. Hernando Cebriá*, El abuso de la posición jurídica del socio en las sociedades de capital (Barcelona 2013) 138–157.

[89] See *L. Enriques*, Do Corporate Law Judges Matter? Some Evidence from Milan, EBOR 3 (2002) 765, 774, 779–780. For relevant reasons, see *D. Latella*, Shareholder Derivative Suits: A Comparative Analysis and the Implications of the European Shareholders' Rights Directive, ECFR 6 (2009) 307; *M. Gelter*, Why do Shareholder Derivative Suits Remain Rare in Continental Europe?, Brook. J. Int'l L. 37 (2012) 844, 856–870.

[90] On the reasons for this statutory change see *M. Gimeno Ribes/J. Liefke*, in: Jung/Krebs/Stiegler (eds.), Gesellschaftsrecht in Europa (Baden-Baden 2019) Spanien, marg. no. 257.

[91] Originally see *G. Calabresi/D. Melamed*, Property Rules, Liability Rules, and Inalienability: One View of the Cathedral, Harv. L. Rev. 85 (1972) 1089. For this specific case, see *H. Fleischer*, Entwicklungslinien des aktienrechtlichen Beschlussmängelrechts. Rechtsvergleichung – Dogmengeschichte – Reformvorschläge, in: Fleischer/Kalss/Vogt (eds.), Aktuelle Entwicklungen im deutschen, österreichischen und schweizerischen Gesellschafts- und Kapitalmarktrecht 2012 (Tübingen 2013) 67, 136; *J. Alfaro Águila-Real/J. Massaguer Fuentes*, in: Juste Mencía (ed.), Comentario de la reforma del régimen de las sociedades de capital en materia de gobierno corporativo (Ley 31/2014). Sociedades no cotizadas (Cizur Menor 2015) Art. 204 marg. no. 58.

2. *Conflicts among shareholders*

Rules on closed companies must address tensions among shareholders. Agency costs do not usually arise between directors and shareholders, since the controlling shareholder appoints the director and can thus easily monitor activities. Conversely, majority shareholders can oppress minority shareholders and extract private benefits.[92] Minority shareholders can also abusively block certain transactions from taking place. In this section we analyze the treatment of majority and minority abuses under Spanish law. Then we move on to the implications of shareholder voting in the general meeting in case of conflict of interest.

a) *Majority and minority abuse*

Spanish law is underdeveloped regarding fiduciary duties among shareholders. These duties are widely recognized between directors and the company but not otherwise. The concentrated ownership structure of closed companies is a strong argument for the recognition of fiduciary duties among shareholders.[93] This would also argue in favor of continental European jurisdictions looking to do so.[94] Nevertheless, this is only statutorily established in partnership law. In certain jurisdictions like Germany, a series of court decisions have developed fiduciary duties among shareholders.[95] The *ITT* case[96] considered the duty of loyalty of a majority shareholder in a private company. The German Supreme Court took into account the personalist components of private companies.[97] Moreover, in the *Linotype* case,[98] the duty of loyalty of a controlling shareholder was also recognized in public companies because of the concentrated structure of the firm.[99]

There are no similar court decisions in Spain. An equivalent concept has been somehow developed by legal scholarship in this jurisdiction. The legal

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[92] *J. Armour/H. Hansmann et al.*, Agency Problems and Legal Strategies, in: Kraakman/Armour et al. (eds.), The Anatomy of Corporate Law (Oxford 2017) 29, 29–31.

[93] *Enriques/Volpin, supra* note 3.

[94] *M. Gelter/G. Helleringer*, Fiduciary Principles in European Civil Law Systems, in: Criddle/Miller/Sitkoff (eds.), The Oxford Handbook of Fiduciary Law (Oxford 2019) 583.

[95] For an overview on the evolution in Germany, see *M. Lutter*, Das Girmes-Urteil, JZ 1995, 1053, 1054–1055; *J. Hennrichs*, Treupflichten im Aktienrecht, AcP 195 (1995) 221; *W. Flume*, Die Rechtsprechung des II. Zivilsenats des BGH zur Treupflicht des GmbH-Gesellschafters und des Aktionärs, ZIP 1996, 161, 162–163; *H. Henze*, Treupflichten der Gesellschafter im Kapitalgesellschaftsrecht, ZHR 162 (1998) 186.

[96] BGH, 5 June 1975, II ZR 23/4, BGHZ 65, 15.

[97] BGH, 5 June 1975, *supra* note 96, 19.

[98] BGH, 1 February 1988, II ZR 75/87, BGHZ 103, 184.

[99] BGH, 1 February 1988, *supra* note 98, 184, 195.

construction has considered both the general principle of good faith[100] and the non-abusive exercise of rights.[101] In particular, since both public and private companies are conceptually quite similar, they have been treated by legal scholars in the same way.[102] Indeed, the personalist characteristics of private companies have not played a special role when establishing the duty of loyalty of a majority shareholder. Remedies for majority abuse have been statutorily introduced in the reforms of 2011 and 2014. The rule introduced in 2011 was configured as an exit right for minority shareholders in case of continuous failure to distribute dividends (Art. 348 bis LSC). However, legal scholars have criticized this statutory option, since it tries to solve a conflict between majority and minority shareholders by transforming it into a conflict between the minority shareholder and the company.[103]

The rule introduced in 2014 concerned the legal grounds on which a decision of the general meeting could be challenged. A decision may not only be challenged if it conflicts with the interest of the company, but also if it is detrimental to minority shareholders and there is no justification for it (Art. 204 para. 1 LSC). In this regard, the reform has followed the same path as other jurisdictions like Germany.[104] This rule may simplify how decisions are challenged when the general meeting systematically agrees to retain the whole of the yearly profits while at the same time paying important sums to the controlling shareholder as director compensation. However, it seems rather unnecessary in light of the legal system as a whole. First, decisions of

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[100] *Alfaro Águila-Real, supra* note 28, 18; *M. I. Sáez Lacave*, Reconsiderando los deberes de lealtad de los socios: el caso particular de los socios de control de las sociedades cotizadas, InDret 1 (2016) 1, 19–24. For Germany, *Hennrichs, supra* note 95, 228–234. More cautiously, *D. Verse*, Treuepflicht und Gleichbehandlungsgrundsatz, in: Bayer/Habersack (eds.), Aktienrecht im Wandel (Tübingen 2007) 579, 602.

[101] See e.g. *L. Hernando Cebriá*, Del socio de control al socio tirano y al abuso de la mayoría en las sociedades de capital, RdS 37 (2011) 173.

[102] *Girón Tena, supra* note 39, 423–428. See also *J. Miquel Rodríguez*, Reflexiones sobre los deberes de fidelidad de socios y accionistas, in: Sáenz García de Albizu/Oleo Banet/Martínez Flórez (eds.), Estudios de derecho mercantil en memoria del Profesor Aníbal Sánchez Andrés (Cizur Menor 2010) 453.

[103] *R. Jiménez de Parga*, La ocurrencia del art. 348 bis de la LSC (hoy suspendida su vigencia), in: Tobío Rivas/Fernández-Albor Baltar/Tato Plaza (eds.), Estudios de Derecho Mercantil. Libro Homenaje al Prof. Dr. Dr. h. c. José Antonio Gómez Segade (Madrid 2013) 213; *A. Marina García-Tuñón*, Los derechos al dividendo y de separación a la luz del art. 348 bis de la ley de sociedades de capital. Una revisión general, RdS 49 (2017) 27, 39; *S. Álvarez Royo-Villanova/L. Fernández del Pozo*, Una propuesta de redacción alternativa del artículo 348 bis LSC, LLM 33 (2017) 1. See also *M. Curto Polo*, La protección del socio minoritario (Especial referencia a la protección frente al atesoramiento abusivo de los beneficios sociales) (Valencia 2019) 252.

[104] *M. Würthwein*, in: Spindler/Stilz (eds.), Kommentar zum Aktiengesetz (4th ed., Munich 2019) § 243 marg. no. 202.

this kind could already be challenged before 2014 as a breach of the general prohibition of abuse of rights (Art. 7 para. 2 CC).[105] Second, decisions of this kind are already indirectly limited by the rule on the adequateness of director compensation (Art. 217 para. 4 LSC), a provision which applies to both public and private companies.[106]

In the *Girmes* case, the German Supreme Court established the minority shareholder's duty of loyalty.[107] This duty arises when a shareholder can abusively block decisions. Compared with the German case, qualified majorities in Spain are lower. Consequently, minority abuse is less frequent since it is more difficult for minority shareholders to exercise a veto right.[108] Indeed, the highest threshold in Spain is the two-third majority, which only rarely applies to private companies.[109] Conversely, under German law, every amendment of the articles of association needs to be approved by three quarters of the shareholders (§ 179 para. 2 Stock Corporation Act [*Aktiengesetz,* AktG]; § 53 para. 2 GmbHG). For this reason, minority abuse under Spanish law will predominantly appear in cases of structural alterations.[110] Rrecognition under Spanish law can be based on both German and French case law.[111] In such cases, one should address the importance of the transaction discussed by the general meeting for the continuity of the company.[112]

Minority abuses usually raise questions regarding the applicable remedy.[113] If a decision has been blocked by a minority shareholder, this minority abuse would not necessarily render a decision invalid before a judge.[114] Under Span-

[105] See *Hernando Cebriá*, *supra* note 101, 184–195; *A. Rojo Fernández-Río*, in: Rojo Fernández Río/Beltrán Sánchez (eds.), Comentario de la Ley de Sociedades de Capital (Madrid 2011) Art. 204, 1434, 1440–1441; *H. Fleischer/J. Trinks*, Minderheitenschutz bei der Gewinnthesaurierung in der GmbH. Ein deutsch-spanischer Rechtsvergleich, NZG 2015, 289, 291–292. See also TS, 10 November 2011, Case 770.

[106] On the adequation rule see *F. J. León Sanz*, in: Juste Mencía (ed.), Comentario de la reforma del régimen de las sociedades de capital en materia de gobierno corporativo (Ley 31/2014). Sociedades no cotizadas (Madrid 2015) Art. 217 marg. no. 2; *M. Ruiz Muñoz*, Nuevo régimen jurídico de la retribución de los administradores de las sociedades de capital, RdS 46 (2016) 53, 93–97; *I. Navarro Frías*, Retribuciones proporcionadas y retribuciones abusivas de los administradores sociales: control judicial, RdS 49 (2017) 151, 167–175.

[107] BGH, 20 March 1995, II ZR 205/94, BGHZ 130, 76.

[108] *Bachmann/Eidenmüller et al.*, *supra* note 23, 71.

[109] See *Gimeno Ribes/Liefke, supra* note 90, Spanien, marg. no. 479.

[110] *L. Hernando Cebriá*, Apuntes sobre el abuso del socio minoritario en las sociedades de responsabilidad limitada, RDM 283 (2012) 271, 285–291.

[111] *Bachmann/Eidenmüller et al.*, *supra* note 23, 72.

[112] For Germany, see *supra* note 107. For France, see Cass. Com., 15 July 1992, 96–17216. For Spain, see *Hernando Cebriá*, *supra* note 110, 290.

[113] *Bachmann/Eidenmüller et al.*, *supra* note 23, 72–73.

[114] *Hernando Cebriá*, *supra* note 110, 290–291.

ish law, minority shareholders may cast their votes but this will be considered a minor conflict of interest (Art. 190 para. 3 LSC).[115] Hence the decision can be challenged and a new agreement by the general meeting is needed.[116]

b) *Conflicts of interest among shareholders*

Conflicts of interest among shareholders have traditionally led to voting prohibitions. This was typically the case in statutory provisions governing private companies[117], as seen in Spanish law (formerly Art. 52 LSRL 1995) and also in Germany (§ 47 para. 4 GmbHG). Due to the closed character of these business forms, one vote in the general meeting could make the difference.[118] In theory, that would not be the case in public companies. However, certain voting prohibitions were extended to public companies in the 2014 reform of Spanish company law (Art. 190 para. 1 LSC). According to the legislature, this extension was made because both forms are used for similar purposes, namely as closed companies.[119] This somehow implies that conflicts in both public and private companies are of the same nature.

Apart from its scope of application, a relevant difference to German law relates to the divergent treatment of certain transactional conflicts.[120] Under German law they entail a voting prohibition (§ 47 para. 4 subpara. 2 GmbHG). Conversely, under Spanish law, they have a different effect. A shareholder challenging a decision for contravening the company's best interest, must only prove that another shareholder voted in a conflict of interest. It is the company that must show that the conflicted shareholder did not vote against the best interest of the company (Art. 190 para. 3 subpara. 1 LSC).

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[115] *A. Recalde Castells*, in: Juste Mencía (ed.), Comentario de la reforma del régimen de las sociedades de capital en materia de gobierno corporativo (Ley 31/2014). Sociedades no cotizadas (Madrid 2015) Art. 190 marg. no. 58.

[116] *S. Rodríguez Sánchez*, La aplicación de la denominada "prueba de resistencia" (Comentario de la STS de 15 de enero de 2013), RDM 292 (2014) 629; *Recalde Castells, supra* note 115, Art. 190 marg. no. 62; *M. A. López Sánchez*, Los supuestos de conflicto de intereses sin privación del derecho de voto: la distribución de la carga de la prueba en caso de impugnación de los acuerdos sociales (art. 190.3 LSC), in: Rodríguez Artigas/Alonso Ureba et al. (eds.), Junta General y Consejo de Administración en la sociedad cotizada (Cizur Menor 2016) 121, 143.

[117] *J. Sánchez-Calero Guilarte*, Conflicto de intereses en la Sociedad de responsabilidad limitada y derecho de voto del socio, RdS Extraordinario (1994) 289, 291–295; *M. Sánchez Ruiz*, Conflictos de intereses entre socios en sociedades de capital. Artículo 52 de la Ley 2/1995, de 23 de marzo (Cizur Menor 2000).

[118] *Sánchez-Calero Guilarte, supra* note 117, 294.

[119] *Comisión de expertos en material de Gobierno Corporativo, supra* note 44, 20.

[120] For the distinction between positional and non-positional (transactional) conflicts, see originally *M. A. Eisenberg*, The Structure of Corporation Law, Colum. L. Rev. 89 (1989) 1461, 1472–1473.

Positional conflicts seem to be excluded from the scope of application of the rule in both jurisdictions (§ 47 para. 4 subpara. 2 GmbHG; Art. 190 para. 3 subpara. 2 LSC).[121] This has been noted by the Spanish lawmaker.[122] These are the situations in which the shareholder in a conflict of interest is voting on her own appointment or on a similar decision regarding her position as a director in the company.[123] Whether the decision on director compensation qualifies as a positional conflict in this regard is a question that remains unclear. Spanish legal scholars have given divergent opinions, although the majority does not consider director compensation as a positional conflict.[124] There is a slightly different approach in Germany, where § 47 para. 4 GmbHG does not apply to corporate acts (*Sozial- und Verbandsakten*).[125] Legal scholars have included director compensation in this group.[126]

V. Finance and Creditor Protection

Closed companies usually present certain similarities regarding their funding. Closed companies and family firms usually have difficulties accessing capital markets. Moreover, closed companies typically face higher costs of debt financing due to a weaker bargaining power with financial institutions[127] and probably to the difficulties determining the amount of future cash flows. Among other reasons, retained profits are the preferred source of finance in these kinds of firms.[128] Empirical evidence shows that closed companies and family firms present lower debt ratios and, consistently, take less financial risk

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[121] *Recalde Castells, supra* note 115, Art. 190 marg. no. 70–75; *López Sánchez, supra* note 116, 134–137.

[122] *Comisión de expertos en material de Gobierno Corporativo, supra* note 44, 20.

[123] *Recalde Castells, supra* note 115, Art. 190 marg. no. 72–73.

[124] *L. Fernández del Pozo*, El misterio de la remuneración de los administradores de las sociedades no cotizadas. Las carencias regulatorias de la reforma, RDM 297 (2015) 199, 235–237; *León Sanz, supra* note 106, Art. 217 marg. no. 36; *López Sánchez, supra* note 116, 136–137; *J. C. Vázquez Cueto*, La remuneración de los administradores mediante participación en los beneficios en las sociedades de capital no cotizadas, RdS 55 (2019) 77, 103. For a different opinion, *Recalde Castells, supra* note 115, Art. 190 marg. no. 73.

[125] On this category, *U. Hüffer*, Der korporationsrechtliche Charakter von Rechtsgeschäften – Eine hilfreiche Kategorie bei der Begrenzung von Stimmverboten im Recht der GmbH?, in: Kübler/Mertens/Werner (eds.), Festschrift für Theodor Heinsius zum 65. Geburtstag (Berlin 1991) 337, 338; *F. Van Look*, Stimmverbot und körperschaftlicher Sozialakt, NJW 1991, 152, 153.

[126] *Bachmann/Eidenmüller et al.*, *supra* note 23, 63.

[127] See *E. Ferran/L. C. Ho*, Principles of corporate finance law (Oxford 2014) 57–58.

[128] Fundamentally *S. C. Myers/N. S. Majluf*, Corporate financing and investment decisions when firms have information that investors do not have, J. Fin. Econ. 13 (1984) 187.

than other types of firms.[129] Retained profits result in lower, and less frequent distributions of profits.[130] In this section we consider the legal issues related to the different sources of finance, notably, debt, equity, and retained profits.

1. Sources of Finance

a) Debt

Debt is usually not the preferred source of funding in closed companies.[131] If possible, shareholders use retained profits for that purpose. However, debt is preferred to issuing new shares allowing third parties to access the firm.[132] Lawmakers are confronted with two kinds of issues when designing statutory rules regarding debt in closed companies. First, they try to facilitate access to debt for closed companies in addition to banking finance, which usually imposes high interests.[133] Second, the law establishes rules to avoid imbalance. The unwillingness to issue new shares is based partly on the fact that the founding shareholders do not want third parties to enter the firm and partly because they may not be willing to make new payments to the company. However, the latter may not necessarily be the case. First, retained profits are usually an important source of finance for closed companies. Second, an imbalance may be avoided by the shareholders at the outset, by introducing ancillary obligations (Art. 86 LSC) consisting of new payments in the articles of association.[134]

The Spanish legislature has addressed both questions. Concerning access to debt, the issuance of debt obligations was restricted until 2015. Only public companies were able to do so and only to a limited threshold (double the amount of equity). However, one of the consequences of the financial crisis was a general restriction on access to bank loans for small and medium size enterprises.[135] The Spanish legislature was concerned and decided to facilitate

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[129] *Instituto de la Empresa Familiar, Red de Cátedras de Empresa Familiar, supra* note 2, 29, 56; *M. Martín Tello*, Evolución de las estructuras de financiación de las empresas familiares españolas y sus características en un entorno de postcrisis, BEE 70 (2015) 113, 135.

[130] *Instituto de la Empresa Familiar, Red de Cátedras de Empresa Familiar, supra* note 2, 64.

[131] See *Myers/Majluf, supra* note 128.

[132] See *Myers/Majluf, supra* note 128.

[133] *S. Holmes/P. Kent*, An Empirical Analysis of the Financial Structure of Small and Large Australian Manufacturing Enterprises, The Journal of Small Business Finance 1–2 (1991) 141, 152. For Spain, *J. Sánchez-Vidal/J. F. Martín-Ugedo*, Financing Preferences of Spanish Firms: Evidence on the Pecking Order Theory, RQFA 4 (2005) 341, 344.

[134] *J. Alfaro Águila-Real*, Prestaciones accesorias, in: Garrido Melero/Fugardo Estivil (eds.), El patrimonio familiar, profesional y empresarial. Sus protocolos (Barcelona 2005) 433; *M. Sánchez Ruiz*, Estatutos sociales y pactos parasociales en sociedades familiares, in: Sánchez Ruiz (ed.), Régimen jurídico de la empresa familiar (Cizur Menor 2010) 43, 53.

[135] *Ferran/Ho, supra* note 127, 57.

the closed company's access to finance in various ways. The 2015 reform[136] suppressed limitations on the issuance of debt by public companies (Art. 401 LSC). It also allowed private companies to issue debt obligations up to double their equity (Art. 401 LSC). Legal scholars had already been pushing for this change since the 1990s.[137] Indeed, it was claimed that the partnership-like components and the closed character of private companies was not really an argument for restricting access to debt finance.[138] To some extent, even non-listed public companies in Spain usually have a closed character. Moreover, as already pointed out, the relative distance between the statutory understanding of private and public companies is rather small. Therefore, a divergence of this kind was abolished.

The second legislative concern regards the ability to repay debts. There is a significant difference when it comes to guaranteeing a minimum liquidity in public and in private companies. Proper capitalization of a firm has always been the goal of every legislature, and in 1976, the Second EEC Directive required public companies have a minimum share capital (Art. 23).[139] However, the way to guarantee a proper capitalization for private companies has not always been the same despite some jurisdictions also introducing a rule on a minimum share capital.[140] Indeed, insolvency mechanisms tend to be preferred over those aimed at a going-concern.[141] The idea behind that legislative option is to foster the incorporation of small businesses, as minimum capital rules can act as barrier to entry.[142] Some jurisdictions like Germany established a statutory rule concerning the subordination of shareholder loans (§ 32a GmbHG). It is relatively difficult for small firms to have access to debt finance when in the vicinity of insolvency. Therefore, shareholders may

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[136] *Ley 5/2015, de 27 de abril, de fomento de la financiación empresarial.*

[137] *Fernández del Pozo, supra* note 9, 5441.

[138] *Fernández del Pozo, supra* note 9, 5441.

[139] Second Council of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others are required by Member States of companies within the meaning of the second paragraph of Art. 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital with a view to making such safeguards equivalent (77/91/EEC). Now included in Directive 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law (codification).

[140] E. g. for Spain, Art. 4 LSC. For Germany, § 5 GmbHG. For Italy, Art. 2463 *Codice Civile*.

[141] See *supra* note 63. See also e. g. *H. Eidenmüller*, Trading in Times of Crisis: Formal Insolvency Proceedings, Workouts and the Incentives for Shareholders/Managers, EBOR 7 (2006) 239. See also *C. Thole*, Gläubigerschutz durch Insolvenzrecht. Anfechtung und verwandte Regelungsinstrumente in der Unternehmensinsolvenz (Tübingen 2010); *F. Steffek*, Gläubigerschutz in der Kapitalgesellschaft. Krise und Insolvenz im englischen und deutschen Gesellschafts- und Insolvenzrecht (Tübingen 2011).

[142] *J. Armour*, Legal Capital: An Outdated Concept?, EBOR 7 (2006) 5, 15, 17.

want to make contributions to the company in order to avoid bankruptcy, although moral hazard may lead them to consider those contributions as loans even if the company is heavily undercapitalized. This way, shareholders want to avoid losing their new contributions. However, this may reduce the amount creditors receive in an eventual insolvency procedure.[143]

According to the cited German provision, these loans are subordinated in insolvency, therefore, shareholders may only get paid after every other creditor. Although originally debated before the enactment of the LSRL 1995,[144] the final decision was to not introduce any statutory rule of this kind in Spain. This seems to be a consequence of the similarities between the two business forms. In 1995, most of the going-concern mechanisms applied to private as well as public companies. Nevertheless, a similar rule was included in the Insolvency Act in 2003 (Art. 92 para. 5 *Ley Concursal,* LC)[145]. In a 2008 reform,[146] Germany also decided to convert the rule into an insolvency law provision (§ 39 para. 1 subpara. 5 Insolvency Statute [*Insolvenzordnung*, InsO]).

b) Equity

Creditor protection was also pursued by fully extending the rules of the Second EEC Directive to private companies in 1995. Among the provisions concerned, those that had generally only applied to public companies were introduced as well.[147] The idea behind it was to strengthen the company's asset base in order to make the business form more attractive.[148] Full payment of

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[143] Generally, see *A. Cahn*, Equitable Subordination of Shareholder Loans?, EBOR 7 (2006) 287, 293–294.

[144] See *L. Fernández de la Gándara*, Tradición y reforma en el nuevo Derecho de sociedades de responsabilidad limitada, in: Menéndez Menéndez (ed.), ¿Sociedad anónima o sociedad de responsabilidad limitada? (Madrid 1992) 181, 205–207; *J. C. Paz-Ares Rodríguez*, La infracapitalización. Una aproximación contractual, RdS Extraordinario (1994) 253, 262–265; *J. Massaguer Fuentes*, La infracapitalización: la postergación legal de los créditos de socios, in: Bonardell Lenzano/Mejías Gómez/Nieto Carol (eds.), La Reforma de la Sociedad de Responsabilidad Limitada (Madrid 1994) 941, 959–963; *F. Sánchez Calero*, Insuficiencia del capital social y postergación legal de los créditos, AAMN 34 (1995) 141.

[145] *Ley 22/2003, de 9 de julio, Concursal.*

[146] *Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen. Gesetz v. 23. Oktober 2008* (BGBl. I S. 2026).

[147] *M. C. Sánchez Miguel*, Las aportaciones en la sociedad de responsabilidad limitada, en particular las no dinerarias, RdS Extraordinario (1994) 91, 93–94; *R. J. Vázquez García*, Las aportaciones sociales, in: Bonardell Lenzano/Mejías Gómez/Nieto Carol (eds.), La Reforma de la Sociedad de Responsabilidad Limitada (Madrid 1994) 191, 217; *León Sanz, supra* note 32, 35. See also *Fernández de la Gándara, supra* note 144, 204.

[148] *Fernández de la Gándara, supra* note 144, 204–205; *Vázquez García, supra* note 147, 193.

contributions (Art. 4 LSRL 1995, now Art. 78 LSC)[149] and personal liability for contributions in kind (Art. 21 para. 1 LSRL 1995, now Art. 73 para. 1 LSC)[150] were key aspects of this agenda. Indeed, rules on public companies deviate from that perspective. There is no need for full payment of contributions at the outset (Art. 79 LSC) and there is no liability for contributions in kind. However, criticism can be levelled at the Spanish legislature for a certain incoherence: too many protections were introduced for a relatively low minimum share capital in the comparative framework. Under Spanish law, the minimum share capital for private companies is 3,000 Euro (Art. 4 LSRL 1995, now Art. 4 para. 1 LSC) whereas it amounts to 10,000 Euro in Italy (Art. 2463 para. 4 Italian Civil Code, *Codice Civile*[151]) and even to 25,000 Euro in Germany (§ 5 para. 1 GmbHG).

The last half decade reveals a certain comparative and even European path[152] in the opposite direction. First, minimum share capital requirements have been rendered significantly more flexible in private companies. Since 2013, a minimum share capital is no longer needed when a private company is incorporated.[153] This is possible if those firms comply with certain rules (Art. 4 bis LSC), which are essentially aimed at strengthening the company's asset base for creditor protection purposes. Second, since 2018 there has been no need to guarantee the existence of contributions (Art. 62 para. 2 LSC).[154]

2. *Transfer of Shares*

Restricted transferability of shares is a special characteristic of closed companies. This is typically the case for private companies[155]. The reverse rule applies for the transfer of shares in public companies. Transfer of private company shares is restricted as a default rule (Art. 107 LSC). Certain provisions of the articles of association may deviate from this rule. However, this may only be the case if, as a consequence, not every share is freely transferable (Art. 108 para. 1 LSC). Inversely, the transfer of shares in public companies is free by default. Certain restrictions may be included in the articles of association, but these may not prevent the transfer of shares (Art. 123 para. 2 LSC). It is interesting to note that the rules governing public companies ex-

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[149] *Fernández de la Gándara, supra* note 144, 205.

[150] *Sánchez Miguel, supra* note 147, 101.

[151] *Approvazione del codice civile,* 16 March 1942.

[152] See *supra* note 63.

[153] See *supra* note 36.

[154] *Ley 11/2018, de 28 de diciembre, por la que se modifica el Código de Comercio, el texto refundido de la Ley de Sociedades de Capital aprobado por el Real Decreto Legislativo 1/2010, de 2 de julio, y la Ley 22/2015, de 20 de julio, de Auditoría de Cuentas, en materia de información no financiera y diversidad.*

[155] *Embid Irujo, supra* note 32, 120–121.

plicitly mention possible restrictions to be introduced in the articles of association (Art. 123 RRM). Surprisingly, this kind of clause is analogous to the default rules for private companies (Art. 107 LSC) and includes both the authorization to transfer the shares by the company and the existence of preemptive rights of the rest of the shareholders. This appears to be another sign of the similarity between both business forms.

VI. Governance and Directors' Fiduciary Duties

In this section, we provide a general assessment of the governance framework for Spanish closed companies. Here again, both public and closed companies must be considered. However, their legal regime presents few differences with regards to the composition and functions of the company's organs, including directors' fiduciary duties and remedies against their breach. Indeed, the general policy guideline no longer appears to discriminate between company type, but increasingly foresees solutions that can be applied to both the S.A. and S.L. The structure of Spanish public and private companies resembles that of any other continental monistic system. An administrative organ, responsible for managing and representing the company must be set in place (Art. 209 LSC). Its members are appointed by shareholders who hold the power to remove them *ad nutum* at any given time (Art. 223 LSC). The dogmatic separation of organs has remained doctrinally undisputed since the LSRL 1995.[156]

Depending on the number of directors and the administrative organ functions, this structure may take four different forms. By virtue of Art. 210 LSC, companies may choose between appointing a sole director, joint and several directors (*administradores solidarios*), joint directors (*mancomunados*) or setting up a board of directors (*consejo de administración*). The board is a more complex structure, both quantitatively – it should be composed of at least three members in the S.A. (Arts. 242, 210 para. 2 LSC) – and qualitatively: the law requires to lay down regulations on its functioning (Art. 245 LSC). Besides, in public companies, minority appointments (Art. 243 LSC) and co-optation (Art. 244 LSC) are possible. The board may delegate powers to one or more executive directors (Art. 249 LSC).

[156] *E. Polo Sánchez*, La reforma del régimen jurídico de los administradores de la sociedad de responsabilidad limitada. Aspectos tipológicos y normativos, in: Bonardell Lenzano/Mejías Gómez/Nieto Carol (eds.), La Reforma de la Sociedad de Responsabilidad Limitada (Madrid 1994) 523, 545–552; *J. Quijano González*, Principales aspectos del estatuto jurídico de los administradores: nombramiento, duración, retribución, conflicto de intereses, separación; los suplentes, RdS Extraordinario (1994) 407, 410–411.

Further regulatory developments for the board of directors have enhanced the difference between its executive and non-executive members, the latter now having increased supervisory duties over the former.[157] For instance, following the *Ley 31/2014*, a contract must be entered into between the executive board members and the company (Art. 249 para. 3 LSC). The contract can be understood as an equivalent of the German *Anstellungsvertrag*, in spite of obvious differences arising from the absence of a formal supervisory board in the Spanish one-tier system.[158] The content of the contract is approved by the majority of the board, with the abstention of the concerned party (Art. 249 para. 3 LSC). Within this regulatory trend, monitoring functions have been reinforced as part of the duty of care (Art. 225 paras. 2, 3 LSC). As a result, Spanish scholarship describes the current model as a renovated monistic system.[159] This refers to a deeper separation of the functions and the legal status between executive and non-executive board members in a way that slightly pushes the abstract model closer towards a two-tier system.

1. General Framework

The current legal framework is the result of a long transition. This is the case for Spanish private company forms, which have evolved from a rather partnership-like model into a capitalistic one. Early rules on private companies often contained provisions that could only be understood as reminiscent of a partnership-oriented system.[160] For instance, under the first Spanish act on private companies, the law expressly foresaw that directors could be appointed through the articles of association (*gestor estatutario*) (Art. 12 LSRL 1953). The phenomenon is not so evident today but may still explain a num-

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[157] *J. Sánchez-Calero Guilarte*, Las políticas en materia de control/supervisión de riesgos, información financiera y sistemas internos de control de riesgos e información. La comisión de auditoría y sus relaciones al respecto con el Consejo de Administración [art. 529 ter 1º.B) y D) en relación con el art. 529 quaterdecies LSC], in: Rodríguez Artigas/Alonso Ureba et al. (eds.), Junta General y Consejo de Administración en la Sociedad cotizada (Cizur Menor 2016) 227, 235–236. See also *L. Fernández de la Gándara*, Las comisiones de supervisión y control del Consejo de Administración (Recomendaciones 44 a 58), RdS 27 (2006) 149.

[158] *F. Sánchez Calero*, Los administradores en las sociedades de capital (Madrid 2007) 103; *León Sanz, supra* note 106, Art. 249 marg. no. 30–42; *P. del Val Talens*, El contrato de consejero ejecutivo: notas para el desarrollo de su régimen jurídico, RDBB 149 (2018) 95.

[159] *G. Esteban Velasco*, La renovación de la estructura de la administración en el marco del debate sobre el gobierno corporativo, in: Esteban Velasco (ed.), El gobierno de las sociedades cotizadas (Madrid 1999) 137, 165–166; *A. Alonso Ureba*, El modelo de consejo de administración de la sociedad cotizada tras la reforma legal de 2014 y el CBG de 2015, in: Rodríguez Artigas/Alonso Ureba et al. (eds.), Junta General y Consejo de Administración en la Sociedad cotizada (Cizur Menor 2016) 27, 87–97.

[160] Similarly, *Viera González, supra* note 8, 246.

ber of default provisions which leave room for party autonomy and expressly mention the possibility of replacing them with the solution generally applicable to partnerships. This is the case in Art. 212 para. 1 LSC, authorizing the articles of association to exclude delegated management (*Drittorganschaft*). Paradoxically, nowadays, the only case in which a mandatory rule requires directors to hold shares is co-optation (Art. 243 LSC), but this mechanism is only applicable to the *sociedad anónima*. It goes without saying that the rationale behind each set of rules is different: the safeguard in co-optation is intended to prevent directors from alienating the management of a company whenever there is vacancy,[161] while the enabling rule in Art. 212 para. 1 LSC allows for personalization of management of the company.

The governance regime for public and private companies is extremely similar, with only few nuances, in particular, regarding the functioning of the board of directors, a few provisions on director compensation, and slight differences with regards to conflicts of interest. Two deeply intertwined aspects – shareholder intervention in management and board independence – may show how this is the case and what policy implications such an approach may have. After the 2014 reform, shareholders might issue binding instructions both in the *sociedad de responsabilidad limitada* and the *sociedad anónima* (Art. 161 LSC). The reform extended the solution typically applicable to private companies to the public company[162] in an attempt to enhance shareholder activism. From a comparative perspective, if considered in light of German company law where shareholder involvement in management via instructions is reserved for private companies, this choice is anomalous. From a policy perspective, extending such a powerful mechanism enabling shareholder intervention to the S.A. blurs the defining features of the board of directors in a public company.

Generally, boards in public companies present a higher degree of board autonomy or board isolation, which is usually a *de facto* consequence of separation of ownership and control,[163] even in concentrated ownership structures.

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[161] *A. J. Rojo Fernández-Río*, La facultad de cooptación del Consejo de administración, RDM 189–190 (1988) 367; *F. Martínez Sanz*, Provisión de vacantes en el Consejo de Administración de la Sociedad Anónima (la cooptación) (Pamplona 1994).

[162] Before the reform, *Á. García Vidal*, Las instrucciones de la junta general a los administradores de la sociedad de responsabilidad limitada (Cizur Menor 2006) 161; *F. Sánchez Calero*, La junta general en las sociedades de capital (Cizur Menor 2007) 454–456. After the reform, *Ley 31/2014, Recalde Castells, supra* note 115, Art. 161 marg. no. 51, 53–54.

[163] For a European approach, *M. Gelter*, The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance, Harv. Int'l L. J. 50 (2009) 129; *S. Cools*, The Dividing Line Between Shareholder Democracy and Board Autonomy: Inherent Conflicts of Interest as Normative Criterion, ECFR 2 (2014) 258.

Empowered boards can be justified by both entrepreneurial and typological constraints: the size of the undertaking usually correlates with the complexity of managerial affairs and, therefore, with technical skills required by those who are responsible for it. In turn, the higher the latter, the less feasible and convenient it becomes to consult shareholders on business decisions. In terms of convenience, technical aspects of business decisions might be out of shareholders' scope of knowledge. Cost-related implications of calling a general meeting are also important. In terms of feasibility, even if shareholders were capable of making business assessments, collective action problems arise.

The scope of board isolation may vary from one country to another. In Germany, board independence is considered to be a core feature of the public company governance model.[164] This principle is commonly derived from § 76 para. 1 AktG, which states that the board should manage the company under its own responsibility. But the normative function of this provision goes far beyond this. It actually works as the legal cornerstone of the administrative organ in the German joint stock corporation (*Aktiengesellschaft*) and underpins not only the general understanding thereof, but the whole scholarly debate and every interpretative option. This provision is at the basis of the well-established scholarly rejection of any form of corporate conduct that might jeopardize the independence of the board. Among many others, § 76 para. 1 AktG upholds the need for a legal regime for groups of companies to legitimize behavior that otherwise would entail a breach of the duty to act independently.[165] In turn, it also functions as a legal ground against the possibility that shareholders of a German *Aktiengesellschaft* intervene in the management of the company and issue instructions.[166]

In the case of Spain, as a result of Art. 161 LSC being applied to the S.A., the public company presents a higher level of shareholder involvement and, consistently, board isolation is nuanced when compared to other continental jurisdictions. Increasing shareholder involvement is usually a suitable policy mechanism to balance directors' power in the absence of a supervisory board, although this was not considered by the legislature. This ongoing difference between one-tier and two-tier systems explains why EU secondary law on company organs might admit different options when it comes to shareholder approval. For instance, Art. 9a para. 1, para. 3 of Shareholders' Right Directive II[167] enables EU Member States to choose between a binding and an

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[164] *H. Fleischer*, in: Spindler/Stilz (eds.), Kommentar zum Aktiengesetz (4th ed., Munich 2019) § 76 marg. no. 56–57; *G. Spindler*, in: Goette/Habersack (eds.), Münchener Kommentar zum Aktiengesetz (5th ed., Munich 2019) § 76 marg. no. 1. See also *H. Fleischer*, Zur Leitungsaufgabe des Vorstands im Aktienrecht, ZIP 2003, 1.

[165] *Fleischer, supra* note 164, § 76 marg. no. 57 and 68–69.

[166] *Spindler, supra* note 164, § 76 marg. no. 27; *Gelter, supra* note 163.

[167] Directive (EU) 2017/828 of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.

advisory shareholder vote on remuneration policy. Monistic systems might be more inclined to enact a binding vote. Conversely, two-tier systems are usually reluctant to do so at this affects the allocation of powers resulting from their organizational structure.[168] Under domestic provisions in dualistic systems, shareholders do not interfere in executive compensation matters.

It is not only the abstract level of statutory board independence, but also the domestic understanding thereof which may be determinant. This can be illustrated by comparing § 76 para. 1 AktG with Art. 228 lit. d LSC, which similarly provides that directors must exercise their office under the principle of personal responsibility (*responsabilidad personal*), with freedom of judgement, and independence vis-à-vis third-party instructions and attachments. Once again, in the case of Spain, the provision applies to public as well as private companies. This article was introduced in 2014 as part of the provisions on the duty of loyalty, and was one of the specific obligations arising from it.[169] A preliminary comparison between the German and the Spanish provisions suggests that they fulfil a similar function: they both provide a general clause imposing a duty on directors to act responsibly and independently. However, a contextualized analysis immediately shows that they are extremely divergent.

First, the Spanish provision on board independence must be examined in the context of i) the functional polyvalence of the S.A.; ii) a subsequent relatively high degree of homogeneity between company forms; and iii) a lower standard for board independence. Under Spanish law, this provision coexists with mechanisms enabling shareholder involvement and other institutions that, under the German approach, would be considered incompatible with the duty of independence. As a result, the general framework imposes a different understanding of the Spanish provision, one that integrates the system. From a legal policy standpoint, it is clear that by introducing Art. 228 lit. d LSC, the Spanish legislature did not intend to further isolate the board from shareholders. The fact that directors must not be pre-empted by any third-party[170]

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[168] *J. Lieder/P. Fischer*, The Say-on-Pay Movement – Evidence From a Comparative Perspective, ECFR 3 (2011) 376, 377; *J. Schmidt*, Die Umsetzung der Aktionärsrechte-Richtlinie 2017: der Referentenentwurf für das ARUG II, NZG 2018, 1202, 1203.

[169] *J. C. Paz-Ares Rodríguez*, Anatomía del deber de lealtad, in: Rojo Fernández-Río/Campuzano Laguillo (eds.), Estudios jurídicos en memoria del profesor Emilio Beltrán: Liber Amicorum (Valencia 2015) 569, 588; *R. Alfonso Sánchez*, Obligaciones básicas derivadas del deber de lealtad: artículo 228, in: Hernando Cebriá (ed.), Régimen de deberes y responsabilidad de los administradores sociales en las sociedades de capital (Barcelona 2015) 187, 221–223.

[170] *J. Megías López*, Una aproximación al deber de independencia en el consejo de administración, in: Fernández Torres/Arias Varona/Martínez Rosado (eds.), Derecho de sociedades y de los mercados financieros: libro homenaje a Carmen Alonso Ledesma (Madrid 2018) 585, 587.

does not liberate them from following legitimate shareholder instructions. In turn, their duty to act in accordance with the interest of the company would require them to test whether instructions issued by shareholders are compatible with that interest. In addition, the Spanish provision should not be awarded an essential role in the legal framework, but rather be understood as part of a comprehensive catalogue of duties. Even if the policy strategy leaning towards such a strong homogenization of S.A. and S.L. is subject to criticism, this does not necessarily constitute an antinomy in the Spanish rules.

One last example, showing how path-dependency in corporate governance traditions explains considerable differences in the understanding of a number of basic features, can be seen in the power shareholders hold to remove directors in private companies. In Spain, Art. 223 LSC vests upon them the power to remove directors at any given time. The decision does not need to be foreseen in the agenda of the general meeting (Art. 223 para. 2 LSC). The power to dismiss directors *ad nutum* has been traditionally considered a mandatory rule for both private and public companies and the predominant scholarly opinion does not conclude that the articles of association establish otherwise[171]. They also should not increase the majority threshold that is needed to decide in the S.A., while Art. 223 para. 3 LSC explicitly permits an increase to a maximum of two thirds of the votes. Again, arguments regarding the special features of each company form are not balanced in the discussion. The German example shows how a different approach to private and public companies in this regard can be easily justified. In private companies, *ad nutum* removal is the default rule, but the articles of association may provide that it is subject to important reason (good cause or *wichtiger Grund*) (§ 38 paras. 1, 2 GmbHG). Board independence in the *Aktiengesellschaft* demands stronger safeguards for administrative positions and, consistently, members of the *Vorstand* may only be removed from office with good cause (§ 84 para. 3 AktG).[172]

A number of policy and hermeneutical implications can be extracted from this analysis. Spanish legal scholarship has long warned against the risk of transplanting German solutions for public companies into the Spanish system.[173] In light of the ever-increasing number of legal transplants in the field of corporate governance,[174] the discussion above shows that utmost care is

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[171] *M. Gimeno Gómez-Lafuente*, El control de los administradores en la S.A. tras la reforma de 1989, RCDI 611 (1991) 1619, 1658; *H. Sánchez Rus*, Las cláusulas estatutarias relativas a la retribución de los administradores en las sociedades de capital, LLM 14 (2015) 1, 12; *M. C. Ortiz del Valle*, Estado actual de la delegación de facultades en las sociedades de capital, CDC 65 (2016) 143, 158. For a different opinion, *F. López de Medrano*, La separación de los administradores de la sociedad anónima (Barcelona 1986) 284.

[172] *Fleischer, supra* note 164, § 84 marg. no. 99.

[173] *Rojo Fernández Río, supra* note 8, 28.

[174] *H. Fleischer*, Legal Transplants in ECL – The Case of Fiduciary Duties, ECFR 2 (2005) 378, 384 et seq.; *J. von Hein*, Die Rezeption US-amerikanischen Gesellschafts-

advisable when designing both a domestic and EU-policy strategy with regards to company forms. The comparison of two core issues of German and Spanish corporate governance indicates that systemic differences persist. From an interpretative standpoint, they should be considered when reading domestic provisions that might seem equivalent as they stand but are indeed entirely different in spirit.

2. Directors' Fiduciary Duties

Within the general corporate governance framework, directors' fiduciary duties have been at the center of the scholarly debate and the legislative agenda in recent times. In Spain, they have developed considerably during the past decade and, in the aftermath of the 2014 reform, they have been subject to extensive doctrinal analysis. The Spanish system follows the widespread two-fold approach and distinguishes the duty of care (Arts. 225 and 227 LSC) and the duty of loyalty (Arts. 228 et seq. LSC). This dual structure was emphasized by the 2014 reform: the underlying policy objective was to strengthen the duty of loyalty, while reinforcing the protection of business judgement.[175] The former consisted of formulating specific obligations arising from the duty of loyalty (Art. 228 LSC), including various forms of conflicts of interest (Art. 229 LSC), and setting in place a clear-cut rigorous procedure intended to prevent, detect and punish illegal related party transactions (Arts. 230–231 LSC). The latter included an explicit formulation of the business judgement rule (Art. 226 LSC) together with a catalogue of duties arising from the general standard of care (Art. 225 LSC). This policy strategy aligned the Spanish system with international regulatory trends and fostered intensive discussion, with two aspects which may warrant criticism.

First, the reform failed to take into account typological specialties and, by doing so, continued to increase the similarities between the S.A. and S.L. Most rules on directors' duties are identical in their application to public and private companies, with only a few exceptions concerning the authorization of related party transactions (Art. 230 LSC). On the one hand, this is not new: the Spanish regime on directors' duties in private companies has never been the object of autonomous regulations. Under the LSRL 1995, director's liability in the S.L. was only regulated by reference to the provisions which applied to the public company (Art. 69 LSRL 1995). On the other hand, the reform has improved regulations on shareholders' conflicts of interest (Art. 190 LSC), which are usually a necessary safeguard in private companies. At the same time, minority shareholders have been granted direct stand-

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rechts in Deutschland (Tübingen 2008) 909 et seq.; *K. Langenbucher*, Economic transplants on lawmaking for corporations and capital markets (Cambridge 2017) 73–81.

[175] *J. C. Paz-Ares Rodríguez*, La responsabilidad de los administradores como instrumento de gobierno corporativo, RdS 20 (2003) 67, 70 et seq.

ing in an *actio pro socio* for breach of the duty of loyalty (Art. 239 para. 1 subpara. 2 LSC). It is true that these two mechanisms also apply in public companies. Scholarship and the judiciary should work to develop special directors' duties for closed companies.

Second, the reform was excessively reliant upon comparative models. The new catalogue of duties arising from the duty of loyalty was strongly inspired by sections 170 to 177 of the UK Companies Act 2006. The Spanish provisions resemble them in their structure and wording. This is, for instance, is the case for Art. 228 lit. a LSC, requiring directors to use their powers for proper purposes, a standard that may be considered reiterative or even foreign to the Spanish company law tradition.[176] The expanded loyalty regime could lead to *false positives*: while increasing awareness of what is deemed due behavior vis-à-vis the company, the fact that a number of its manifestations are not deep-rooted in the system may produce cases in which lawful behavior is assessed as a breach of the duty of loyalty.

VII. Family Firms

We now provide insight on the economic and legal background of family firms in Spain. Here, we first discuss the funding and governance framework for family-owned or controlled undertakings. We will then analyze its regulatory implications and compare the results with the legal regime of family businesses, to reveal certain flaws in the underlying policy strategy. In line with the comparative framework, there is no definition for a 'family firm' under Spanish law. Efforts to elaborate a legal definition have been unsuccessful, although the fact that a firm is owned or controlled by family members fulfils a certain normative function. Today, the preamble of the *Real Decreto 171/2007*,[177] regulating publicity of family protocols, defines family firms in broad terms as those where ownership or decision power is totally or partially held by persons related to each other by blood or marriage. This definition determines the scope of application of provisions regarding family protocols (Art. 1 *Real Decreto 171/2007*), which are defined as pacts between shareholders or between them and third parties with whom they hold family ties. The definition is predominantly subjective.[178] However, it does not in-

[176] *Alfonso Sánchez, supra* note 169, 191–193; *P. del Val Talens*, El ejercicio de las facultades de los administradores con fines adecuados: análisis del artículo 228.a) LSC, RdS 50 (2017) 225, 227.

[177] *Real Decreto 171/2007, de 9 de febrero, por el que se regula la publicidad de los protocolos familiares*.

[178] *Iglesias Prada, supra* note 12, 5417–5418; *M. Sánchez Ruiz*, Introducción. Una aproximación a las empresas y las sociedades familiares, in: Sánchez Ruiz (ed.), Régimen

clude intergenerational transmission of the business as a way of retaining control in the hands of the family, although the preamble does refer to it twice. This is due to the fact that the temporal aspect is not deemed essential in the traditional scholarly concept of family firms.[179] Conversely, from a legal perspective it may be easier to construct a definition on objective grounds (family attachments and control) as opposed to a subjective criterion (the aim of maintaining the latter).[180]

Spain lacks a continuous legal policy strategy for family firms, although the legislature has sometimes considered them when amending provisions on the S.L.[181] Family firms represent a significant reality within the domestic business environment,[182] but predominantly adopt the form of companies.[183] As a result of the homogenization between the S.A. and S.L., there is broad consensus on the fact that both forms of public and private companies suit the needs of family firms.[184] Family firms are not necessarily small or medium undertakings, and may adapt to the features of public companies – also in systems with stronger differences between these and private companies – or even be publicly traded. However, the predominance of SMEs in the Spanish business environment, together with the limited development of partnerships, may explain the preference for the S.L.[185] Even in the context of strong similarities between public and private companies, the traits typical of the S.L., including mechanisms that allow retention of family control, e.g. multiple-

jurídico de la empresa familiar (Cizur Menor 2010) 15, 21; *F. Alonso Espinosa*, La empresa familiar como problema, RDM 283 (2012) 33, 39, 41.

[179] From a management perspective, see *R. Sabater Sánchez*, Concepto, dimensiones y modelos de empresa familiar, in: Monreal Martínez/Sánchez Marín et al. (eds.), La gestión de las empresas familiares: un análisis integral (Cizur Menor 2009) 99, 100–101.

[180] *S. Sánchez Gimeno/J. V. Cuesta López*, El gobierno de la sociedad limitada familiar, in: Garrido de Palma (ed.), Estudio sobre la sociedad de responsabilidad limitada (Madrid 2004) 155, 157.

[181] *Informe de la Ponencia de Estudio del Senado de 23 de noviembre de 2001*. See *F. J. Olmedo Castañeda*, Hacia un estatuto de la empresa familiar: necesarias reformas legales, CDC Extraordinario (2017) 369, 388 et seq.

[182] *Alonso Espinosa, supra* note 178, 59–60.

[183] *F. Vicent Chuliá*, Organización jurídica de la sociedad familiar, RdP 5 (2000) 20, 21; *Alonso Espinosa, supra* note 178, 59–60; *I. G. Revilla Fernández*, Fórmulas societarias existentes al servicio de la empresa familiar, CDC Extraordinario (2017) 189, 195–196, 199.

[184] *Vicent Chuliá*, *supra* note 183, 33; *Alonso Espinosa, supra* note 178, 74; *F. Rodríguez Artigas*, Sociedad de responsabilidad limitada y empresa familiar (notas sobre una reforma de la LSRL), RdS 21 (2003) 15, 18.

[185] See also *Sánchez Gimeno/Cuesta López, supra* note 180, 159; *Revilla Fernández, supra* note 183, 230.

voting shares or restricted share transfer have traditionally resulted in them being regarded as better equipped for family-run undertakings.[186]

3. Empirical Data

We now focus on empirical data with regards to a number of finance and governance related issues, reviewing their common trends in order to further explain the underlying economic and legal policy rationale.

a) Finance

With regards to their finances, studies show that Spanish family firms present lower debt ratios than other firms.[187] They prefer internal financing (own resources) and, therefore tend to be less exposed to financial risk than other firms. They show a higher tendency to reinvest profits, this is, to retain resources while reducing or limiting distribution among shareholders.[188] Some studies claim that access to finance is not one of the main concerns of family firms, an assertion that seems doubtful in absolute terms, notably, against the background of the economic crisis, but somewhat true in relative terms when comparing family firms to undertakings that are not under a family's control.[189] These results are consistent with the pecking-order theory.[190]

b) Governance

As far as their governance is concerned, family firms operating under company forms will follow the organizational structure required by the law. When it comes to administrative organs, Spanish family firms frequently organize their management by setting a board of directors in place.[191] As described above, this is only one of the four alternative forms the administrative organ may take.[192] Managerial literature correlates an increasing preference for the board with the passage of time: as the control of the company is passed on to subsequent generations, the number of persons – different generations, siblings, bloodlines, family branches – who intervene in running the company

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[186] *Vicent Chuliá*, *supra* note 183, 33–34; *Iglesias Prada, supra* note 12, 5421; *de la Vega García, supra* note 81, 30.

[187] *Instituto De La Empresa Familiar, Red De Cátedras De Empresa Familiar, supra* note 2, 29, 56.

[188] *Instituto De La Empresa Familiar, Red De Cátedras De Empresa Familiar, supra* note 2, 64.

[189] *KPMG*, VI Barómetro de la Empresa Familiar (Madrid 2017) 8.

[190] See *Myers/Majluf, supra* note 128.

[191] *A. J. Carrasco Hernández/R. Sabater Sánchez*, Gobierno y organización de la empresa familiar, in: Monreal Martínez/Sánchez Marín et al. (eds.), La gestión de las empresas familiares: un análisis integral (Cizur Menor 2009) 144, 150–151.

[192] See *supra* XI.

increases.[193] This idiosyncratic tendency to form a more complex structure makes sense whenever different family groups or bloodlines wish to be represented and to intervene in the direction of the company. In a peaceful family context, its members might be reluctant to exclude family members from the board even if they lack technical skills.[194]

However, empirical evidence also associates this idiosyncratic preference for the board with inefficiencies arising from excessively large administrative organs.[195] This may be the case if family members lacking technical skills or sufficient experience access the board. It may lead to boards formed by a larger number of property directors as opposed to executive and independent directors. Awarding executive functions to family members has been associated with a negative impact on financial performance due to risk-aversion on the part of family CEOs.[196] On the contrary, replacing independent directors with family members should not raise unnecessary concern since empirical evidence suggests that the role of independent directors in Spanish family firms varies from one generation to another: while they adequately fulfil a monitoring task when the company is run by the first generation, their presence has no effect on performance from the second generation onwards.[197] In turn, more simple administrative structures formed by two persons may easily find themselves dead-locked and are therefore not always a feasible alternative.[198] Management scholars also point out a higher risk of entrenchment associated with a large number of property managers, usually, members of the family, which results in lower value creation.[199]

4. *Economic Rationale and Policy Assessment*

The framework described above can be better understood in light of general management theory. Common practice in Spanish family firms is consistent with its results. Reattaching empirical finance and governance data with general theory on management may improve policy-making specifically targeting family firms. The following analysis emphasizes that a number of mechanisms designed by the Spanish legislature to ameliorate the finances of closed

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[193] *Carrasco Hernández/Sabater Sánchez, supra* note 191, 153.

[194] Similarly, *Alonso Espinosa, supra* note 178, 66.

[195] *R. García-Ramos/M. García Olalla*, Estructura del consejo de administración en la empresa familiar versus no familiar: evidencia empírica en España, REFC 149 (2011) 35.

[196] *J. L. Miralles-Marcelo/M. M. Miralles-Quirós/I. Lisboa*, The impact of family control on firm performance: Evidence from Portugal and Spain, JFBS 5 (2014) 156.

[197] *B. Arosa/T. Iturralde/A. Maseda*, Outsiders on the board of directors and firm performance: Evidence from Spanish non-listed family firms, JFBS 1 (2010) 236.

[198] *V. Martí Moya*, La resolución de conflictos en la empresa familiar. El arbitraje societario, in: Sánchez Ruiz (ed.), Régimen jurídico de la empresa familiar (Cizur Menor 2010) 203, 205–206.

[199] *García-Ramos/García Olalla, supra* note 195, 35 et seq.

undertakings and family firms might not be aligned with their specific financing preferences and therefore will have a limited practical impact. It also anticipates the potential effects and uses of certain governance mechanisms.

a) *Finance*

With regards to their finances, the Spanish data for family firms is consistent with the pecking-order-theory.[200] According to its proponents, firms prefer to use internal resources to finance new investments. For this purpose, they will be inclined to retain profits, and will only resort to external finance sources when internally generated earnings are not enough. Of these, their first option tends to be debt, followed by other types of securities, such as bonds and only exceptionally will they issue share capital. However, studies specifically focusing on continental markets and analyzing family firms in Spain, have pointed out that, even if their financial structure is coherent with the pecking-order theory, the underlying rationale is slightly different from Anglo-Saxon jurisdictions.[201] In family firms, the controlling group will commonly oppose non-family members accessing the company, which explains why issuing share capital is the last resort. Nevertheless, pre-emptive rights and restrictions on transferring shares in continental closed company forms and allowing existing shareholders to retain control reduce the risk of third-party access. Empirical evidence on family firms suggests that within such a legal framework, the financial structure of Spanish family undertakings could be explained by the so-called *debt or supply gap* and the motivation to retain control.[202] These results also show that the issuance of debt securities is unlikely to be a preferred funding alternative for family firms. In contrast, legal scholarship has traditionally seen it as a feasible option for this kind of undertakings.[203]

b) *Governance*

In terms of governance, the legal framework facilitates and offers safeguards against reinforced control on the part of family members. Entrenchment of family members is not undesirable *per se,* as long as it does not result in the extraction of private benefits at the expense of minorities. Rules on shareholders' conflicts of interest (Art. 190 LSC) together with directors' fiduciary duties (Arts. 225 et seq. LSC) are designed to prevent tunneling. In addition, a number of organizational alternatives might diminish conflicts arising from

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[200] See *Myers/Majluf, supra* note 128 and XI.1.a).

[201] *J. Sánchez-Vidal/J. F. Martín-Ugedo*, Financing Preferences of Spanish Firms: Evidence on the Pecking Order Theory, RQFA 4 (2005) 341.

[202] *Sánchez-Vidal/Martín-Ugedo, supra* note 201, 344 et seq.

[203] *F. Rodríguez Artigas*, La empresa familiar y las reformas de la ley de sociedades limitadas, in: Garrido Melero/Fugardo Estivill (eds.), El patrimonio familiar, profesional y empresarial. Sus protocolos (Barcelona 2005) 383, 315.

unequal treatment of family blocks, lines, or members. It is often suggested that family firms which are performing well should ensure that self-generated funds allow family members to continue with their independent projects.[204] Although reinvesting profits will likely to be first source of finance, it is also advisable that sufficient output is distributed among family members who are shareholders, in accordance with the performance of the company.[205] The inefficiencies described above correlate with large boards and family CEOs can tackle this by creating informal family organs, which are not integrated in the legal organizational structure, but which undertake important functions: they keep family members adequately informed, enable discussions that might not be entirely business-related and supervise management.[206] Regulations on the functioning of the board (Art. 245 LSC) should enable any organizational structure that suits the needs of the family, for instance, whenever different bloodlines need to be proportionally represented.[207]

VII. Conclusions

1. Interchangeability of public and private forms in Spain explains why public companies can fulfil endogenous features of closed undertakings. Public (S.A.) and private (S.L.) companies are similarly suitable for such undertakings. Similarities between the Spanish forms can be historically justified. The current framework is the result of recasting provisions on the S.A. and the S.L. followed by a number of corporate governance reforms that did not take typological specialties into account.
2. For years, the S.A. and the S.L. have been assessed within a uniform policy strategy. If this approach is maintained, the need for two legal forms must be reconsidered. In addition, the system is not compatible with legal transplants from the German system since, when imported into Spain, provisions may be equally applicable to public and private companies. Consequently, emulating the German system would require an *ex ante* as-

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[204] *Alonso Espinosa, supra* note 178, 71.

[205] *Sánchez Gimeno/Cuesta López, supra* note 180, 161. Slightly different, referring to the value, *Alonso Espinosa, supra* note 178, 71.

[206] *M. J. Verdú Cañete*, Estructura orgánica de la sociedad familiar, in: Sánchez Ruiz (ed.), Régimen jurídico de la empresa familiar (Cizur Menor 2010) 75, 92, 95; *Alonso Espinosa, supra* note 178, 65; *S. Hierro Anibarro/M. Zabaleta Díaz*, Principios de gobierno corporativo en sociedad no cotizada, in: Hierro Anibarro (ed.), Gobierno corporativo en sociedades no cotizadas (Madrid 2014) 39, 67–74.

[207] *Sánchez Gimeno/Cuesta López, supra* note 180, 182; *J. Martínez-Cortés Gimeno*, Conflictos más frecuentes en el marco de la empresa familiar y su prevención, CDC Extraordinario (2017) 765, 817–818.

sessment on the rationale and scope of the provision. This applies mainly to the field of governance and to directors' duties in particular.

3. Differences between the S.A. and the S.L. with regards to sources of finance have not been correctly addressed by the legislature. Concerning share capital, too many rules on the maintenance of capital were imported from the S.A. regime in spite of the S.L. having a relatively low minimum capital. Regarding debt, traditional restrictions for the S.L. to access the debt market have only recently been abolished in the aftermath of the financial crisis.
4. The Spanish system presents a well-equipped system of minority protection in closed companies, which was improved by the *Ley 31/2014*. In this regard, extending rules on conflicts of interest among shareholders is arguably a consequence of similarities in ownership structures of closed undertakings formed as both S.A. and S.L. Excessive control on the part of the commercial register may indirectly reduce minority protection by relegating a number of organizational issues to shareholders' agreements.
5. To date, the Spanish legislature has only sporadically assessed family firms. This lack of an independent policy strategy for family firms is partially justified. Empirical evidence shows that solutions suggested by legal scholarship may not always be entirely consistent with common practice among family firms.

Abide or Leave

Withdrawal Right for Retention of Profits, Close Family Companies and Rule of Law

F. Javier Arias Varona

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I. Introduction

Shareholder conflicts are defined as a cardinal problem of closed corporations.[1] Among them, minority oppression in closed corporations is a well-known issue (although oppression can go both ways)[2], in particular as the abusive retention of profits. A decision to not distribute dividends, although legally permissible, does not harm the majority shareholders'[3] interests when they can obtain gains from the activity of the company by other means, or

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[1] *H. Fleischer*, Shareholder Conflicts in Closed Corporations, in: Bachmann/ Eidenmüller et al. (eds.), Regulating the Closed Corporation (Berlin 2014) 29.

[2] For a quick overview of oppression by minority, see *Fleischer, supra* note 1, 71 et seq.

[3] In this paper, I will use the terms *shares* and *shareholders* to refer to partners of a company and those parts in which the legal capital is divided. Under Spanish law, shares and shareholders apply only to corporations (*sociedades anónimas*, german AG). A different term is used for *sociedades de responsabilidad limitada* (german GmbH)*: participaciones*, instead of *acciones*, and thus *socios* and not *accionistas*. Shares and shareholders should be understood as also referring to *participaciones* and *socios*, unless otherwise noted.

when it is used as leverage to force minority shareholders to sell their part of the company. Although it is always possible to retain profits to serve the best interests of the company, when it is a recurring decision it usually can only be explained as abusive behavior by the majority.

Preventing majority abuse has always been a challenge for closed corporations, in particular in the case of abusive retention of profits. This is due to the fact that, as a matter of principle, companies' decisions are taken in accordance to the majority principle. As a consequence, the interests of the company represent majority decisions, therefore, there is a natural resistance to voiding these decisions.

How to tackle potential abuses in the form of profit retention is still one of the most challenging issues in modern company law that may be summarized in several basic questions: how should legislators and minority shareholders act against this behavior?; what should be the role of courts and how does this affect the managerial discretion for dividend policy?; and finally, can the right to dividends be enforced in civil proceedings? The difficulty in answering these questions is increased by the reluctance shown by academic literature to interfere on the dividend policy due to three combined facts:[4] retention has positive effects for the company (compensates for weak legal capital and strengthens the future financial situation); decisions on this matter are usually considered purely business decisions (that thus should be left to directors or shareholders, depending on the jurisdiction); and there are procedural obstacles to granting adequate protection.

There is no dominant approach to this problem. Different jurisdictions provide different solutions but in general terms, there are two basic possibilities. Firstly, drafting a legal provision that, to a certain extent, provides protection for the minority against this majority behavior. In this case, the rule may grant a right to a minimum dividend distribution or, alternatively, provide the minority with some rights in the case of non-distribution, specifically the right to exit the company. Secondly, it might be thought preferable not to address this question via legislation, but rather to leave the solution to the courts, which act on a case by case analysis, under more general principles such as the duty of *bona fide*.

Spanish law follows the first approach. Since 2011,[5] Art. 348 bis of the Spanish Corporations Act[6] (*Ley de Sociedades de Capital,* LSC)[7] has granted

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[4] As stated in *H. Fleischer/J. Trinks*, Minderheitenschutz bei der Gewinnthesaurierung in der GmbH – Ein deutsch-spanischer Rechtsvergleich, NZG 2015, 289, 290.

[5] This was the first time that a legal provision was finally passed, but not the first time that a legal rule was drafted to provide protection to minority shareholders against undue retention of profits – in 1993: draft of a proposal of a law for *S.L.* (right to 1/3 of profits required by at least a 5% of the legal capital; in 2002: proposal of a Code of Commercial Corporations (right to exit from the fifth financial year if at least 1/3 of profits are not distributed as dividend); in 2014, draft of a Commercial Code (right to exit from the fifth

shareholders an exit right to protect them against abusive retention of profits.[8] The rule serves to overcome the difficulties of proving abuse in these cases

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financial year if at least 1/4 of profits are not distributed as dividend and several other requirements).

[6] For reference purposes, it is useful to include the present wording of Art. 348 bis LSC.

"Article 348 bis. Right of exit due to failure to distribute dividends.

1. Unless otherwise provided for in the articles of association, after the fifth financial year counting from the entry of the company in the Companies Register, any partner whose protest against an insufficient dividend distribution is recorded in the general shareholders' meeting minutes shall be entitled to exit the company if the ordinary general meeting does not decide to distribute a dividend of at least twenty-five per cent of the legally distributable profit earned in the preceding year, provided that profits were obtained in the three preceding financial years. Nevertheless, partner will not be entitled to exit if the total distributed dividends in the last five financial years amount to, at least, twenty-five percent of the legally distributable profit accrued during this period of time.

The provisions of the above sub-paragraph do not affect the right to challenge shareholders' meeting decisions nor do they prejudice any liability action.

2. Any decision to abolish or amend the exit right provided for under the preceding paragraph will require a unanimous vote of the partners, unless an exit right is granted to any partner who does not vote in favor of this decision.

3. The right to exit must be exercised within one month following the day on which the general meeting was held.

4. The right to exit can be exercised by the partners of the parent company of a company providing consolidated accounts, even where the requirements of the first paragraph are not met, if the said [parent] company does not decide to distribute a dividend of at least twenty-five percent of the consolidated profits ascribed to the parent company that were earned in the preceding financial year, provided that they are legally distributable and that consolidated profits were obtained and ascribed to the parent company in the three preceding financial years.

5. The provisions included in this article will not apply in the following cases:

a) If the company is listed or its shares are traded in multilateral trading facilities.

b) If the company is under insolvency proceedings

c) If, in accordance with insolvency regulations, the company has notified the competent court that it has started to negotiate a refinancing agreement or adhesions to an early proposal for an insolvency agreement, or when the court has been notified that negotiations of an out-of-court payment agreement have commenced.

d) If the company has reached a refinancing agreement that meets the insolvency law requirements to be granted protection against insolvency rescission actions.

e) If the company is a Public Limited Sports Company [Sociedad Anónima Deportiva]."

[7] *Real Decreto Legislativo 1/2010, de 2 de julio, por el que se aprueba el texto refundido de la Ley de Sociedades de Capital.*

[8] The is undoubtedly aimed at providing protection against majority abuses in the form of profit retention, but in fact its original design allowed its automatic application even if no abuse was present (*J. Brenes Cortés*, El derecho de separación en caso de falta de distribución de dividendos: la entrada en vigor del controvertido artículo 348 bis de la Ley de Sociedades de Capital, RDM 305 [2017] 37), something that was partially solved in a later amendment.

and the limited practical relevance of voiding a decision of the general meeting not to distribute dividends.[9] Without it, courts resorted to other tools of company law, namely the duty of loyalty, or made more general calls to the *bona fide* principle to solve these conflicts.

Notwithstanding the academic attention,[10] the rule was not really tested until 2017 due its tortuous first years of life.[11] Its entry into force and its extensive application stimulated a critical analysis of the provision that led to a substantial amendment of the provision in December of 2018 (Law 11/2018 of 28 December 2018). The changes introduced were thought to solve several problems arising from the provision, and also to cover certain scenarios not initially considered, but the policy and the structure of the rule remained intact, except for the very relevant change making the rule voluntary.[12]

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[9] *L. Fernández del Pozo*, Derecho de separación ex 348 bis en grupos de sociedades, Almacén de Derecho, 22 January 2019 (<https://almacendederecho.org/derecho-de-separacion-ex-348-bis-en-grupos-de-sociedades>).

The issue that shall not be developed here. However, some context must be given. In general terms, when a decision is successfully challenged, the basic consequence is the voidance of the agreement. However, it is hardly possible to force the court to declare some form of dividend distribution. This is not only a consequence of a basic methodological question (may a court overrule a company's will?, a good example in AP Barcelona, 7 May 2014, ECLI: ES:APB:2014:5381) but also reflects a very conservative approach as to the ability of judges to decide on business matters (i.e., on matters covered by the business judgment rule), *M. J. Guerrero Lebrón*, El Art. 348 bis LSC como mecanismo de protección del socio externo ante una gestión desleal del grupo, RdS 54 (2018) 5, also *Fleischer/Trinks, supra* note 4, 297. This latter question is, however, debatable, as judges do decide on very technical matters (doctors' malpractice or negligence in technical construction designs, to name just two) and it is unclear why a court should be less prepared to judge a pure business decision. However, the problems and the approach seem very similar in continental Europe.

[10] The number of contributions on Art. 348 bis LSC, in particular since 2017, is so extensive that it is impossible to take them all into account in their entirety for this contribution. It must be noted, therefore, that only a fraction of them (the most relevant among the most recent, in particular) will be cited here.

[11] Art. 348 bis LSC was in force for a very limited time in the first years after the amendment. It entered into force in October 2011, but was suspended in June 2012 (just before most of the ordinary general meetings take place in Spain, where this meeting must be held in the first six months of the financial year, which usually finishes on 31 December every year). This suspension was initially limited (until December of 2014) but was later extended until December of 2016. Consequently, Art. 348 bis LSC started to be generally applied from January 2017 and hence (in most cases) to general meetings deciding dividend distributions for the financial year 2016 in the first months of 2017 (typically, around May or June 2017).

[12] See a short and clear analysis in *S. Álvarez Royo-Villanova*, El nuevo 348 bis LSC: reforma del derecho de separación por falta de dividendos, Hay Derecho, 16 January 2019 (<https://hayderecho.expansion.com/2019/01/16/nuevo-348-bis-lsc-reforma-derecho-separacion-falta-dividendos/>).

Spanish law exemplifies the challenges faced when trying to solve a problem with a particular provision of this kind. At the same time, the Spanish case may help to show the shortcomings inherent to this approach: while it provides greater legal certainty, it does not replace the need to evaluate shareholders' behavior under the light of the *bona fide* principle, as happens in countries where these situations are left to the control of the courts (such as in Germany).

Here, we begin with a general framework of the problem and possible solutions (II.), followed by the analysis of the rule of Spanish law (III.). This will be divided into five sub-paragraphs, offering an analysis of the key issues of the legal provision that may be more interesting for international readers. These are: the scope of application (1.); the thresholds for the right to exit to be granted (2.); the effectiveness of the rule on group structures (3.); the relationship between the rule and the decision of the general meeting (4.); and the shortcomings of a rule on opportunism of the company or the shareholders (5.). It must be emphasized that this selective approach necessarily results in a non-exhaustive analysis. Interested readers will find thorough and sectorial analysis in the numerous cited contributions.

II. Retention of Profits, Minority Protection and Closed Family Companies

1. Closed Companies as the Natural Environment of Abuse

Minority oppression problems typically arise in closed companies.[13] In this regard, there is a common division between public and closed corporations. While the usual conflicts in public corporations are due to agency conflicts (i.e., shareholders-managers), in closed corporations, conflicts are more likely to occur among shareholders and consequently may lead to abusive behavior as a consequence of the majority rule. This difference is probably due to the fact that managers are usually the controlling or majority shareholders in this category of companies. This overlap of ownership and management is so extensive in closed corporations that, in some instances, is thought to be one of their distinctive features.

Of course, conflict among shareholders and abusive patterns may also occur in public corporations. However, strong ties among shareholders are frequent in closed corporations, which are very often incorporated with relatives or friends. They help to build the necessary trust in the early stages of the compa-

[13] Conflicts are "the Achilles heel" of closed companies, *M. Neville*, Shareholders Conflicts in the European Private Company (SPE), in: Hirte/Teichmann (eds.), The European Private Company – Societas Privata Europaea (SPE) (Berlin 2013) 193, 194.

ny, but also increase the severity of these conflicts: they are usually intense and, therefore, more difficult to resolve, as it is not uncommon that economic, professional or business problems are mixed with strong personal differences.

Family companies are usually equivalent to closed companies. Although there are examples of big, public companies, that may be still characterized as family companies, these are largely the exception. Strong family ties are embedded into the company structure in such a way that the characteristic features of a closed company usually follow. Conflicts among shareholders, eventually leading to abuses in the form of profit retention, are very well observed in family companies. Here, the strong personal ties that help to build the company in its early days, have quite the opposite effect when the personal relationship deteriorates, aggravating shareholders' conflicts.[14]

Paradoxically, although these conflicts are well-known and frequent, scholars have traditionally paid them less attention,[15] as focus has been more generally put on public corporations,[16] where these conflicts are less common or relevant, even in the context of dividend policies.[17] Although abuses and, in particular, retention of profits have been a common source of concern, even in terms of legislative policies in several countries, closed corporations and their problems were to some extent left unattended, despite the increased interest in this form and policies in the EU context.[18]

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[14] *Fleischer, supra* note 1, 31. The relevance of trust is highlighted in *B. Means*, A Contractual Approach to Shareholder Oppression Law, Fordham L. Rev. 79 (2010) 1161, *passim* and the only apparent contradiction in *Neville, supra* note 13, 198.

[15] *H. Wells*, The Rise of the Close Corporation and the Making of Corporation Law, Berkeley Bus. L. J. 5 (2008) 263. Of course, there are relevant contributions on closed corporations, both in academia and in other environments. The main focus, however, remains on the public companies. This is even more problematic in countries, like Spain, with a majority of SMEs (98.9% of businesses have less than 49 employees, see <http://www.ipyme.org/es-ES/ApWeb/EstadisticasPYME/Documents/CifrasPYME-mayo2019.pdf>) and, therefore, a dominance of closed and small companies in the economic structure (LLCs [*S.L., GmbH*] represented more than 99% of the total of companies incorporated in 2018, according to the National Institute of Statistics, *INE*).

[16] The predominance of public companies in the analysis is even transferred to the law, where the profound differences among public and closed corporations are forgotten, and the usual point of view ends up promoting rules that barely adapt to this latter particular environment. This is, for instance, a commonly highlighted problem with the amendment of the Spanish Corporations Act in 2014, that originated in a discussion on public (listed) companies and the proposal from a group of experts, but ended up in legal rules that apply to any company, making it very problematic to apply to small and closed corporations.

[17] *D. K. Moll*, Shareholder Oppression & Dividend Policy in the Close Corporation, Wash. & Lee L. Rev. 60 (2003) 841, 842.

[18] The increasing number of contributions clearly shows the academic interest in closed companies. Some good examples in the European literature are shown in collective monographs: Hirte/Teichmann (eds.), The European Private Company – Societas Privata Europaea (SPE) (Berlin 2013); Viera/Teichmann (eds.), Private Company Law reform in

Minority abuse or oppression comes in many different forms[19], one of the most prevalent being the abusive retention of profits. Identifying retention of profit as abuse relies on the basic idea that shareholders join a company with a common lucrative goal.[20] Of course, this is not always the case, as it is possible to identify alternative goals. Nevertheless, in the context of companies with business activities, it is a valid presumption: shareholders are there for financial gain.[21] In small companies, this interest is jeopardized if shareholders receive no dividend or other alternative share in the business returns (like a salary, a very common alternative in closed companies).[22]

Consequently, retention of profits is characterized as a case of abuse, because it typically leads to an uneven result for shareholders. In closed corporations, controlling (or majority) shareholders can make profits without dividends. A common example is the use of salaries, manager's remuneration, or contracts with related parties. In fact, the literature often describes these activities as common and expected forms of participating in the company's profits (*de facto* dividends).[23] At the same time, these are described as the perfect example of a hidden distribution of profits from the company to the shareholders; *de facto* dividends counterbalance the dividend retention.[24] Of course, this tunneling mechanism is not available for minority shareholders without the controlling shareholder's consent. Ultimately, the majority may have a share of earnings, albeit indirectly, from which the minority is excluded, due to the absence of *true* dividends.

Europe: the race for flexibility (Cizur Menor 2015); Viera/Teichmann (eds.), Conflicts of interest between majorities and minorities in the EU Member States Private Company Law (Cizur Menor 2019).

[19] See a quick categorization in *Fleischer, supra* note 1, 37 et seq.

[20] The lucrative element serves as a basis to claim that, even absent a rule of law, the starting point should be that shareholders have a right to receive the dividend, that could only be excluded by sound reasons that should be proved by the majority. See, for all, *A. Campins Vargas/J. Alfaro*, Abuso de la mayoría en el reparto de dividendos y derecho de separación del socio en las sociedades de capital, in: García de Enterría (ed.), Liber amicorum Juan Luis Iglesias (Cizur Menor 2014) 65, 79.

[21] "Every shareholder reasonably expects that her position as a stockholder entitles her to a proportionate share of the company's profits. Whenever this 'general' reasonable expectation is frustrated in a closed corporation, oppression liability should arise", *Moll, supra* note 17, 856. This does not exclude the presence and relevance for the analysis of some other social reasons, *Means, supra* note 14, 1172 et seq. and 1194 in particular.

[22] *Moll, supra* note 17, 848.

[23] Preference for this method is usually explained by tax reasons (salaries are deductible, while dividends are not). *F. H. Easterbrook/D. R. Fischel*, Close Corporations and Agency Costs, Stan. L. Rev. 38 (1985) 271, 273; *Moll, supra* note 17, 876 et seq.

[24] Majority shareholder employed by the Company will be greater benefitted by the future growth of the Company and the value increase deriving from the retention of earnings; *Moll, supra* note 17, 901 et seq.

Oppression, however, may also occur even without hidden distribution, thus materially preserving the equality principle between shareholders. The retention of profits by itself may satisfy the controlling shareholder's own interest by not sharing a part of the earnings with other shareholders and that shareholder can cope with the internalization of the value in the company. This may conflict, for example, with a minority shareholder who needs the distribution of dividends at a precise moment of time and in a certain quantity (for instance, a minority shareholder who needs a small dividend to cover the payment of the mortgage of her main residence). This behavior is, in many cases, part of a broader strategy aimed at buying out minority shareholders. In this case, the retention of profits is used as leverage in negotiating a lower price if the majority is in a better position to hold out for a longer term in the absence of returns. In the most severe cases, such behavior conceals an expropriatory goal: the majority intends to force the minority to leave at a minimum price[25] and the dividend policy is used to signal the extremely weak position of the minority and the unlikelihood of receiving any gain or benefit from their participation in the company. Of course, these are harder cases: if all shareholders are treated the same way and equally bear the effects of the decision, in the end, how can a minority shareholder claim oppression?

Dividend policy is quite a difficult matter also because returns do not have to be in the form of yearly dividend and, even if a shareholder expected such a payment, the other shareholders may decide that not distributing is more in the interest of the company. In fact, in this area, there are two conflicting interests that increase the difficulty of the decision, the interest of individual shareholders to receive their part of the yearly profits and the interest of the company in having a stronger financial situation in the future. Neither is subordinate to the other, even in light of the observation that shareholders generally join a company to receive dividends on a regular basis for the earnings that will result from it.[26]

This could be the reason that shareholders have not been provided with an absolute right to receive dividends. In the end, companies are free to decide if yearly profits should be distributed among shareholders or, alternatively, retained in the company. Nevertheless, in those jurisdictions where this decision is made by shareholders (namely, European jurisdictions),[27] there is a

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[25] In fact, the presence of *de facto* dividends usually stimulates conservative policies of not distribution: *H. G. Manne*, Our Two Corporation Systems: Law and Economics, Va. L. Rev. 53 (1967) 259; *Moll, supra* note 17, 849.

[26] *Fleischer/Trinks, supra* note 4, 293.

[27] The situation is different in the US, where directors decide dividend distribution. There, courts usually declare that the decision falls within the business judgment rule. Thus, they normally only intervene in extreme circumstances of fraud, bad faith or unreasonableness and place the burden of proof on the complaining shareholder. Critical of this traditional view in the context of closed corporations, following *Manne, supra* note 25,

probability that the natural independence of shareholders ends up in an abuse of the right to decide on the application of earnings.

The identification of abusive patterns in the form of retention of profits is unlikely to occur in public listed companies. Here, shareholders unhappy with the decision can easily exit the company by selling their stock. This possibility deters majorities in such companies, both because of the reputational effect and the consequences for the price of stock associated with an arbitrary decision on dividend distribution. On the contrary, shareholders face a different situation in closed companies. The scarcity (or non-existence) of possible buyers implies that an appreciation in value cannot be monetized by minority shareholders for whom, in addition, it is almost impossible to leave the company.[28] In this context, the majority may use the majority principle to deprive minority shareholders of their legitimate expectations, without a real interest for the company. Frequent recurrence of this decision may be evidence of an abusive pattern. Absent the market constraints of listed companies,[29] oppressed shareholders will inevitably ask for court intervention.

2. *Overview of Policy Alternatives to Prevent Abusive Retention of Profits*

The retention of profits is one example of the broader category of abuse. Therefore, general considerations of the legal tools for combatting abuses are also relevant, including discussion of the necessity of the retention itself.[30] It is useful to recall here the distinction made between rigid or flexible mechanisms (*starre/bewegliche Schranken*) to limit the power of majorities in companies, deriving from the majority principle.[31] This perfectly applies to the policy alternatives in the context of abusive retention of profits.

Rigid mechanisms are legal restrictions, designed to be generally applied, thus absolute in character. Flexible mechanisms refer to judicial controls based on general clauses, ensuring maximum adaptation to the case in question. Among these flexible mechanisms, the shareholders' duty of loyalty is the most salient, notwithstanding other principles also used in other instances (abuse of law or abuse of rights, good faith, more general fiduciary duties, etc.). The development of company law shows a progressive strengthening of flexible mechanisms. This is due, among other reasons, to the fact that ab-

280; *Moll, supra* note 17, 863: "In the closed corporation context, therefore, the judicial deference embodied in the business judgment rule makes less sense."

[28] *Moll, supra* note 17, 843 and 858; general considerations can also be found in *F. H. Easterbrook/D. R. Fischel*, The Economic Structure of Corporate Law (Cambridge Mass. 1991) 229 et seq.

[29] *Neville, supra* note 13, 207.

[30] See an insightful general analysis in *Fleischer, supra* note 1, 45 et seq.

[31] *A. Recalde Castells*, Limitación estatutaria del derecho de voto en las sociedades de capitales (Madrid 1996) 150, recalling the original work from *Zöllner*.

stract and absolute legal rules do not take the different factual substrates and how capital is distributed among shareholders into account. In analyzing possible abuses, these are determining factors when deciding the balance or imbalance of positions. Of course, in the context of the retention of profits, a rigid system is even more problematic, because it must consider the situation of the affected company, also in financial terms, and the different interests at stake, which are variable in each case.

Under these general considerations, there is some agreement on the shortcomings of conventional protection tools that either do not exist or are ineffective. This applies to both the articles of association and shareholders' agreements. Of course, this is not to deny the presence and usefulness of conventional rules on dividend distributions or other protections. In closed companies, where there should be a greater margin for private autonomy, conventional solutions are thought to be the best option. However, these provisions are not widely used,[32] which may contribute to the idea that conventional solutions are not very effective.[33] Additional protection is then necessary.[34]

The case for abuse by the majority, in particular in the form of retention of profits, will always be present, as will be the discussion on the best policy approach to address it. The alternatives may be classified according to the aforementioned categorization: judges' discretion based on general principles of law (flexible solution) or some form of rule of law for this matter (rigid solution).

a) Court protection

The first alternative is leaving these situations to courts. In this case, whenever the minority considers that a decision is abusive, they should challenge it and the court will ultimately decide on the matter. This solution is the most

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[32] As in Denmark, for instance, *Neville, supra* note 13, 214.

[33] The problems of conventional solutions to shareholder conflicts in private closed companies are usually highlighted. As with any other contract, it is difficult for the parties to identify future eventualities and conflicts and, of course, to reach a consensus on its solution. The solutions to anticipated events are not neutral and create further problems and costs. Furthermore, family or friendship links are the norm in these companies, which increases the difficulty to negotiate eventual future conflicts, because it might show mistrust, which has a heavier impact on this kind of relationships, as behavioural economics has shown. In the end, even increasing costs in the form of legal advice plays an additional role in the problematic scenario of conventional solutions to minority-majority conflicts. For a thorough analysis of these questions, see *Means, supra* note 14, *passim*; also *Fleischer, supra* note 1, 48 and *Fleischer/Trinks, supra* note 4, 296, comparing the situation of Spain and Germany in practical terms.

[34] The usual law and economics approach for closed corporations, requiring courts to restrict their focus to the parties' agreement does not attend to the real behaviour of parties in closed companies, as shown by behavioural economics. See the critic in *Means, supra* note 14, 1172 et seq.

adaptable to the various circumstances in which the retention of profits may happen. Courts may resort to creativity and flexibility to provide a more accurate response to a particular situation. However, this approach in practice reveals some shortcomings.

From a pure policy perspective, there is a conceptual obstacle: the majority rule is founded on the idea that the company's interest is reflected in the will of the majority, as a basic functioning principle of corporations. However, that does not exclude the possibility of challenging majority decisions as abusive (i.e., those that cannot be reasonably explained by the interest of the company, that are detrimental to the interest of minority shareholders and whose aim is to damage these shareholders or which are disproportionate in terms of the advantage for the majority and the damage for the minority). This is possible, but usually difficult for a court without the clear support of a legal rule. In the context of the retention of profits, the reluctance of courts is greater, due to the business nature of the decision and the positive effects that it may also have for the company. It is debatable, however, whether a particularly stringent burden of proof should be put on the minority shareholder.[35] If a shareholder's legitimate expectation is to have a share in the profits, it would be better to adopt a minority perspective, that focuses more on the effect of the expectations than on the decision of the majority.[36] Therefore, if the minority proves the frustration of its legitimate expectation, the burden should be on the majority to prove that the decision is not oppressive.[37]

From a general perspective, the recognition of abuse as a valid ground for challenging a general meeting's decision, even where no damage for the company arose (as it happens under Spanish law, Art. 204 LSC), will partially pave the way for minority protection. The issue, however, remains problematic even under this scenario.[38]

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[35] Courts should therefore put the burden of proof on the minority shareholder: if the company shows retention is a plausible decision, the minority claim shall fail unless it proves the retention had in reality no real interest for the company (for instance, if no future investments or downturns are predictable in the near future), *Fleischer/Trinks, supra* note 4, 298.

[36] *Moll, supra* note 17, 871.

[37] Of course, this approach has a critical point, which is the identification of the reasonable and legitimate expectations of shareholders in closed corporations: the fact that shareholders expect returns does not necessarily mean that they can demand dividends at any time. At the same time, subjective expectations from minority shareholders should not be enough to determine oppression. If there was not a specific agreement, the best option is to ask what shareholders would have agreed *ex ante*; see the thorough analysis in *Moll, supra* note 17, 872; also *Fleischer, supra* note 1, 59.

[38] *M. Sánchez Ruiz*, Derecho de separación por falta de reparto de dividendos e impugnación del acuerdo social de aplicación del resultado: oportuniad, eficacia y compatibilidad, in: González Fernández/Cohen Benchetrit (eds.), Derecho de sociedades. Cuestiones sobre órganos sociales (Valencia 2018) 367, 376 et seq.

Firstly, the above described requirements must be met, complicating this means of challenging decisions (decisions approved by the majority should be initially considered valid and therefore preserved).[39] But, overall, the main problem is that the right to challenge general meeting decisions is naturally designed to void decisions, but not to substitute the will of the company determined in the shareholders' meeting. Essentially, the right to challenge is very effective for *positive* decisions (i.e., to void a decision *to distribute dividends*), but not so much for *negative* decisions (i.e., when the decision is *not to distribute dividends*). In the first case, the court will simply decide to reverse a successfully challenged decision. In the second case, that is more difficult.

The problem is ultimately linked to the power of a court to substitute the will of the company (i.e., *forcing a distribution* that was excluded). This power is attributed to the court if a decision is mandatory (i.e., forced dissolution in deadlock scenarios), but it is less clear when the decision is not mandatory. Granting power to the court is even more debatable in business decisions where the business judgment rule applies: which undoubtedly includes dividend distributions.[40]

b) Legal rules

Particular legal provisions may serve to provide protection for the minority against an abusive retention of profits and will be helpful to overcome the shortcomings of alternative protection through court intervention. Drafting specific provisions will increase legal certainty and offer objective and general results,[41] in particular for scenarios of abusive retention of profits, a problem which if repeated year after year, is something that courts cannot efficiently tackle. However, *ex ante* definition of the general requirements

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[39] See, for instance, the enumeration of possible grounds for abuse that have been rejected as valid evidence of its existence in the context of the retention of profits in *N. Iraculis Arregui*, Impugnación del acuerdo de no repartir dividendos: atesoramiento abusivo de los beneficios, RDM 281 (2011) 251. Also *Sánchez Ruiz, supra* note 38, 376, highlighting that some procedural rules of Spanish law may serve to ease these difficulties.

[40] AP Madrid, 24 September 2009, JUR 2009, 470747: "The court is not a body to oversee if business decisions are mistaken, nor is it a body that dictates what should be convenient for society at any given time", see *M. Martínez Muñoz*, Entre el abuso de mayoría y el de minoría en la política de distribución de dividendos: a propósito del "nuevo" artículo 348 bis de la Ley de Sociedades de Capital, RdS 55 (2019) 203. However, this is a flawed approach in this context. Courts decide on very technical terms every day and it is not clear why should they be less prepared to analyze these decisions. This is clear for cases where the majority receives *de facto* dividends, but even without, courts have the competence to make an informed decision. In fact, they make decisions on extremely difficult cases of business valuation, where they do not have the expertise to perform calculations but rely on experts – *Moll, supra* note 17, 917.

[41] *Brenes Cortés, supra* note 8.

and thresholds that make the solution less adaptable to the particular circumstances of the company would be necessary.

This policy may take two forms: (i) a minimum (mandatory or non-mandatory) dividend distribution, provided there are distributable profits, or (ii) a right to exit for those shareholders who do not agree with the decision to withhold dividends. In both cases, any legislature would need to overcome the difficulties of drafting a general rule to be applied only when necessary to cases that are inherently diverse in nature and context.

Minimum dividend distribution is a possible approach that will ensure distributions up to a certain amount. However, mandatory distributions constitute a severe limitation on the company's power to decide. Of course, the higher the minimum, the more restrictive the rule, with a mandatory distribution of all profits being the most extreme position.

Almost no company law presently attributes shareholders an absolute right to receive dividends.[42] Companies have the freedom to decide whether to distribute or not. This is a purely business decision that should consider the circumstances and prospects of the company. Decisions made by managers (in US) or shareholders' general meetings (in Europe) will transform a general shareholder's right to have a share in the results of the activity into an effective right to receive a dividend. Before (or without) this decision, shareholders cannot force the company to distribute the dividend.

As in other countries that have never adopted such a rule,[43] there have been some failed proposals to introduce the right of shareholders to a minimum dividend in Spain. A proposed amendment in 1993 included a mandatory distribution of a third of the distributable profit if it was required by at least a 5% of the legal capital after the third year from the incorporation of the company. This provision, would have applied only to *S.L.s*, and created a minority right equivalent to other already (and still) existing in these companies (such as, for instance, the right to ask for the convocation of a shareholders' general meeting). This provision was never included in later drafts and the idea was later abandoned.[44]

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[42] According to *Fleischer/Trinks, supra* note 4, 297, only Finland and Portugal have such a provision in the European context. There are, however, legal provisions mandating particular destiny for profits, but they have a different purpose. For instance, under Spanish law there is a mandatory ascription of 10% of profits to legal reserve until 20% of legal capital is reached (Art. 274 LSC) and it is also compulsory to use profits to set-off former losses if equity is below legal capital (Art. 273 LSC). Both rules limit the freedom of shareholders to decide on profits, but in both cases the rationale is the protection of the integrity of legal capital, rather than the interest of shareholders.

[43] The situation is similar in Germany, where two different proposals included some form of minimum dividend in 1971 and 1973, both unsuccessfully; *Fleischer/Trinks, supra* note 4, 291.

An alternative legal approach is to include non-distribution of dividends as cause to withdraw from the company. This is the solution adopted in Spain by Art. 348 bis LSC. The right to exit does not provide shareholders with a right to force dividend distribution[45] but may play a similar role, because in many cases the eventual exercise of that right deters the company from retaining profits.[46] A particular challenge for a rule like this is how to ensure it can be adapted to varying circumstances to provide companies the necessary leeway to adopt an optimal solution without harming minority shareholders.

The same result follows from the existence of a right to exit the company based on a more general cause that could include cases of abusive retention of profits (just cause, legal motives, *wichtiger Grund*). This seems to be a common solution among jurisdictions, where it is usually accepted that shareholders should have the right to exit the company if there is just cause. Although the decision is not easy, courts may use this general provision to grant minority shareholders this right when faced with an abusive retention of profits. This is the case in Germany[47] and the United Kingdom, and was the proposed approach for the *Societas Privata Europea*.[48] Although with differences, the tendency is similar in the US.[49]

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[44] *Á. Rojo*, La responsabilidad limitada: Problemas de política y de técnica legislativas, in: Almoguera/Bonardell et al. (eds.), La Reforma de la Sociedad de Responsabilidad Limitada (Madrid 1994) 75.

[45] *Sánchez Ruiz, supra* note 38, 371.

[46] *Martínez Muñoz, supra* note 40, 14.

[47] In Germany, § 61 German Limited Liability Companies Act (*Gesetz betreffend die Gesellschaft mit beschränkter Haftung*, GmbHG) is generally thought to serve as a base for the right to exit with just cause (*wichtiger Grund*) – the rule, however, refers to the dissolution of the company: "Die Gesellschaft kann durch gerichtliches Urteil aufgelöst werden, wenn die Erreichung des Gesellschaftszweckes unmöglich wird, oder wenn andere, in den Verhältnissen der Gesellschaft liegende, wichtige Gründe für die Auflösung vorhanden sind."

[48] The Proposal for a Statute for European Private Company (SPE) included the possibility for partners to leave "if the activities of the SPE are being or have been conducted in a manner which causes serious harm to the interests of the shareholder" (Art. 18.1), specifically providing that this harm may be caused when "no dividend has been distributed for at least 3 years even though the SPE's financial position would have permitted such distribution" (Art. 18.d).

[49] The US is a different case and there are significant differences even among states. However, the approach is quite similar to others, showing that the basics of the problem and the possible solutions are not dependent on local particularities. In general, the retention of profits is analysed as a case of minority oppression. Minority oppression is identified as (i) wrongful conduct departing from the standards of fair dealing; (ii) breach of an enhanced fiduciary duty among shareholders or (iii) the frustration of the reasonable expectations of shareholders. The frustration of reasonable expectations is widely accepted. *Moll, supra* note 17; also *D. K. Moll*, Shareholder Oppression in Texas Close Corporations: Majority Rule Isn't What It Used To Be, Hous. Bus. Tax L. J. 1 (2001) 12 et seq.

Of course, this latter model, granting the right for more general reasons, transforms the solution into a flexible one. In the end, the rule will not provide shareholders with a specific solution, but rather with a tool that the courts may use to protect minority shareholders against abuse, albeit on a case by case basis.

III. Key Issues for a Legal Rule, as Viewed from the Spanish Experience

1. Scope of Application

The right to exit should be identified and framed by a particular environment (closed corporations) and the special position of shareholders requiring protection (minority abused using retention of dividends). How to transform this vague reference into a precise rule with legal certainty, serving to limit a solution as extraordinary as the right to leave the company to only those cases where it is necessary, is one of the biggest challenges for a rule of law with this purpose.

a) Closed companies

Although possible, abusive retention of profits in public corporations is unlikely to occur. Closed companies are the usual environment for abusive retention of profits, where partners cannot easily sell their part in the capital and leave the company when it does not deliver the expected dividends. This simple (and easy) approach becomes a very difficult task when it has to be transformed into a precise definition in the context of a rule of law.

There is no legal concept of a closed corporation and, under Spanish law, it would be also wrong to identify a closed corporation with a particular company form.[50] This absence of a legal concept is a consequence of the difficulty in finding a definition that meets the necessary standards of legal certainty,

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[50] In Spain, companies resembling closed corporations are most frequently limited liability companies (*sociedades de responsabilidad limitada*, S.L.), which are the most common type of company in these cases, *A. Sequeira Martín*, La naturaleza del derecho de separación del socio en caso de falta de distribución de dividendos en el Texto Refundido de la Ley de Sociedades de Capital (Art. 348 BIS LSC), in: Fernández Torres/Arias Varona/Martínez Rosado (eds.), Derecho de sociedades y de los mercados financieros. Libro homenaje a Carmen Alonso Ledesma (Madrid 2018) 831, 834. However, the characteristic features of closed corporations can also be present in public companies (*sociedades anónimas*, SA) and, as a consequence, the rule cannot be limited to a certain type of company. The relationship between legal and empirical forms has been a traditional object of study, see *A. J. Viera González*, Las sociedades de capital cerradas. Un problema de relaciones entre los tipos SA y SRL (Cizur Menor 2002).

because the various notions of a closed corporation rely more on the factual circumstances that on precise conceptual elements. The usual definition refers to the absence of a market where the shares of that company could be sold,[51] a particularly important source of problems for dividends distribution.[52] It is also common to identify certain features that may help qualify a company as closed, like the size, the fact that shares are not freely traded, the limited number of shareholders, and the absence of separation of ownership and control (exacerbated by the frequent majority shareholder/manager as one person constellation). This latter is sometimes seen as the distinctive feature of closed corporations[53] and is usually a source of the characteristic conflicts in these companies.

In order to avoid an overly extensive application of the rule, Art. 348 bis LSC includes a set of exclusions based on the characteristics of the affected company that may serve to prevent unnecessary application (i.e., in non-closed companies). This is particularly clear for listed companies, the most salient exclusion, serving to restrict the application of Art. 348 bis LSC to its natural environment.

Listed companies have been excluded from the application of the right to exit in Art. 348 bis LSC since its original wording. Spanish scholars[54] highlighted the general reasons for this exclusion: listed companies have particular incentives to pay dividends and secondary markets allow shareholders to

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[51] Closely held corporations are those "for which there is no public market for shares and, sometimes, no market at all", *E. B. Rock/M. L. Wachter*, Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations, in: McCahery/Raaijmakers/Vermeulen (eds.), The Governance of Close Corporations and Partnerships (Oxford 2004) 93.

[52] *Easterbrook/Fischel, supra* note 23, 275.

[53] Following *H. Wells, supra* note 15, 274: "It is usually smaller than the public corporation, though size alone does not always mark a closed corporation. Its shares are not freely traded; indeed, the standard treatise on the closed corporation defines a 'closed corporation' as a corporation whose shares are not generally traded in the securities market. Equally important, the closed corporation does not suffer from the separation of ownership and control. A closed corporation has only a few owners, and these are usually its managers as well; several scholars have identified this unity of ownership and control as the distinctive feature of the closed corporation." In a very similar way for the US, also *A. R. Pinto*, Protection of Close Corporation Minority Shareholders in the United States, Am. J. Comp. L. Supp. 62 (2014) 361: "(1) legal personality, (2) limited liability for owners, (3) a small number of owners, (4) no ready market for owners' interests, (5) centralized management where owners often participate in the corporation's management, and (6) perpetual existence." Similarly, *Moll, supra* note 17, 846. The approach is equivalent under Spanish law: *Viera González, supra* note 50, 44 et seq.

[54] See, for instance, *J. Pulgar Ezquerra*, Reparto legal mínimo de dividendos: protección de socios y acreedores (solvency test), in: Fernández Torres/Arias Varona/Martínez Rosado (eds.), Derecho de sociedades y de los mercados financieros. Libro homenaje a Carmen Alonso Ledesma (Madrid 2018) 686.

abandon the company as soon as it does not meet the expected returns in the form of dividends. Therefore, there is no shareholder captivity, which serves as the ground to grant a right to exit.[55] The need to exclude listed companies in Art. 348 bis LSC was never discussed.

A more difficult decision faces companies whose shares are not public, but are traded in multilateral facilities. Of course, those shares can be traded, but there is some concern regarding the company's liquidity, at least in Spanish markets. On pure policy grounds, it may be sustained that there is a lack of the same incentives as in public companies for the distribution of dividends, or the same easy exit for disappointed shareholders. The absence of a reference to this case in the original wording of Art. 348 bis LSC was the source of debate on whether to include those companies in the scope of the provision or not[56]. Now, this problem has been solved through an express reference in Art. 348 bis LSC, that excludes companies whose shares are traded in these facilities (the most relevant example in Spain is the *Mercado Alternativo Bursátil,* MAB). When trying to balance the protection of minority shareholders and the flexibility of these companies to decide on dividends, the rule has clearly opted for the latter. This may act as an incentive for certain companies to start trading their shares in multilateral trading facilities, without going public. Even though liquidity depends on demand more than simply on the existence of a trade facility, this step may help to increase the size of these markets and make leaving the company easier for minority shareholders.

Further exclusions were later included in 2018. Most of them do not refer to the intrinsic nature of the company, but rather to particular situations, mainly solvency problems affecting the company, that will be considered below. The only relevant new exclusion is the one affecting Public Limited Sports Companies. There was no public statement or reasoning behind this amendment, although discussions in parliament showed it was based on the particular situation of those companies which shareholders do not join expecting dividends, but often to provide some form of financial stability or for

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[55] There are significant examples of public companies that do not traditionally distribute dividends but where this protection is unnecessary, because shareholders (*rectius*, investors in most of the cases) internalize earning via the increase in the value of the stocks, that could be easily transformed into money (and hence, allows the shareholder to leave the company). For instance, Apple traditionally paid no dividend (though it has since adopted a different policy, that was the case between 1995 and 2012, see a basic description of the policy in <https://www.fool.com/investing/2016/08/29/apple-dividend-history-yup-the-tech-giant-is-offic.aspx>). Now, Amazon is the most salient example (the company has never distributed dividends but the stocks have skyrocketed since it went public).

[56] *S. Alvarez Royo-Villanova*/*L. Fernández del Pozo*, Una propuesta de redacción alternativa del artículo 348 bis LSC, LLM 33 (2017) 1; *Brenes Cortés, supra* note 8; *Pulgar Ezquerra, supra* note 54, 688.

non-lucrative and *emotional* motives.[57] Also, the need to preserve these companies from the financial tensions that this rule might create in this sensitive environment may have played a role in the solution finally adopted.

It is surprising, however, that no particular reference is made to the exclusion of time-limited companies. In these cases (frequently tied to SPVs), shareholders will have their share of the profits when the company is liquidated on the due date. Therefore, excluding the right to exit could be possible in these cases. This question (that, nevertheless, creates particular problems, such as how to avoid circumvention of the rule through extremely long durations or how to protect shareholders against later modifications to the duration of the company)[58] has become less relevant since the rule is not mandatory and companies can include conventional solutions in the articles of association.

b) Abused minority (dissenting?) shareholders

The rule is intended to protect minority shareholders against abusive behavior by majority shareholders. Of course, this proposition simplifies the frequently more complicated distribution of capital in companies, where there is often not a clear duality between a majority and a minority shareholder. Less concentrated ownership offers a more flexible environment, where the majority/minority is made up of groups that may differ in their composition during the life of the company. The need to grant the right to exit only in the presence of abuse requires a link between the rule and the position of shareholders as regards the distribution of dividends, i.e., considering their positions in the general assembly meeting where the resolution was adopted, more than a theoretically stable majority/minority distribution.[59]

The paradigmatic situation occurs in a company with two shareholders where one of them votes in favor of the distribution, but the majority shareholder's vote rejects the proposal. This view affected the drafting of the rule, that was initially limited to shareholders who "voted in favor of the distribution of profits" (*votado a favor de la distribución de los beneficios sociales*, Art. 348 bis LSC before 30 December 2018). This option, however simple, created many problems and could be circumvented via strategic wording of the proposed decision by the majority, as sometimes exemplified by some Court decisions.[60] Of course, in the end it was always possible to identify the general principle and provide protection even if the situation did not exactly

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[57] Diario de Sesiones del Congreso de los Diputados, Núm. 171, 13 December 2018, 24.

[58] *Alvarez Royo-Villanova/Fernández del Pozo, supra* note 56; *Brenes Cortés, supra* note 8.

[59] The proposition of the text is valid but suffers in the context of these pages. Except in very exceptional circumstances, abuse cannot be present without recurring behavior. It follows from that fact that some form of a stable distribution of the power in the company is necessary, which eases identification of some form of majority/minority juxtaposition.

correspond to the wording of the clause. Nonetheless, this approach is more problematic than it seems at first reading.

Any alternative that links the right to exit to the vote of a particular shareholder creates similar problems. If the purpose of the rule is to protect the minority from abusive decisions of the majority, it would be better to somehow identify this opposition to the resolution finally adopted. In fact, it could be possible that a decision in favor of some (insufficient) distribution is made, or that the drafting of the proposal makes it difficult to show, at the moment of voting, the discrepancy or the exact will of the minority shareholders. For these reasons, the solution finally adopted in Spanish law after the amendment of Art. 348 bis LSC in December 2018 must be seen in a positive light, as it serves to overcome the problems arising from a rule defining the protected shareholders according to their votes in the general meeting.

Pursuant to the amendment, the right to exit is dependent on an explicit disagreement with the final decision of the general meeting. The exercise of this right is conditioned on a formal protest against an insufficient dividend distribution recorded in the minutes of the general shareholders' meeting. In this sense, a purely procedural act is transformed into a substantial reference to identify the position of shareholders and to determine who qualifies, in a precise environment and situation, as the minority to be protected. This solution is smart, because it helps identify the necessary dissent when, for instance, some form of distribution is agreed, but at a lower amount. In these cases, it would be absurd to force shareholders to vote against the proposal and refuse any distribution. Of course, this solution is not without problematic issues.

The most relevant of these is that the majority may use the rule to confer itself an exit right, simply by protesting against the general meeting decision. This, however, is a clear example of *venire contra factum proprium*, because that decision could only be possible with the support of the majority. In this sense, the rule could never work in favor of the majority. A different case happens if the *majority* cannot, by itself, ensure the dividend distribution (for

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[60] For instance, a decision of the Provincial Court of Barcelona warned about the interpretative problems of the wording of the clause and highlighted how it could be the source of surprising results. For instance, it could be impossible to vote in favour of distribution if the proposed decision simply included the destination of earnings to reserves. In those cases, the vote could be against or in favour, but could never be *in favour of the distribution of profits*, however implicit in the vote against the proposal. At the same time, there could be differences on the amount on which minority shareholders would disagree. On those grounds, the court considered that the shareholder clearly showed its will to obtain dividends and that was enough to grant the right to exit. (AP Barcelona, 26 March 2015, ECLI: ES:APB:2015:6055). However, the requirement of the vote had the advantage that the rule was limited in practice to shareholders involved in the company, *M. B. González Fernández*, El derecho de separación previsto en el artículo 348 bis LSC en el caso de acciones y participaciones sociales en usufructo, RDBB 152 (2018) 129.

instance, a company with a distribution of 60/20/20 and a particular provision in the articles of association requiring the vote of 70%). Here, the *majority* cannot push through a specific dividend distribution and thus the provision of Art. 348 bis LSC should of course apply.

The second problematic issue is the recognition of this right only for those shareholders attending the general meeting, and the requirement that the protest be recorded in the minutes of the meeting. This policy decision is a less intrusive rule forcing shareholders to a minimum proactive behavior to ensure the protection of their interest. An alternative rule (granting the right to absent shareholders, those who abstained, or those simply voted against the particular proposal) would probably lead to an excessive ampliation of the right in this delicate balance between the basic rules on the formation of the company's will and the protection of minorities against majority decisions.

Finally, the problems arising from situations where the formal position of shareholders and their material interests are dissociated, or equal, cannot be underestimated. Even though the right is assigned to shareholders, the solution is unclear in several cases.[61]

2. The Challenge of Objectively Identifying Abusive Behavior and Deciding Reasonable Thresholds Ex Ante

Any measure to protect minority shareholders should only be adopted when damage to the minority is unnecessary and there is no real company interest in the decision. As previously explained, the retention of dividends may be in accordance with the interest of the company. Hence, one of the most challenging issues for a legal provision is to define *ex ante,* and with the necessary precision, which requirements must be met to avoid excessive and potentially detrimental application of that measure.

The extremely variable forms of an abusive retention of profits makes it impossible to anticipate all possible situations and to draft a rule that covers all alternatives. As a consequence, the rule must consider the foundations of an abusive pattern, in abstract and general terms. The abusive retention of profits is usually a function of two variables, time and quantity: i.e., for *how long* and *how much* of the profits are being retained. Abuse usually happens when there is a recurrent retention of profits in such measure as to have a material impact on the position of shareholders. Of course, it would be necessary to define their quantitative terms (how long is too long and how much is too much), something that it is almost impossible to do successfully. The

[61] Some of the cases have already been studied, although this matter is still pending a thorough analysis by Spanish academics. See *González Fernández, supra* note 60; *J. C. Sánchez González,* Ejercicio del derecho de separación por el socio ex Art. 348bis LSC: plazo, forma y actos posteriores, in: González Fernández/Cohen Benchetrit (eds.), Derecho de sociedades. Cuestiones sobre órganos sociales (Valencia 2018) 317.

vicissitudes rife in the corporate environment make it very difficult to draft a rule that fits a hundred percent to every possible situation. However, a defined scope is necessary for legal certainty and, it may also be useful as a model for the courts when they need to decide on situations where the rule does not apply.

a) *The time problem*

Abuse requires recurrent retention. Only in very exceptional cases it could be otherwise. Consequently, it is necessary to define the moment from which the retention may be deemed abusive. This is a specific requirement for a legal rule that does not necessary apply in flexible mechanisms (*bewegliche Schranken*), because the judicial approach is always subject to case by case analysis and, thus, there is no need to decide *ex ante* the date from which dividend retention should be considered unfair and detrimental for minority shareholders.

Spanish law initially disregarded this technical question. Art. 348 bis LSC used an absolute reference that only considered the time elapsed since the incorporation of the company, a reference which has been retained although slightly changed to resolve some relevant interpretative problems with the initial drafting of the law.[62] Now, the right to exit is extended when enough dividends are not been distributed once the "fifth financial year counting from the formation of the company" has concluded.

This approach is problematic, because it does not integrate any recurrence in the retention of profits. Consequently, this rule simply ensures that the right to a dividend does not harm the financial situation of the company in its early stages[63]. Of course, this is not to be criticized. Some caution may be advisable during the early stages of a company that could justify the retention of profits despite a dividend distribution being possible. It could also be argued that granting a right to exit is not the best idea when the financial situation of a company is probably still unstable[64]. However, this time frame does not con-

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[62] Art. 348 bis LSC initially used the expression "from the fifth financial year." This reference was a source of argument among Spanish scholars, because it was not clear enough if the right to exit started within the fifth financial year (i.e., once the fourth was over and dividends were not distributed) of after that moment. The scarcity of Court decisions due to the suspension of the rule did not help to reach an interpretative consensus, though the decision of the Provincial Court of Barcelona of 26 March 2015, *supra* note 60, opted for this latter interpretation (the rule should be understood as referring to the results of the fifth financial year and, hence, the right to exit would arise after it, i.e., during the sixth financial year when the decision on profits for the fifth year is made). For all, see *Brenes Cortés, supra* note 8, 8.

[63] *Brenes Cortés, supra* note 8, 8.

[64] *Fleischer/Trinks, supra* note 4, 297. The time passed since incorporation increases the suspicion of oppression, *Moll, supra* note 17, 912.

sider if any dividend was possible or even the length of time the retention has been ongoing. Therefore, it fails to provide an adequate balance between the interests of the company and the interests of minority shareholders to have a share in the profits. In the end, if this is the only time limit impeding the exercise of the right to exit, it could be exercised the first time there are distributable profits, as long as five years have passed since the incorporation.

A better approach is to evaluate the point from which dividends have been retained despite the existence of profits. This alternative reference is better suited to the circumstances that recommend a right of exit (i.e., the abusive behavior of majority shareholders). In fact, recurring retention of profits was a common requirement in court decisions in this matter and some academics also highlighted this issue prior to the latest amendment, and proposed alternative approaches[65].

Although the initial design of the rule has been preserved, criticism of this absolute time frame was not unfounded or in vain. Despite its persistence, the latest amendment to Art. 348 bis LSC has included an exception to the right to exit, considering the previous existence of profits and the absence of previous dividend distributions. Both references will play an equivalent role as a dynamic reference integrating recurrence into the behavior, serving to complement the amount of time that should pass from the incorporation for the right to exit to come into being. According to Art. 348 bis para. 1 LSC, the right to exit requires "that profits were obtained in the three preceding financial years" and the "partner will not be entitled to exit if the total distributed dividends in the last five financial years amount to, at least, twenty-five percent of the legally distributable profit accrued during this period of time".

The rule accumulates three different time periods, two of them of the same duration to determine whether there is a right to exit. Firstly, five financial years must have passed since the moment when the company was incorporated. Secondly, there must have been profits for three financial years (those preceding the exercise of the right to exit). And, thirdly, if dividends were distributed in the last five financial years, they should have been less than 25% of the totally distributable amount for that period. Of course, all these time references refer to the past, i.e., previous financial years.

The dynamic references inherited a problem present in the original wording: it was unclear if the last financial year should also be included (the third or the fifth). The amendment for the absolute reference since the moment of incorporation makes it easier now to reach a conclusion. For coherence, the time reference should in both cases be counted since the last financial year

[65] *Alvarez Royo-Villanova/Fernández del Pozo, supra* note 56, who proposed the use of the median in dividend distribution during a certain amount of time to evaluate possible abuses in the retention. See also the critical approach, among others, of *Guerrero Lebrón, supra* note 9, 15; *Pulgar Ezquerra, supra* note 54, 688.

for which accounts have already been approved by the general assembly. Consequently, the right to exit will be granted if dividends are not distributed in the sixth financial year, when the decision on the profits of the fifth is taken. The solution must be the same for every time reference.

An example will give more clarity to the proposed interpretation. For a typical financial year, starting in 1 January and finishing on 31 December, the decision on dividend distribution will take typically place in a general meeting around March–June. Therefore, for the financial year 2018, the right of a partner to exit the company due to the absence of dividend will require an evaluation of whether the company was incorporated before 2014, whether there were dividends during 2016–2017–2018 and, whether at least 25% of the total profit during the period 2014–2015–2016–2017 and 2018 was distributed. Hence, the right to exit would only be granted after the general meeting of March–June 2019, when the decision for financial year 2018 and dividend distribution is taken.

There is no particular reason for the time frames of three and five years,[66] although five years is a usual reference for exceptional rules referring to some period since incorporation (like, for instance, the possibility of banning transactions on participations in S.L., Art. 108 para. 4 LSC; or the time limit to pay pending contributions in kind in the SA, Art. 80 LSC). Five years is also a common reference in other contexts (like, for instance, duration of liability for the valuation of contributions in kind in S.L., Arts. 75 and 331 LSC).

b) *The quantity problem*

The second variable of abusive behavior is quantitative. Abuses can be identified not only when there is no dividend distribution, but also if dividends are distributed at an amount low enough to severely limit the right of shareholders to have a share in the profits. Consequently, any legal rule on this matter needs to take a stand on the minimum dividend distribution. Under Spanish law, the limit is set using two different references: one static, referring to the financial year results (25% of the profits) and one dynamic, referring to the existence of profits in the past (there must have been profits in the three preceding financial years).

This combined reference helps to connect the right to exit to a recurring behavior such as the distribution of profits. The original wording fell short on

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[66] In fact, it is impossible to decide a threshold, except for very extreme cases (for instance, when evaluating abuse, a retention for two years would not be enough: *J. Alfaro*, El acuerdo de aprobación de la gestión social no puede ser abusivo pero sí lo es no repartir dividendos sin justificación y en beneficio del mayoritario y perjuicio del minoritario, Derecho Mercantil, 27 August 2019 (<https://derechomercantilespana.blogspot.com/2019/08/el-acuerdo-de-aprobacion-de-la-gestion.html>), on a decision of the Provincial Court of A Coruña of March 2019).

this issue, as it referred only to the profits of the financial year. This allowed shareholders to exit from the first instance of non-distribution, which made the rule even more rigid and likely to be applied in contexts where abusive behavior was unlikely to be identified.

However, the adopted solution creates several interpretative problems and raises some policy questions, despite the technical improvements introduced by way of the amendment of December 2018.

In policy terms, it is reasonable to include a precise quantitative limit and that poses the question of what a *reasonable* quantitative limit is. Legal certainty requires what seems to be an impossible *ex ante* decision to ensure the necessary flexibility to adapt to the variable circumstances of these cases. Of course, it is always possible to use a relative reference to the usual distribution for a certain company.[67] However, this reference is only helpful when there is a change in the dividend policy, and is useless if the retention is present from the beginning. Additionally, it creates negative incentives for majority shareholders to decide for higher dividends, which could be later used to force distributions or exercise a right to exit. Finally, it does not adapt well to situations when a change in dividend policy is caused by a change in circumstances (for instance, when a company that usually distributed 100% of the dividend faces a financial situation that makes a more restrictive policy necessary).

If the reference is static, thresholds are necessary. Under Spanish law, the original wording, requiring a distribution of a third of the distributable profit, has been lowered to a quarter, probably following the idea expressed by some scholars that a third was an excessive percentage to be set as a minimum.[68] It is however impossible to decide what is the minimum *fair* dividend that should be ensured for shareholders. This is because there is no consensus on the optimal and most efficient rule, not only for dividend policies, but also for capital structures.[69] The absence of consensus on these points makes the quantitative threshold an open issue. A limit should be set at some point, as the decision will always be debatable, except for the most extreme cases.

Spanish law also provides a good example of the interpretative problems that could arise in reference to the notion of profits. Undue retention requires distributable profits. That notion can nevertheless be more problematic than it seems (including the definition of profits in group structures, a topic that will be covered in the following paragraph).

Firstly, a decision must be made whether ordinary earnings alone should be considered for the right to exit. The rule was originally drafted to only include earnings coming from the ordinary course of business (*beneficios propios de la explotación del objeto social*). This theoretical notion had no

[67] *Alvarez Royo-Villanova/Fernández del Pozo, supra* note 56.

[68] For all, see *Brenes Cortés, supra* note 8, 11.

[69] *Alvarez Royo-Villanova/Fernández del Pozo, supra* note 56.

legal definition and, therefore, the limitation caused relevant interpretative issues.[70] The amendment, removes this confusion, simply referring to *distributable profits*. With the new wording it is now unnecessary to debate what constitute ordinary earnings, but, of course, extraordinary earnings will be included to calculate the quantitative limit to grant the right to exit. In terms of policy, although debatable (is it *fair* to provide protection when shareholders expectations are naturally linked to the business results and could not anticipate extraordinary earnings like those arising, for instance, from the revaluation of assets?), this is the preferable solution. There is no reason for excluding profits according to their origin and the proposed time reference prevents the right to exit being granted only for extraordinary earnings.

Also, the notion of distributable profit may be the source of specific problems with so-called voluntary reserves. Under Spanish law, dividends can only be distributed after meeting the requirements laid down by law and in the articles of association and if the value of the corporate equity is not, would not be, less than the company's capital (Art. 273 para. 3 LSC). Of course, the obligation to devote a 10% of the profits to legal reserve until it reaches a 20% of the capital or the rule regarding the corporate equity is not problematic, due to their mandatory nature. However, it is always possible for the companies to voluntarily incorporate in the articles of association a mandate for earnings to be devoted to a particular reserve. This, of course, negatively affects the right to exit, because profits can only be distributed after attending that mandate. In this case, although the legal right to exit would still be formally present, the need to devote a certain amount of profits to this voluntary reserve may in practice deprive shareholders of the right granted by Art. 348 bis LSC.

If the voluntary reserve is present from incorporation, the provision will obviously be valid, because the articles of association can limit or even eliminate the right under Art. 348 bis LSC. Deciding if, and how, such a provision could be later included by amending the company´s articles of association is a more difficult proposition (see 4. below).

Finally, the reference is inherently rigid; whether absolute or relative, the ability to adapt to the particular circumstances of a particular company at a particular time is very limited. Spanish rule has not taken this into consideration: for instance, it is irrelevant if the company has the financial liquidity to pay the dividend.[71] This may be problematic in those cases when the profits

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[70] See, for instance, the academic discussion in *Alvarez Royo-Villanova/Fernández del Pozo, supra* note 56; *Brenes Cortés, supra* note 8, and the approach form the Companies Registry in two decisions of the DGRN, 28 November 2017.

[71] Some form of liquidity test was asked for before the amendment was finally passed, unsuccessfully, in *E. García Morales/L. Jiménez López*, ¿Es compatible el artículo 348 bis LSC con las restricciones al reparto de dividendos previstas en determinados contratos de financiación?, Diario La Ley 9150 (2018) 8.

are, for instance, the effect of mandatory revaluations of assets, common in some corporate transactions, which do not reflect in cash income. Group structures may also feature in this situation, for instance, when subsidiaries' earnings are not distributed. It is then possible that the company must resort to external financing to obtain the cash needed to distribute dividends to avoid the exercise of the corresponding right to exit, making financial liquidity shortage a sound argument against distributing dividends.

It is debatable whether sufficient liquidity to pay dividends should be required to grant shareholders the right to exit. If, as currently under Spanish law, it is not necessary, the question alters. Without a legal solution to this problem, it is formulated as an example of *bona fide* or duty of loyalty: does this duty preclude the right of exit if the distribution of profits or the consequent exercise of the right to exit would harm the financial situation of the company, due to the need to resort to external financing? This situation is, of course, especially problematic when the distribution of dividends or the exercise of the right to exit may compromise the solvency of the company. This latter scenario has been partially addressed by Spanish law (see 5.b below).

3. Group Structures

Article 348 bis LSC was originally drafted with a sole company in mind, not one that was part of a bigger group structure. This approach is therefore very limited and causes problems when applied to a group. In particular, for external shareholders of a parent company, when the group itself has earnings on a consolidated basis, but there is no dividend distribution from the top of the structure. The group figures can be excellent – on a consolidated basis – but the result may not be reflected for the parent company, because the directors of the subsidiaries are instructed not to distribute dividends, a restriction which allows the controlling shareholder of the parent company to retain earnings at lower levels.[72] As always, the controlling shareholder can balance this retention using alternative methods (i.e., lucrative contracts with a specific subsidiary),[73] although these may be subject to restriction by other rules

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[72] *L. Fernández del Pozo, supra* note 9.

[73] This problem was not addressed in the original form of Art. 348 bis LSC and raised serious concerns. Several contributions tried to grant equivalent protection using different interpretative and methodological tools – with possibly the most interesting suggested by *Guerrero Lebrón, supra* note 9, using the wording of the original version of the article to include in the notion of profits deriving from the course of business as well as the ones deriving from the industrial or economic activity. The problem, however, was near insurmountable and criticism emerged from scholars of the issue, see *Guerrero Lebrón, supra* note 9; *S. Alvarez Royo-Villanova*, Derecho de separación por falta de reparto de dividendos: el Art. 348 bis, in: Emparanza Sobejano (ed.), Los intentos de reforzamiento del poder de la junta y de los socios en los grupos de sociedades (Madrid 2018) 139; *F. Silván Rodríguez/I. Pérez Hernando*, Derecho de separación y dividendos: el controvertido

(for instance, the duty of loyalty for directors in the context of related parties' transactions, or even criminal law).

This scenario is clear in pure holding companies, i.e., companies that have no other activity than to own shares in subsidiaries. The economic or industrial activities are hence developed by subsidiaries and their results are consolidated and eventually derived to the parent company by way of dividend distributions from the bottom to the top.

The case is not unusual in family companies where participation in the business is structured through a parent company whose sole purpose is to hold shares in industrial or commercial subsidiaries. This holding is often the result of a subsidiarization of these latter activities at a certain moment, like when the founder dies, and her shares must be transferred to her heirs. In these cases, shareholders may have agreed to a certain distribution of dividends in the parent company to ensure their share of the profits, trusting that they will flow from the subsidiaries to the top of the structure. However, majority shareholders may use their position as managers to block distributions in subsidiaries, by exercising the vote of the parent company as majority or sole shareholder of the subsidiary. Then, any right to a dividend held by their relatives and co-shareholders at the parent level will be frustrated, even if, as sometimes happen, the minimum dividend at the parent company is measured based on the global group results on consolidated level.

This is a paradigmatic example, but there are also other alternatives and they may require slight adaptations. For instance, the parent company may have its own industrial or economic activity and, consequently, profits could stem from both the consolidated results and the individual activity carried out by the parent company. Here, the minority shareholder of the parent company has protection from the retention of profits in the consolidated structure or in the parent company, namely those originating from its own industrial activity.

The following paragraphs will offer a critical approach of the current situation under Spanish law, after the inclusion of specific rules for groups following the amendments of December 2018.[74] The solution finally adopted may shed light on the particular problems of a rule of law intended to solve the undue retention of dividends in group structures.

a) Combined problems in parent companies

The protection of minority shareholders of a parent company may follow from two different situations. Firstly, it is possible for the company itself to

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artículo 348 bis LSC, Diario La Ley 7813 (2012); *N. Iraculis Aguirre*, La separación del socio sin necesidad de justificación: por no reparto de dividendos o por la propia voluntad del socio, RdS 38 (2012) 225.

[74] See a recent and thorough analysis of this matter in *A. Muñoz García*, Distribución obligatoria de dividendos y grupos, RdS 55 (2019) 145.

have distributable profits originating from its own activity or as a result of dividend distribution from subsidiaries that are unduly retained. In this case, no particular rule is required due to its nature as parent company: a general rule on dividend distribution and shareholder protection is enough. Secondly, it is possible that the accounts at the highest level of the group structure (i.e., the parent company) show consolidated earnings. Here, however, a general provision that does not consider the particularities of the group structure would not apply. Both situations shall be examined independently. For policy reasons, it may be possible that protection is given only on an individual basis with no differentiation on the grounds of the existence of a group. But if some protection for external shareholders of a group is included, a specific rule is necessary and the requirements will undoubtedly differ.

The difficulties of drafting the rule increase if the group structure is taken into consideration. The optimal solution on policy terms must first be determined (and here, policies on how to solve group problems will play a relevant role) and then, if rules for companies in a group are to be included, particular attention shall be put on the coordination of both levels of protection (individual–consolidated).

Spanish law has followed a dual structure on this matter since the amendment of Art. 348 bis LSC in 2018. The situation is handled on an individual basis and a specific provision for parent companies is added in Art. 348 bis para. 4 LSC. This provides two complementary solutions to the problem of dividend retention in group structures. The first refers to any company within the structure, whose shareholders' rights are evaluated solely by an individual company analysis. In this case, the retention of profits uses the individual result as a reference, be it for the parent or any subsidiary, even if the subsidiary itself has more subsidiaries (subgroup). The particularities of the group are only taken into account at the parent level. Here, Art. 348 bis para. 4 LSC provides shareholders with the right to exit considering the results on a consolidated basis. This is the only rule to resolve the specific situation of groups, i.e., retention of profits in subsidiaries rather than transfer to companies higher up in the group, whose individual accounts would not allow shareholders to claim the distribution of (non-existent) profits for that particular company.

The rule for the parent company is not seen as a sub-case of the general rule and therefore is drafted as a specific provision for this particular case, intended to contain all the necessary elements as to define the right by itself. That conclusion may follow from the initial wording referred to the first paragraph ("even when the requirements of the first paragraph are not met"). This is hardly possible, as the only real difference is the calculation of the thresholds (referring to the consolidated results). Many of the general conditions apply to all cases, including groups, and therefore the wording is misleading. In fact, despite the initial impression, the provisions in Art. 348 bis

para. 4 LSC must be complemented with several of the general requirements included under the first paragraph. For instance, the non-mandatory nature of the rule, as stated under the first paragraph also applies. The same must be understood for the required protest by the shareholder for the right to be granted or compatibility with other means of protection (challenging the decision or liability actions against directors), also provided for in Art. 348 bis para. 1 LSC. In addition, the limit of at least 25% of the legally distributable profit accrued during the last five financial years also applies, despite the lack of reference in the fourth paragraph (for ease of comprehension) to the recognition of the right to exit.[75] Finally, paragraphs two and three also apply.

It follows from the individual approach that the exclusions of Art. 348 bis para. 5 LSC (i.e., listed companies, public limited sport companies, etc.) have to be evaluated as regards the parent company. This is of particular relevance for groups including listed companies. The exclusion will only apply if the parent company is listed, but not in those cases (not so uncommon) when the parent is not listed, but some (or all) of the subsidiaries are.[76] The condition of subsidiaries is therefore irrelevant in terms of the right of external shareholders of the parent company to exit due to profit retention in the group structure. The exclusions referred to insolvency or pre-insolvency proceedings also apply to the parent company for the right to exit on consolidated grounds.

b) Scope of the rule: groups and consolidation

Article 348 bis para. 4 LSC does not refer directly to a group (although the context is obvious: the *parent company* shareholder), but rather to the results of consolidated accounts. In this instance, consolidation acts as a proxy for the existence of a group; under Art. 42 of the Spanish Commercial Code (*Código de Comercio,* CCom)[77] a group is considered to exist whenever a company directly or indirectly controls other companies. The use of the obligation to consolidate accounts, however, has relevant shortcomings that may not have occurred if the rule had been simply tied to the existence of a group.

In the first place, as the rule considers only companies required to provide consolidated accounts,[78] external shareholders of parent companies not required to provide consolidated accounts under the applicable law receive no

[75] *Fernández del Pozo, supra* note 9; *Brenes Cortés, supra* note 8, 44.

[76] See *Brenes Cortés, supra* note 8, 36.

[77] *Real Decreto de 22 de agosto de 1885 por el que se publica el Código de Comercio*.

[78] Art. 43 CCom and Arts. 8 and 9 of the Rules for the Preparation of Consolidated Accounts (*Real Decreto 1159/2010, de 17 de septiembre, por el que se aprueban las Normas para la Formulación de Cuentas Anuales Consolidadas y se modifica el Plan General de Contabilidad aprobado por Real Decreto 1514/2007, de 16 de noviembre y el Plan General de Contabilidad de Pequeñas y Medianas Empresas aprobado por Real Decreto 1515/2007, de 16 de noviembre*).

protection under Art. 348 bis para. 4 LSC. This implies the exclusion of external shareholders of small companies exempted from the consolidated account requirement for reasons of size.[79] This exclusion is of particular relevance for economies, like Spain, where small and medium businesses are prevalent.

The use of mandatory consolidation also therefore includes companies that do not provide consolidated accounts, despite being so obliged. However, the approach creates particular problems in this case (statistics seem to indicate this may be a common situation in Spanish law).[80] It is harder for external shareholders to know (and prove) that the company must provide consolidated accounts, than it is to know that a company is a parent of a group. For this reason, a less restrictive view of the shareholder's right to be informed is being promoted among Spanish scholars.[81] In this sense, and following a Supreme Court decision,[82] the idea that shareholders should have access to information from subsidiaries is now more widely accepted. It is particularly convenient in the context of Art. 348 bis para. 4 LSC,[83] as it has sometimes

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[79] According to Art. 43 CCom and Art. 258 LSC, it is not mandatory to provide consolidated accounts if a company meets at least two of the following requirements: (a) the company total assets are not higher than eleven million four hundred thousand euros; (b) the company net annual turnover is not higher than twenty-two million eight hundred thousand euros or (c) the company average head count during the financial year is not higher than two hundred fifty employees.

[80] *Fernández del Pozo, supra* note 9.

[81] Information rights of shareholders in closed companies as regards annual accounts and accounting has been strengthened by the Supreme Court, where it has expressly been recognized that shareholders can also access confidential documents when certain requirements are met. See, lately, the valuable contribution of *M. T. Martínez Martínez*, Alcance del derecho de información contable del socio minoritario (25 por 100 del capital social) en una sociedad anónima familiar, in: Yzquierdo Tolsado (ed.), Comentarios a las sentencias de unificación de doctrina: civil y mercantil, Vol. 6 (2013–2014) (Madrid 2016) 669 et seq., commenting the Supreme Court decision 531/2013, of 19th of September.

[82] TS, 15 July 2015, RJ 2015/3932 granted information rights to minority shareholders of the parent company regarding a fully owned subsidiary. In this case, however, the minority shareholder held almost 50% of the capital and the parent company was a pure holding company. Both circumstances may have been relevant to the decision. A different approach is sometimes seen in the lower courts (for instance, AP Madrid, 25 May 2018, ECLI: ES:APM:2018:7792 denied the right to a shareholder of an intermediate company for the subsidiaries, but in this case the company had no obligation to provide consolidated accounts, because it was not the parent company of the group).

[83] See, before the amendment of December 2018, *Guerrero Lebrón, supra* note 9, 20, reasoning that, if the right could only then be granted attending to profits originating from industrial or economic activity, it was necessary to ensure this extended information right to external shareholders of the parent company. Otherwise, it would be easy for the controlling shareholder to circumvent the safeguard by simply distributing dividends in companies where external shareholders were not present. Also, under the present wording see *Fernández del Pozo, supra* note 9; *M. T. Martínez Martínez*, El derecho de información del socio minoritario de la sociedad dominante sobre la filial. Su posible ampliación a través de

been highlighted in the context of the right to exit as a protection against oppression.[84] The provision of Art. 348 bis para. 4 LSC will undoubtedly reinforce this idea, because some mechanism of control should be given to external shareholders to prevent depriving them of the right to exit by simply not complying with the legal mandate to provide consolidated accounts. If the company does not provide consolidated accounts, despite being so required, shareholders may use their rights to appoint an independent auditor to review the accounting.[85]

c) The reference to consolidation and its effects on quantitative thresholds

The right to exit in this case uses different references for minimum dividend distribution. For obvious reasons, these must consider the situation of the group and of the company as parent company of a group. Consequently, although a failure to distribute 25% of profits is still the threshold requirement, it refers to the consolidated profits. Also, the requirement that profits were obtained in the three preceding years is transformed to adapt it to the special group environment. Here, the condition refers to the existence of (consolidated) profits ascribed to the parent company in the three preceding financial years.[86] Thus, the affected company must have been the parent company of the group for at least this long, with a continuous obligation to provide consolidated accounts for at least the same amount of time profits were obtained.[87] This has to be considered an added requirement. In particular, this reference to three years is complemented by the five years since incorporation rule from the first paragraph.

No reference is made to the distribution of consolidated profits because there is no such concept in consolidated accounts.[88] This explains a difference to the rule from the strictly individual perspective. In the case of Art. 348 bis para. 4 LSC, exiting shareholders cannot be required to hold a position as re-

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los puntos informativos en el orden del día propuestos por las minorías de socios, in: Emparanza Sobejano (ed.), Los intentos de reforzamiento del poder de la junta y de los socios en los grupos de sociedades (Madrid 2018) 45. This approach is consistent with the particular relevance of information rights for minority protection, *Fleischer, supra* note 1, 68.

[84] *Neville, supra* note 13, 232.

[85] In favour of sanctioning this behaviour as if the annual accounts had not been submitted to the Companies Register, *Fernández del Pozo, supra* note 9, even though admitting that this solution has never been applied.

[86] There is a particular item for this in the consolidated accounts model (49510, see *Orden JUS/318/2018, de 21 de marzo, por la que se aprueba el nuevo modelo para la presentación en el Registro Mercantil de las cuentas anuales consolidadas de los sujetos obligados a su publicación*).

[87] See *Brenes Cortés, supra* note 8, 43.

[88] It will be thus necessary to adapt the requirement of *distributable* profit to this context; more extensively on this, *Fernández del Pozo, supra* note 9.

gards the distribution of consolidated results, because there cannot be any general shareholders agreement. Consequently, the right to exit follows from the simple fact that the dividend paid at the parent company did not meet the minimum percentage of the profit in the consolidated account. Shareholder protest is always necessary, but referred in this case to the fact that the parent does not distribute the minimum consolidated profit. Considering that the right arises either on an individual or consolidated basis, it requires a clear statement of grounds (i.e., if the protest is based on individual company results, *ex* Art. 348 bis para. 1 LSC; or on consolidated group results, *ex* Art. 348 bis para. 4 LSC), considering the different requirements in each case.

To prevent the right to exit being exercised, the parent company must distribute dividends where the legal requirements are met (Art. 273 LSC). Of course, there could always be profits in consolidated accounts, but no possibility to distribute them at the parent company level. This is, however, the scenario that the law intends to prevent. This situation could be solved by the parent company simply exercising its role as head of the group to decide the distribution of dividends in the subsidiaries, which then flow bottom-up in the necessary measure as to allow distribution by the parent company.

Article 348 bis para. 4 LSC and the way that consolidated accounts work creates particular difficulties for cash and profit management in groups. Profits from lower levels are included in the accounts in subsequent financial years. The greater the number of companies in the lower levels, the later the profit will flow to the top (in fact, the number of years will be a function of the number of subsidiaries: if there are three fully owned subsidiaries of the parent company, profits at the lowest level will only be in the parent company three years later). However, these profits will be shown in the consolidated accounts. This may require the parent company to resort to interim dividend distribution, something that is not always possible, and probably not convenient even in the most beneficial form of group financing (like pool-cash), due to transfer pricing rules.

d) The absence of a rule covering shareholders in intermediate subsidiaries

The need to protect minority shareholders in group structures can also be identified by subgroup, i.e., subsidiaries of a parent company which have their own subsidiaries. It is perfectly possible that in this structure, external shareholders are only present at lower levels. Of course, if there are external shareholders in the parent company, undue retention of profits may stem from the intermediate levels, because of the disciplinary effect of the right to exit at the parent level company (to distribute dividends, they must flow bottom-up, which will also benefit external shareholders in intermediate steps).

However, there could be cases where the rule provides no protection to external shareholders. Consider, for instance, the case of a group consisting of a

parent company (A) with only one shareholder, and two subsidiaries, one fully owned (B) and the other (C) owned only at 80% with another shareholder at 20%. Commercial activity occurs at the next lower level, for instance through subsidiaries B1, B2 and B3, fully owned by (B) and C1, C2 and C3, fully owned by (C). The only shareholder needing to be protected against retention of profit is the minority shareholder in (C). If the rule is drafted only for the parent company, the minority shareholder in (C) could not claim any specific right if the profits of C1, C2 and C3 are not distributed.

The rule of Art. 348 bis LSC does not provide protection, directly or indirectly, to external shareholders of intermediate subsidiaries if the parent company has no external shareholder. At the same time, the rule offers easy circumvention of external shareholder rights in case of conflict: simply incorporate a company to act as parent company and transfer the shares of the majority shareholder to that company. Following the previous example, (C) could have previously been the parent company and is now located at the second level simply because the sole shareholder (A) transferred its 80% part in (C) to the later and newly created (A). The shortcoming is evident.

One possible solution to this problem is to extend the legal provision to dissenting shareholders in intermediate subsidiaries by analogy. This approach is problematic.[89] In this case there seems to be no loophole in the law, but a stringent definition of the scope of application of the legal rule that automatically precludes other possible, although similar, scenarios. Also, the rule shares the exceptional nature of any rule of law granting a right to exit. Both reasons make it difficult to accept that the right may be extensively applied by analogy, for instance, to minority shareholders of a subsidiary.[90] In these cases, it is only possible to grant the right to exit according to the particular circumstances of the individual company (i.e., if the requirements of Art. 348 bis para. LSC are met for that specific company).

On the other hand, one approach originally possible under the original version of Art. 348 bis LSC is no longer available. Some scholars suggested that, considering the right was linked to ordinary earnings, it might be possible to use the earnings from industrial activities as the reference. That would help to conclude that at any level in group structures, the right to exit should be measured in accordance with the results of subsidiaries actually engaging in industrial activities.[91] Now that the reference to ordinary earnings has disappeared, this possible interpretative approach is virtually impossible.

[89] Analogy was used to extend the provision to external shareholders in group structures before the introduction of particular provisions in 2018. See *S. Alvarez Royo-Villanova, supra* note 73, 139, 151 et seq.

[90] *Brenes Cortés, supra* note 8, 32.

[91] *Guerrero Lebrón, supra* note 9.

It could only be concluded that the rule does not apply in cases like this. The fact that it cannot be applied however, should not be identified with the absence of any protection for a minority shareholder. What it actually happens is that protection is derived to other mechanisms. As in other situations not covered by Art. 348 bis LSC, the rule of law does not fully replace the more general principles of *bona fide* and the duty of loyalty among shareholders in the exercise of their rights. The case of the group structure offers a vivid example of the inherent limitations of a rule of law on this matter. It will undoubtedly help to prevent situations of abuse, but it is unlikely that it can address every possible case and, thus, there will always be situations to be covered by general principles.

4. Mandatory or Non-mandatory Rule?

Rules for protecting minority shareholders should be mandatory where they are necessary to protect shareholders who cannot guarantee themselves adequate protection. This is the traditional approach among Spanish scholars as regards the right to exit,[92] but it does not necessarily imply that shareholders cannot individually relinquish their rights or that it is not possible to agree on this particular matter in a shareholder agreement.[93] Here, the difference between mandatory company rules and individual rights is of the utmost importance. A rule providing certain minority rights that cannot be affected by the articles of association does not prevent individual shareholders deciding whether to exercise or not that right or even agree on it on individual basis.

The mandatory or non-mandatory nature of shareholders' right to exit has been a common source of disagreement among scholars in Spain, who analyzed this issue to differing extents on the grounds of the original wording of Art. 348 bis LSC.[94] In fact, from a more general perspective, the policy is still open on whether dividend distribution or special minority rights in case of abusive retention of profits should be mandatory. The initial decision of the Spanish legislature to make the rule mandatory was one of the most significant bases for criticism. Of course, mandatory rules provide a stronger protection but, also render the provision more rigid and more difficult to adapt to different situations.[95] In this context, the mandatory nature not only forbids

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[92] *Sequeira Martín, supra* note 50, 832. Within the context of Art. 348 bis LSC *Brenes Cortés, supra* note 8, 17 et seq.; also *Guerrero Lebrón, supra* note 8, 12.

[93] *Guerrero Lebrón, supra* note 8, 13; *Silván Rodríguez/Pérez Hernando, supra* note 73.

[94] There is a thorough review in *Sequeira Martín, supra* note 50. Both positions in terms of policy can be exemplified in *Campins Vargas/Alfaro, supra* note 20; *T. Vázquez Lépinette*, La separación por justa causa tras las recientes reformas legislativas, RDM 283 (2012) 169.

[95] Even if the rule is mandatory, some interpretative leeway was found to sustain the possibility for the company to rule out the right to dividend distributions, with the conse-

alternative agreements in the articles of association, but also excludes the freedom of shareholders to decide on profits in the annual general meeting.

A non-mandatory rule on dividend distribution serves as a reference and probably provides a standard which helps courts decide on abuses, while also respecting the autonomous decision of shareholders for every company and fiscal year. Even more importantly, such a rule makes it possible for companies to include alternative provisions in their articles of association and may nudge parties towards deciding on this point.[96] This allows predefined protection to be decreased or eliminated (i.e. making requirements more stringent or even denying any right to exit in the case of non-distribution of dividends).[97]

Making the rule non-mandatory was one of the most salient changes made by the December 2018 amendment to Art. 348 bis LSC.[98] Now, the rule specifically preserves the right to provide for an alternative in the articles of association. This is the right option: it should be possible for the parties to decide on this matter and their will should prevail. It is often the case, for instance, that investors in a company require, as a particular condition, that dividends should not be distributed, but rather kept in the company for some time to finance future expansions.[99] The law should respect that intention but, at the same time, should also consider the risk of abusive behavior.

The current wording allows more restrictive approaches when the company is incorporated. In fact, even a clause excluding any right to exit in case of non-distribution of dividends would be valid.[100] No general principles of

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quent effect of the exclusion of any right to exit. This interpretation relies on the validity of an individual relinquishing the right and supports the idea that this possibility could be effective through including specific clauses at the incorporation of the company, as they require unanimity and could be treated as individual decisions of shareholders. *Campins Vargas/Alfaro, supra* note 20; *Pulgar Ezquerra, supra* note 54, among others.

[96] In oppressive behaviour, however, nudges seem not to provide enough protection for minority shareholders in closed companies, *Means, supra* note 14, 1183.

[97] For mandatory rules, it is usually accepted that the articles of association can increase protection (i.e., including the obligation to distribute dividends under certain conditions or easing the requirements to grant the right to exit). The rule here acts as the minimum protection standard.

[98] The amendment now creates particular problems for courts deciding on cases where shareholders agreed on dividends *before* the amendment. A good example with commentary in *J. Alfaro*, Separación ex Art. 348 bis LSC y política de dividendos acordada por todos los socios: el carácter modificativo o interpretativo de la reforma de 2018, Derecho Mercantil, 27 August 2019 (<https://derechomercantilespana.blogspot.com/2019/08/separacion-ex-art-348-bis-lsc-y.html>).

[99] In these cases, there is explicit evidence that the majority and minority shareholders agreed to defer dividends and minority could not claim that the absence of distribution illegitimately frustrated its expectations, *Moll, supra* note 17, 873, with further references to statutory provisions. Some examples in *Easterbrook/Fischel, supra* note 23, 281.

[100] This does not mean, however, that a side agreement with financers at the moment of incorporation could be enforceable *vis á vis* a shareholder who later joined the company,

company law could forbid that clause either. Under Spanish law, pursuant Art. 2 LSC a company may be incorporated with no lucrative goal, if the clause is included in the initial articles of association, and if every shareholder individually consented, except in very extreme cases of vitiating factors (misrepresentation, mistake, undue influence, etc.). If the absence of a lucrative goal is possible, a provision excluding exit rights in the articles of association should be perfectly valid and applicable.

On the other hand, the restriction or elimination of any particular right to dividend or to exit in case of non-distribution may be acceptable even if the company has a lucrative goal. It is not uncommon that, even in these cases, shareholders' interests may be well be satisfied in liquidation. There are companies, whose shareholders want to receive their part when the activity is finished but have no interest in dividends when distribution might not be convenient for the company (i.e., real estate, construction or companies incorporated as special purpose vehicles for a simple investment of short-term activity).

The analysis is more difficult for later amendments to the right to receive a dividend or to the right to exit in the articles of association than those under which shareholders agreed to join the company.[101] Some form of protection for these scenarios is a necessary complement to the basic rule. The solution adopted by the Spanish law requires a unanimous vote of the partners, unless an exit right is granted to any partner who does not vote in favor of this decision (Art. 348 bis para. 2 LSC). The solution, however, is apparently straightforward.

The amendment can result in a better position for shareholders (i.e., providing the right to exit for any case of non-distribution or eliminating a clause excluding that right), or the contrary (i.e., limiting a pre-existing right to dividend distribution or increasing the requirements of the right to exit to make it more restrictive than the one provided for in Art. 348 bis LSC). Both possibilities create similar conflicts. For instance, an amendment increasing the rights to dividend distributions may conflict with shareholders who want to preserve the initial configuration, forcing profits to be retained in the company until a certain moment. However, the analysis is usually limited to those amendments detrimental to the right to dividends or the right to exit. This is because these cases are more sensitive: the amendment may be used to circumvent a legal right that protects minority (*rectius*, dissenting) shareholders from abusive behavior of the majority. It would only be necessary to have enough voting

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without adhering to the original agreement. In this case, the provision would be *res inter alios acta* and, therefore, not enforceable. It was the case in the DGRN, 10 May 2019, commented by *J. Alfaro*, ¿Puede separarse ex art. 348 bis el socio que ha aceptado una limitación al reparto de dividendos?, Derecho Mercantil, 2 September 2019 (<https://derechomercantilespana.blogspot.com/2019/09/puede-separarse-ex-art-348-bis-el-socio.html>).

[101] *Fleischer, supra* note 1: "even sworn adherents of freedom of contract argue in favour of some protective measures when dealing with *midstream changes*."

power to amend the articles of association to deprive shareholders of the right to exit at a given time to make the right practically useless.

Any alteration of the shareholders' position as regards dividend distribution and their right to exit would require unanimity, if the amendment seeks to "abolish or amend the exit right", according to Art. 348 bis LSC. It seems that the rule takes detrimental amendments into consideration. The verbs used (*abolish or amend*) helps it be read in this way, and its structure also amounts to this idea. Unanimity should be required because individual rights of shareholders would be affected by the amendment, however, there is nothing in the rule that necessarily forces that conclusion. A new rule broadening or easing the right to exit (whether directly or indirectly by way of a provision on dividend distribution), should be treated in the same way. There is a similar alteration to the position of shareholders as regards their rights on dividends whereby dissenting shareholders must be also protected. Consider the situation where an investor requires profits be retained for the first six years, but the majority amends the articles of association to make them distributable from the second and grants an exit right if no distribution is decided. The rights of that dissenting shareholder are substantially altered and deserve the same protection. Hence, any amendment affecting the right to exit shall be subject to the same rules, because the provisions of Art. 348 bis LSC do not restrict that conclusion.

The structure of the rule (unanimity or exit) has given rise to some doubts among Spanish scholars. The basic understanding leads one to think that these amendments require unanimity and, if unanimity is not reached, the amendment effectively grants dissenting shareholder(s) an exit right. This structure replicates the one presented in other scenarios, namely the one provided for in case of substitution or substantial amendment of the corporate purpose (Art. 348 LSC). However, an alternative interpretation has been promoted,[102] namely that the exit right provided for in Art. 348 bis LSC in favor of dissenting shareholders is not equivalent to the exit right granted in some cases of amendments of the articles of association (where dissenting shareholders will be bound by the new rules once amended, but where they can exit the company to avoid that effect); rather, it is said to be the same exit right granted in Art. 348 bis LSC. Under this view, if the decision is not unanimous, the dissenting shareholders will maintain their rights as previously provided for by the law or the articles of association. This position is however, marginal among Spanish scholars and has the inevitable inconvenience that it entails an implicit (therefore, not unknowable by third parties) creation of different classes of shares. Furthermore, in my view, it does not successfully challenge the evident connection to other rules with a similar structure

[102] *M. M. Sánchez Álvarez*, Primer comentario del artículo 348 bis.4 LSC (Dividendos y derecho de separación del socio de la sociedad dominante), LLM 55 (2019), 1, 7.

(unanimity or right to exit for those opposed to the decision) and the systematic integration of the right laid out in Art. 348 bis LSC into the more extensive rules on the right to exit, as a general category.

The fact that shareholders may have a right to exit does not preclude the use of alternative means of protection. In particular, dissenting shareholders may always challenge a general assembly decision, whenever they decide that this solution better protects their interest. It is possible that a shareholder may not want to further limit their rights and, but, at the same time, does not want to leave the company. The special protection mechanism provided by Art. 348 bis LSC is not exclusive: Art. 348 bis LSC preserves the right to challenge the general assembly decision despite the express legal attribution of the right to exit ("The provisions […] do not affect the right to challenge shareholders' meeting decisions"). The right also applies to the associated protection against later amendments affecting the right to exit.

Finally, the provision on amendments does not clearly state its scope of application. Of course, it will apply whenever the amendment directly refers to the right to exit provided in Art. 348 bis LSC. However, it is still unclear how it would apply to those amendments which may indirectly affect that right, for instance, any amendment referring to the basic general requirements of Art. 348 bis LSC (i.e., the time and quantitative references). If those requirements are directly modified, the amendment will undoubtedly fall into the scope of the provision, requiring unanimity. However, the answer is not so clear in other cases, such as amendments made to the articles of association to create or increase reserves that should take precedence over determining distributable profits. Although this could be debatable, my impression is that any agreement on reserves should not be affected by the rule and, therefore, could only be evaluated under more general tools (abuse, *bona fide* and duty of loyalty). This amendment has an indirect impact on whether the requirements of Art. 348 bis LSC can be met, i.e., the right to exit is only granted if dividends are not distributable. This depends on the previous application of profits to legal and voluntary (but provided for in the articles of association) reserves. It is evident that creating a reserve or increasing its size might be detrimental to the right to exit, but only indirectly. The most convincing reason for concluding that the protection of shareholders should not require unanimity (by application of Art. 348 bis LSC) is that, in these cases, no special protection is needed because there is no *negative* decision. Abused shareholders may be perfectly protected using the general rules, namely, an opportunity to challenge an abusive decision, and have it declared invalid and, thus, rendered ineffective. The main reason for the special protection (i.e., the inherent limitation of the right to challenge negative decisions of the general assembly) is not present in this case and it seems preferable not to extend such an exceptional provision (unanimity) to cases where it would not be required to grant sufficient protection to shareholders.

Finally, whether the provisions of the articles of association will absolutely frame the rights of shareholders should be analyzed as regards the distribution of dividends. In particular, whether they will deny shareholders protection against general assembly decisions to not distribute profits. There are two different possibilities.

Firstly, it is possible that the restriction or exclusion refers to the right to receive dividends. Of course, the starting point is that conventional rules will be binding. As a consequence, if the general assembly decision is coherent with the provision in the articles of association, shareholders will have no right to challenge it. This, of course, does not prejudice the right of shareholders to challenge the general assembly decision in two cases. It will always be possible for shareholders to challenge decisions detrimental to their rights according to the provisions of the articles of association. That would be the case, for instance, when the general assembly decides not to distribute dividends for the sixth concurrent year and the articles of association excludes the distribution for four years. General considerations on the abusive retention of profits will apply in this case. Furthermore, as explained above, shareholders may challenge the restriction itself when it is included by amending the articles of association. This, however, could only be successful if this inclusion results from abusive behavior by the majority. Once included, my understanding is that it is not possible to challenge the articles of association because of abusive conduct.

Secondly, the restriction or exclusion may refer to the right to exit. Once again, conventional rules will be binding as to this right, but will not prejudice the right to challenge the decision to distribute dividends. This will be the case, for instance, if the articles of association specifically exclude the right to exit because dividends are not distributed but does not include any provision on the right to dividend. In this case, the exclusion refers to the protection mechanism against retention of profits, but not to the right itself. Consequently, any shareholder can challenge the decision not to distribute dividends in the general context of abusive retention of profits.

5. *Right to Exit and Opportunistic Behavior*

Opportunistic behavior is less probable when there is no particular legal provision and courts decide depending on the circumstances of the case and following the more general principles of *bona fide* or duty of loyalty. On the contrary, a right to exit for retention of profits based on a general rule may be strategically used for both the shareholders and the company. One of the challenges of a rule of law on this matter is how to efficiently address this risk. The present situation in Spanish law offers a useful perspective on how to approach this issue and its potential shortcomings.

a) Majority forcing minority to sell

The company (more precisely, the majority) may use the connection between the retention of profits and the right to exit to force minority shareholders to leave the company, blocking the distribution of dividends to unlock that right. Of course, in this case a fair value for their shares is paid (this, of course, creates a different problem).[103] However, this solution may not be in the best interest of the shareholder, because it may deprive him of the possibility of receiving a share in future earnings.

To provide the most adequate protection of minority shareholder interests, the right to exit should not exclude other possibilities, namely the possibility to force distribution of dividends. In the absence of a legal rule forcing dividend distribution, it becomes a question of the compatibility of the right to exit with challenging a shareholders' general meeting decision to withhold profits.

The original wording of Art. 348 bis LSC remained silent on this possibility. Now Art. 348 bis LSC expressly provides that the right to exit does not preclude other possibilities, in particular, the right to challenge a decision not to distribute dividends. This allows shareholders to opt between the right to exit or the right to challenge the decision, using the protection that will better suit their particular interest (i.e., leaving a company where they may have no share of the annual profits or staying, and challenging the absence of distributions).[104]

The fact that shareholders may opt for one possibility or the other does not remove the difficulties associated with challenging this category of general meeting decisions.[105] Several arguments favor the idea that the latter mechanism is less effective in protecting minority shareholders, mainly due to its uncertainties. This is likely to induce shareholders to exercise the right to exit and leave challenging general meeting decisions to extreme cases where the expropriation effect of the right to exit materially damages the shareholder's

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[103] A different question is who should value the shares, and how it should be done. This problem is not specific to the issue covered here, but rather a common situation for any case of shareholders leaving the company. The general provisions for the exit and exclusion of shareholders include particular rules for the valuation of the shares in these cases, that shall be done by an external expert appointed by the Companies Registry if the parties do not reach an agreement (see Art. 346 LSC). Once the right to exit is granted, the uncertainty is therefore transferred to the result of the valuation (*Brenes Cortés, supra* note 8). This simple answer belies the difficulty of valuation in closed corporations (*Fleischer, supra* note 1, 36).

[104] Before the amendment, *González Fernández, supra* note 60, supported the idea that the rule providing a right to exit prevented the courts imposing a distribution of dividends.

[105] As it has been previously noted, retention of profits is simply a particular (though relevant and common) case of abuse of the minority, suffering from the same problems of other cases of this latter more general category; see a categorization of these situations in *M. T. Martínez Martínez*, Los acuerdos adoptados con abuso de mayoría en perjuicio de los socios minoritarios: caracterización y casuística, RDM 310 (2018) 4.

interest. To better support this statement, the difficulties of challenging decisions must, once again be highlighted. The experience gained before the entry into force of Art. 348 bis LSC, when this was the only possibility for protection offers clear examples of its shortcomings.[106]

b) Minority forcing majority to distribute dividends

A legally granted right to exit for retention of profits may easily offer shareholders the possibility to force the distribution of dividends even if it may be detrimental to the interests of the company. The situation usually arises where the distribution may affect the survival of a company in difficulties, but that is the most extreme example of a bigger problem. In fact, this conflict can exist in different situations where it is in the company's best interest to retain profits in anticipation of future investments. Furthermore, even voluntary provisions in the articles of association face the risk of opportunistic behavior by minority shareholders[107] and a balanced solution is very difficult to achieve via a legal provision.[108] Those situations have only been partially addressed (and only after the amendment of December 2018), and the rules included will not help to solve other possible scenarios of opportunism that should be solved using the more general abuse of rights tools and *bona fide* principles.[109]

Distribution in companies with solvency problems is the most extreme example of this conflict and, as such, it was one of the first problematic scenarios highlighted by Spanish scholars. The rule of Art. 348 bis LSC did not contain any provision limiting the right to exit when it created significant problems for the financial condition of the company. The clearest case is the exercise of an exit right that renders the company insolvent, in the sense of Art. 2 of the Spanish Insolvency Act (*Ley Concursal,* LC)[110]. This could come as a side effect of the obligation to pay the fair value of the shares owned by the exiting shareholder. Absent this limitation in the rule, these situations could only be evaluated under the duty of loyalty of shareholders

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[106] *A. Recalde Castells*, Regulating Majority Oppression in Close Corporations. The Case of Limiting the Distribution of Profits of a Company due to Shareholders Decision Not to Give Dividends, ECLE Meeting Cologne, December 2018.

[107] *Easterbrook/Fischel, supra* note 23, 285; *Neville, supra* note 13, 219; *H. J. Haynsworth*, The Effectiveness of Involuntary Dissolution Suits as a Remedy for Close Corporation Dissension, Clev. St. L. Rev. 35 (1987) 25, 30.

[108] *Neville, supra* note 13, 237.

[109] Although the case applied the original wording of Art. 348 bis LSC, the case decided by the Provincial Court of Vizcaya in its decision of 18 December 2018, denied the shareholder the right to exit for abusive (ECLI: ES:APBI:2018:2223), with a short comment of *J. Alfaro*, Ejercicio abusivo del derecho de separación ex Art. 348 bis LSC, Derecho mercantil, 27 August 2019 (<https://derechomercantilespana.blogspot.com/2019/08/ejercicio-abusivo-del-derecho-de.html>).

[110] *Ley 22/2003, de 9 de julio, Concursal.*

Article 348 bis LSC in its current wording excludes the right to exit under certain circumstances, related to the financial problems of the affected company. Its scope is nevertheless limited, as the exclusions only refer to existing insolvency or pre-insolvency proceedings. Under Art. 348 bis para. 5 lit. b–d LSC, the right to exit is excluded if the company is under insolvency proceedings, has notified it is going into refinancing negotiations (or similar agreement) or has reached a refinancing agreement. The rule creates particular interpretative problems, that will not be addressed here.

The narrow legislative approach is unhelpful: it cannot be applied to every possible situation and leaves most cases of opportunistic behavior unresolved. This is particularly true in those cases when there is a healthy financial outlook that would be dramatically transformed if a shareholder exercised the right to exit, due to the company's need to pay fair value to the exiting shareholder. Of course, if the distribution of dividends is possible without a significant worsening of the company's financial situation, the right to exit should be observed, because the company may avoid its negative effect by simply distributing dividends. However, if it is not the case, it remains an open issue if the right should nevertheless be granted, or if the *bona fide* principle could serve as a ground for denial. Contractual restrictions on dividend distributions is a frequent and particularly difficult case. These are common terms in financing agreements, whereby the parties agree to limit or even exclude any dividend distribution for a period of time. In these cases, the interest of the company can be severely harmed either if the shareholder exercises the exit right or if the company is forced to distribute dividends.

If the exercise of the right to exit will lead to the insolvency of the company, it is possible that the alternative (to distribute dividends) is also harmful if contracts in force forbid such distribution.[111] This is a common clause in contracts that is usually linked to an early termination clause. The effect of both clauses together may make it impossible for the company to distribute dividends, if it would qualify as a breach of the agreement and provoke the early termination of a loan that could not be paid back at that time. Whether paying dividends or granting the exit right, it will compromise the future of the company.

This adverse situation can only be analyzed under the light of the *bona fide* limit to the right to exit, thus evaluating if the duty of loyalty should be construed in a way as to limit a right legally granted to shareholders. In this regard, the right to exit should not be treated differently than other rights and, therefore, its abuse is not protected by law. Consequently, in these extreme scenarios it should be possible to refuse the exit right. However, legal recognition of the right must be included in the analysis. The provision of

[111] In fact, contracts often include any kind of distribution to shareholders, not only including dividend, but also capital restitution, what would also affect the exercise of the right to exit.

Art. 348 bis LSC clearly shows that, under Spanish law, shareholders may count on the existence of a right to dividend if some requirements are met. As this is the standard, the refusal of that right may only happen in exceptional circumstances. In the context described, shareholders shall be allowed to exit unless the company clearly demonstrates it is impossible to implement any of those potential solutions without compromising its own future viability. For instance, the company must prove that the lender refused to provide a waiver for the distribution and indicated its intent to use the early termination clause. For that reason, general reference by the company to the covenant and the early termination clause would not be enough to block the valid exercise of the right to exit by a dissenting shareholder.

Of course, the situation described may also be present even in the absence of such a critical situation. Even when not affecting the current financial situation or putting the survival of the company at risk, distributions may negatively affect the interest of the company, in general. Both the duty of loyalty and the interdiction against the abuse of rights play a role in the context of Art. 348 bis LSC. Legal provisions for solvency problems are undoubtedly explained under this rationale. However, the right to exit should be limited in those cases when it is significantly harmful to the company or reflects a clearly abusive use of the right. The right to exit for undue retention of profits puts a restriction on the freedom to exercise an economic activity as a fundamental right and, therefore, it should only come into play in extreme circumstances.[112]

The question of whether the right to exit can be denied in cases not expressly included on these grounds is still open (for instance, if solvency is not compromised, but a dividends payment would incur a very costly indebtedness or it is absolutely unadvisable considering the financial situation of the company). A first reading of Art. 348 bis LSC shows that limits prevent the dividend distribution affecting the solvency of the company, but do not provide an answer for cases where the problem is the compatibility of dividend distribution with the interest of the company.[113]

However, the principles previously described would apply. *Bona fide* and duty of loyalty must play their roles even in the context of the right to exit for non-distribution of dividends, but application shall be more and more restricted as the situation moves farther from the cases expressly excluded. Hence, if refusal to distribute dividends by companies under covenants should only happen in very specific scenarios, the position must be even stricter when any limitation on these grounds is only based on the potential that the interests of the company could eventually be damaged. Once the right

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[112] *Brenes Cortés, supra* note 8, 12, but concluding that Art. 348 bis LSC in its original wording did not meet this requirement.

[113] *Brenes Cortés, supra* note 8, 15.

to exit has been exercised, there must be solid reasons in the interest of the company (as a whole, i.e., exceeding the interest of the majority) to deny it. As in previous scenarios, denial could only be accepted if it is not reasonably possible to pay out the minimum dividend.

Excessive Retention of Profits and Minority Protection

A German Perspective

Jennifer Trinks

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I. Introduction

Decisions on profit distribution can easily become a tantalizing matter in family firms. Not only is it difficult to develop an adequate dividend policy – paying shareholders their proverbial due while retaining sufficient funds to develop the business – the matter is made more complicated by the fact that majority shareholders can deliberately turn a corporation's dividend policy into an oppression strategy against minority shareholders.[1]

In many jurisdictions, the decision to distribute or retain a corporation's profits stands or falls on the votes of the majority shareholders[2]; majority

[1] This contribution is based on a previous comparative analysis of German and Spanish Law by *H. Fleischer/J. Trinks*, Minderheitenschutz bei der Gewinnthesaurierung in der GmbH, Ein deutsch-spanischer Rechtsvergleich, NZG 2015, 289.

[2] Critically on the majority shareholders' powers in Germany *K.-P. Martens*, Grundlagen und Entwicklung des Minderheitenschutzes in der GmbH, in: Lutter/Ulmer/Zöllner (eds.), Festschrift 100 Jahre GmbH-Gesetz (Cologne 1992) 607, 619 et seq. For the US see

shareholders can even decide the full retention of profits against the will of the minority. The majority can thus cut off the minority from any source of income from their corporation, leaving financial profits dangling in sight, but out of the minority's reach. Especially in family firms, where the corporation's payments constitute the main source of income for their shareholders, the retention of profits can thus threaten the financial subsistence of the minority and put them under substantial pressure.[3] German scholars have even coined the term starvation dividends[4] (*Hungerdividende*) for this phenomenon. At the same time, majority shareholders remain largely unaffected as they can secure their liquidity through other ways of profit extraction from the corporate firm, e.g. by granting themselves a generous salary or substantial payments for services provided.[5] In consequence, the retention of profits has become a wide-spread method to oppress or even to force out minority shareholders of close corporations.[6]

Like other jurisdictions, German law is struggling to rein in such behavior and to protect minority shareholders. The statutory and contractual framework for the distribution of a corporation's profits in German Limited Liability Corporations (*Gesellschaft mit beschränkter Haftung* – GmbH) underlines the difficulty of drafting clear-cut rules to prevent the excessive retention of profits (II.). Scholars and courts draw on the shareholders' *Treuepflicht*, the shareholders' fiduciary duty towards the corporation and each other, to police shareholder resolutions on the application of profits (III.). However, even where a shareholder resolution to retain profits has been found to violate the law, providing an adequate remedy may prove difficult (IV.). While the flexible approach under fiduciary duty thus allows for a reasonable standard of review of shareholder resolutions, it might be worth reconsidering the general

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the majority's influence via the board of directors, *D. K. Moll*, Shareholder Oppression & Dividend Policy in the Close Corporation, Wash. & Lee L. Rev. 60 (2003) 841, 862 et seq.

[3] Cf. *P. Hommelhoff*, Auszahlungsanspruch und Ergebnisverwendungsbeschluß in der GmbH, in: Pfeiffer/Wiese/Zimmermann (eds.), Festschrift für Heinz Rowedder zum 75. Geburtstag (Munich 1994) 171 et seq.

[4] For all *G. Bachmann/H. Eidenmüller/A. Engert/H. Fleischer/W. Schön*, Regulating the Closed Corporation (Berlin/Boston 2014) 39.

[5] See e.g. *P. Hommelhoff*, Gesellschaftsrechtliche Fragen im Entwurf eines Bilanzrichtlinie-Gesetzes. Bemerkungen zur Umsetzung der 4. EG-(Bilanz)-Richtlinie, BB 1981, 944, 952.

[6] See e.g. *Moll, supra* note 2, 841; for oppression strategies involving the earlier stages of preparation and approval of the corporation's annual accounts *R. Bork/K. Oepen*, Schutz des GmbH-Minderheitsgesellschafters vor der Mehrheit bei der Gewinnverteilung, ZGR 2002, 241, 282 et seq.; see also *M. B. Gutbrod*, Vom Gewinnbezugsrecht zum Gewinnanspruch des GmbH-Gesellschafters, GmbHR 1995, 551 et seq.; *S. Mock*, in: Heidinger/Leible/Schmidt (eds.), Michalski Kommentar zum GmbHG (3rd ed., Munich 2017) § 29 marg. no. 22 et seq.

principles for the application and distribution of profits which form the backdrop to these resolutions (V.).

II. Statutory and Contractual Framework for Profit Distribution

The German Limited Liability Corporations Act (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung* – GmbHG)[7] provides shareholders with ample leeway when it comes to deciding how to apply the corporation's profits (1.). Shareholders of a GmbH can generally decide the distribution or retention of profits with a simple majority of votes[8] unless the corporation's articles of association provide otherwise, and indeed, shareholders seem to rarely contract for different or more specified rules on profit distribution (2.).

1. A Self-Effacing Legislative Compromise

Current German law leaves the decision on how to use a corporations' profits largely to its shareholders. While the right to participate in the corporation's gains constitutes one of the main shareholder rights[9], it requires a shareholder resolution to materialize. Only once the shareholder meeting has decided to distribute profits do shareholders have a valid and enforceable claim for payment of a dividend from the corporation.[10]

The GmbHG holds few limitations on the shareholders' decision-making power. It limits distributable profit to the amount of the annual surplus plus any profit carried forward and minus any losses carried forward, or respectively to the net earnings according to the corporation's balance sheet, and excludes sums required to be retained by statute or the corporation's articles of association.[11] Beyond these constraints, shareholders are free to decide the retention of profits or to carry them forward, as § 29 para. 2 GmbHG express-

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[7] *Gesetz betreffend die Gesellschaften mit beschränkter Haftung in der im Bundesgesetzblatt Teil III, Gliederungsnummer 4123-1, veröffentlichten bereinigten Fassung, das zuletzt durch Artikel 10 des Gesetzes vom 17. Juli 2017 (BGBl. I S. 2446) geändert worden ist.*

[8] For statutory limits on the distribution of dividends see e.g. §§ 30 para. 1 sent. 1, 58d GmbHG, §§ 253 para. 6 sent. 2, 268 para. 8 German Commercial Code (*Handelsgesetzbuch* – HGB), further *L. Leuschner*, in Habersack/Casper/Löbbe (eds.), Gesetz betreffend die Gesellschaften mit beschränkter Haftung. Großkommentar. Vol. II (3rd ed., Tübingen 2020) § 29 marg. no. 91 et seq.

[9] See also *W. Zöllner*, Die sogenannten Gesellschafterklagen im Kapitalgesellschaftsrecht, ZGR 1988, 393, 418.

[10] On the differentiation between an enforceable claim for payment of a dividend (*Gewinnanspruch*) and the general shareholder right to participate in the corporation's profits (*Gewinnstammrecht*) see e.g. *Leuschner, supra* note 8, § 29 marg. no. 5; *D. A. Verse*, Scholz Kommentar zum GmbH-Gesetz, Vol. I (12th ed., Cologne 2018) § 29 marg. no. 9.

[11] See § 29 para. 1 GmbHG.

ly states. Furthermore, in the absence of a specific majority requirement, the decision to retain or distribute the corporation's profits can be taken with a simple majority of the votes cast in accordance with general rules.[12]

However, this authority was only put into shareholders' hands in 1986.[13] In its original version, § 29 GmbHG contained an imperative to fully pass on the distributable profits to shareholders (so-called *Vollausschüttungsgebot*), which could only be derogated by a provision in the corporation's articles of association.[14] Early on, this rule has attracted reform proposals. Already the 1939 draft bill for a new GmbHG recommended allowing shareholders to retain profits and build reserves through a simple majority resolution.[15] The proposed reform bills of 1971[16] and 1973[17] included similar provisions. However, as both attempts at comprehensive reform of the GmbHG failed, the decision on profit distribution only became the prerogative of a simple majority of shareholders with the Accounting Directives Act of 1985 (*Bilanzrichtlinien-Gesetz* – BiRiLiG)[18] which entered into force on 1 January 1986. New and stricter rules on accounting had made it necessary to grant more flexibility in the application of profits to allow for the regular adjustment of the cor-

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[12] See § 47 para. 1 and 2 GmbHG.

[13] For an overview of the norm's history see *V. Emmerich*, Fortschritt oder Rückschritt? Zur Änderung des § 29 GmbHG durch das Bilanzrichtlinien-Gesetz von 1985, in: Bärmann/Weitnauer (eds.), Festschrift für Hanns Seuss zum 60. Geburtstag (Munich 1987) 137, 138 et seq.; also *Verse, supra* note 10, § 29 marg. no. 3 ff. In detail on the previous legal situation *M. Winter*, Mitgliedschaftliche Treuebindungen im GmbH-Recht (Munich 1988) 276 et seq.

[14] Cf. § 29 sent. 1 GmbHG 1892: "Die Gesellschafter haben Anspruch auf den nach der jährlichen Bilanz sich ergebenden Reingewinn, soweit nicht im Gesellschaftsvertrage ein Anderes bestimmt ist." Pointing to the then available leeway used in establishing the financial statements *D. Joost*, Beständigkeit und Wandel im Recht der Gewinnverwendung, in: Lutter/Ulmer/Zöllner (eds.), Festschrift 100 Jahre GmbH-Gesetz (Cologne 1992) 289, 292 et seq.

[15] See §§ 87 para. 2, 89 paras. 6, 7 Draft of the Ministry of Justice of the Reich for a GmbHG 1939, reproduced at W. Schubert (ed.), Entwurf des Reichsjustizministeriums zu einem Gesetz über Gesellschaften mit beschränkter Haftung von 1939 (Heidelberg 1985) 118 et seq., 160 et seq.

[16] See § 45 Government draft for a reformed GmbHG 1971 (*Entwurf eines Gesetzes über Gesellschaften mit beschränkter Haftung [GmbHG]*), 31 January 1971, BT-Drs. VI/3088, 14.

[17] See § 45 Government draft for a reformed GmbHG 1973 (*Entwurf eines Gesetzes über Gesellschaften mit beschränkter Haftung [GmbHG]*), 26 February 1973, BT-Drs. 7/253, 14.

[18] *Gesetz zur Durchführung der Vierten, Siebenten und Achten Richtlinie des Rates der Europäischen Gemeinschaften zur Koordinierung des Gesellschaftsrechts (Bilanzrichtlinien-Gesetz* – BiRiLiG*)*, 19 December 1985, BGBl. I S. 2355.

poration's financing policy to evolving business needs.[19] In consequence, the principle of full distribution of profits was replaced by the (majority) shareholders' power to decide the full or partial retention of profits.

This decision-making authority was never intended to go unrestricted. All reform proposals up to the Government draft for the BiRiLiG counterbalanced the shift from full distribution of profits to a distribution according to the shareholder majority's decision with the possibility of pushing for a minimum dividend.[20] On the model of § 254 German Stock Corporation Act (*Aktiengesetz* – AktG)[21], shareholders were intended to be given the right to claim annulment of a shareholder resolution on the retention of profits when, firstly, from the perspective of a reasonable business person, this retention of profits was not necessary to secure the viability and resilience of the corporation for the foreseeable future given its economic and financial needs, and, secondly, the shareholder resolution does not arrange for the distribution of profits in the amount of at least 4% of the share capital minus shareholder contributions which have not been called.[22] As the annulment of a resolution requires proof of both conditions, this provision ultimately grants a *de facto* right to a minimum dividend. However, with 4% of the share capital, the amount of this minimum dividend probably would not satisfy the expectations and needs of shareholders. While this has already been criticized with regard to § 254 AktG[23], it holds even more true in close corporations, especially the GmbH, whose share capital typically lies far below the share capital

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[19] See the justification given in the Government draft for the Accounting Directives Act (*Entwurf eines Gesetzes zur Durchführung der Vierten Richtlinie des Rates der Europäischen Gemeinschaften zur Koordinierung des Gesellschaftsrechts [Bilanzrichtlinie-Gesetz]*), 26 August 1983, BT-Drs. 10/317, 109.

[20] Cf. § 130 para. 3 Draft of the Ministry of Justice of the Reich for a GmbHG 1939, *supra* note 15, 131, 160 et seq.; § 205 GmbHG as proposed by the Government draft for a reformed GmbHG 1971, BT-Drs. VI/3088, 57; § 205 GmbHG as proposed by the Government draft for a reformed GmbHG 1973, BT-Drs. 7/253, 57.

[21] *Aktiengesetz vom 6. September 1965 (BGBl. I S. 1089), das zuletzt durch Artikel 1 des Gesetzes vom 12. Dezember 2019 (BGBl. I S. 2637) geändert worden ist.*

[22] See § 42h GmbHG as proposed by the Government draft for the BiRiLiG, BT-Drs. 10/317, 39: "Der Beschluß über die Verwendung des Ergebnisses kann unbeschadet anderer Anfechtungsgründe angefochten werden, wenn die Gesellschafter aus dem Jahresüberschuß Beträge in Gewinnrücklagen oder in einen Gewinnvortrag einstellen, die nicht nach Gesetz oder Gesellschaftsvertrag von der Verteilung unter die Gesellschafter ausgeschlossen sind, obwohl die Einstellung bei vernünftiger kaufmännischer Beurteilung nicht notwendig ist, um die Lebens- und Widerstandsfähigkeit der Gesellschaft für einen hinsichtlich der wirtschaftlichen und finanziellen Notwendigkeiten übersehbaren Zeitraum zu sichern, und dadurch unter die Gesellschafter kein Gewinn in Höhe von mindestens vier vom Hundert des um noch nicht eingeforderte Einlagen verminderten gezeichneten Kapitals verteilt werden kann."

[23] *E. Stilz*, in: Spindler/Stilz (eds.), Kommentar zum Aktiengesetz, Vol. 2 (4th ed., Munich 2019) § 254 marg. no. 2: "Effektivität der Vorschrift ist zweifelhaft".

of publicly traded corporations and whose shareholders largely rely on the stream of income from the corporation.[24] Promising little relief, this particular ground for annulment has consequently been left out of the GmbHG.[25]

The lack of a statutory limit to the shareholders' decision-making authority does however not mean that majority shareholders are completely free to decide the retention of profits. The legislative abstention from posing fixed thresholds is instead understood to delegate the matter to scholars and courts in order for them to develop a flexible solution.[26] This solution has been provided with the shareholders' *Treuepflicht*: Measuring a shareholder resolution to retain profits against the *Treuepflicht* indeed offers a soft standard which allows for the annulment of a resolution even where a dividend exceeding the 4% threshold is paid to shareholders.

In this vein, the legislative reticence to fix a uniform quantum for the distribution of profits might be interpreted as an acknowledgment that no single ratio between retention and distribution of profits can adequately satisfy the needs of all corporations, allowing them to flourish in the most diverse fields of operation and under all range of circumstances, not even as a mere default rule.[27] The lawmakers rejecting a one-size-fits-all-solution means there is also no room for the analogous application of § 254 AktG in a GmbH.[28] Further-

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[24] *Hommelhoff, supra* note 5, 952: "ridiküle 4%"; *L. Vollmer*, Mehrheitskompetenzen und Minderheitenschutz bei der Gewinnverwendung nach künftigem GmbH-Recht, DB 1983, 93, 94; specifically with regard to close corporations *C. Einhaus/W. Selter*, Die Treuepflicht des GmbH-Gesellschafters zwischen Ausschüttungs- und Thesaurierungsinteresse, GmbHR 2016, 1177, 1181; see further *Winter, supra* note 13, 291 et seq. on the constraints such a provision would have entailed.

[25] See Recommendation and report of the Legal Affairs Committee, BT-Drs. 10/4268, 131: "§ 42 h GmbHG-E wird aus ordnungspolitischen Gründen nicht übernommen. Ein bestimmter Gewinnanspruch der Minderheitsgesellschafter soll im Gesetz nicht ausdrücklich festgeschrieben werden."

[26] *P. Hommelhoff*, Die Ergebnisverwendung in der GmbH nach dem Bilanzrichtliniengesetz, ZGR 1986, 418, 424; *Verse, supra* note 10, § 29 marg. no. 7.

[27] *R. Liebs*, Die Anpassung des Gesellschaftsvertrags der GmbH an das Bilanzrichtlinien-Gesetz, DB 1986, 2421; generally on the difficulty of drafting a one-size-fits-all solution *Hommelhoff, supra* note 5, 953, proposing to adopt a statutory mandate for shareholders to agree upon a contractual rule on the matter of profit distribution.

[28] *M. Ehlke*, Ergebnisverwendungsregelungen in der GmbH nach dem BiRiLiG, DB 1987, 671, 677; *Einhaus/Selter, supra* note 24, 1181. For an analogous application of § 254 para. 1 AktG at least for non-personalistic GmbHs see *G. Hueck*, Minderheitsschutz bei der Ergebnisverwendung in der GmbH, Zur Neuregelung des § 29 GmbHG durch das Bilanzrichtlinien-Gesetz, in: Baur/Hopt/Mailänder (eds.), Festschrift für Ernst Steindorff zum 70. Geburtstag am 13. März 1990 (Berlin/New York 1990) 45, 56; also *C. Kersting*, in: Baumbach/Hueck Gesetz betreffend die Gesellschaften mit beschränkter Haftung (22nd ed., Munich 2019) § 29 marg. no. 31; critically *J. Ekkenga*, in: Fleischer/Goette (eds.), Münchener Kommentar zum GmbH-Gesetz, Vol. I (3rd ed., Munich 2018) § 29 marg. no. 166.

more, the legislative refusal to set a certain number as the minimum distribution requirement cautions against the application of other fixed thresholds. A proposal by an eminent author to allow for the retention of 60% of a corporation's profits up to the amount of its share capital, exempting resolutions within these boundaries from any material scrutiny would very well have improved the predictability and clarity of the law.[29] Nonetheless, it lies at odds with the legislative desire for a flexible and case-specific solution. Finding an adequate ratio poses additional difficulties, which would have been made even greater with the methodical justification of such a number which has no basis in the GmbHG or in established legal principles.[30] As long as the legislator does not step in[31], it thus seems measuring shareholder resolutions for the retention of profits against a clear-cut rule was impossible.

Of course, § 29 para. 1 sent. 1 GmbHG has opened the floor to shareholders themselves: in the articles of association, they can mandate the full or partial retention of profits by fixing a dividend policy and pre-forming the corporation's financial planning. Practice has shown, however, that only few shareholders have made use of this opportunity.

2. *Lack of Contractual Specification*

The shareholder meeting can only decide the retention or distribution of profits within the boundaries traced by statute, or by the articles of association. While the GmbHG generally allows for a full retention of profits, shareholders can dictate a different framework in the corporation's articles of association.[32]

Establishing a dividend policy in the articles of association allows the shaping of shareholders' expectations and can circumvent later disagreement. Particularly in light of the importance of profit distribution, commentaries and manuals regularly recommend including a provision in the founding document of a GmbH, to specify how the corporation's profits will be used.[33]

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[29] *Hommelhoff, supra* note 26, 427 et seq., with an additional absolute threshold for the retention of profits; also *P. Hommelhoff*, Lutter/Hommelhoff GmbH-Gesetz Kommentar (20th ed., Cologne 2020) § 29 marg. no. 25: "lediglich pauschalierende Richtwerte".

[30] *Ekkenga, supra* note 28, § 29 marg. no. 166; *Joost, supra* note 14, 302; *Kersting, supra* note 28, § 29 marg. no. 31; *K. Schmidt*, Scholz Kommentar zum GmbH-Gesetz, Vol. II (11th ed., Cologne 2014) § 46 marg. no. 31; also *Ehlke, supra* note 28, 678; *Liebs, supra* note 27, 2421; pointing further to the limited informational value of a GmbH's legal capital for predicting its actual financial needs *Leuschner, supra* note 8, § 29 marg. no. 131.

[31] Cautioning however against a uniform statutory distribution quota *H. Fleischer*, Excessive Retention of Profits and Minority Protection: Comparing German and French Law of Close Corporations, RTDF 3-2015, 56, 59.

[32] As to specific requirements for introducing such a provision see *Ekkenga, supra* note 28, § 29 marg. no. 175 et seq.; *Kersting, supra* note 28, § 29 marg. no. 37.

[33] *Ekkenga, supra* note 28, § 29 marg. no. 169; *Hommelhoff, supra* note 29, § 29 marg. no. 26; *Kersting, supra* note 28, § 29 marg. no. 34; *Verse, supra* note 10, § 29 marg. no. 7;

Even the Governance Code for Family Businesses, a collection of guidelines for the development of an adequate governance structure for family-owned enterprises put forward by a private initiative of associations of family firms and academics, advocates for "a reliable framework for all stakeholders" and recommends "that basic principles governing the allocation of earnings be incorporated within the articles of association".[34] More specifically, authors propose fixing a minimum retention or distribution quota, or establishing qualified majority requirements for shareholders decisions on the retention of profits, or delegating the decision-making authority to other bodies like a supervisory board or a shareholder committee. These various tools can of course be combined.[35]

However, such provisions appear to be used only rarely in practice.[36] A recent study has looked at the articles of association of 200 GmbHs with two or more shareholders and found that only four percent of these articles of association actually contained some form of distribution clause.[37] This reticence to contractually cover the question should not even be surprising: Usually, in the founding phase of the company, shareholders have little inclination to imagine future contention; with the typical dose of over-optimism, they might even think that the corporate project will continue running as smoothly as the founding process may have done. Additionally, shareholders might refrain from discussing the sensitive topic of profit distribution and financing policy with their fellow shareholders in an early phase when the problem seems abstract and far away. The anticipation of future conflict risks undermining

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further *M. Heusel/M. Goette*, Zum Gewinnausschüttungsanspruch bei Pattsituationen in der GmbH, GmbHR 2017, 385, 386 et seq.; *Hueck, supra* note 28, 47; *Ehlke, supra* note 28, 675 et seq.; even *Martens, supra* note 2, 621, holding the lack of a contractual provision to be a "kautelarjuristische[r] Kunstfehler"; comp. further *P. Hommelhoff/U. Hartmann/K. Hillers*, Satzungsklauseln zur Ergebnisverwendung in der GmbH, DNotZ 1986, 323, 326 et seq.

[34] P. May et al. (eds.), Governance Code for Family Businesses, 2015, 5.2.4. (p. 27), <http://www.kodex-fuer-familienunternehmen.de/images/Downloads/Kodex_englisch_2015.pdf>.

[35] For an overview *C. H. Seibt*, in: Römermann (ed.), Münchener Anwaltshandbuch GmbH-Recht (4th ed., Munich 2018) § 2 marg. no. 411; see already the examples of *Ehlke, supra* note 28, 676 et seq.; *Hommelhoff/Hartmann/Hillers, supra* note 33, 327 et seq.; *Liebs, supra* note 27, 2424 et seq.; also *Kersting, supra* note 28, § 29 marg. no. 35.

[36] Differently *Kersting, supra* note 28, § 29 marg. no. 35: "weit verbreitet"; also *H. Heckschen*, in: Heckschen/Heidinger (eds.), Die GmbH in der Gestaltungs- und Beratungspraxis (4th ed., Cologne 2018) Chapter 4 marg. no. 373.

[37] *F. Wedemann*, Gesellschafterkonflikte in geschlossenen Kapitalgesellschaften (Tübingen 2013) 212, 214, 215; cf. for the scarcity of contractual conflict-resolution mechanisms in the articles of association of close corporations with two shareholders with equal rights *J. Lieder/T. Hoffmann*, Die paritätische Zweipersonen-GmbH. Rechtstatsachen und Satzungsanalyse, GmbHR 2017, 1233, 1240 et seq.

confidence before the common project has even taken off and might endanger a frictionless conclusion of the founding process.[38] Finally, the reticence to negotiate a provision on the distribution of future profits might even be rational considering the difficulty of finding the perfect provision. Drafting a precise and clear-cut rule which is at the same time flexible enough to serve the company in different stages of its development and evolving economic contexts, is a herculean task.[39] This shows in the lack of a statutory specification; one might further see the impossibility of drafting the ideal rule reflected in corporate law manuals highlighting the need to tailor an adequate rule on the distribution and retention of profits to the particular corporation concerned[40] – thus delegating the task of finding the perfect custom-made rule to the individual lawyer when such a perfect rule might not even exist.

Finally, case law illustrates the difficulty of formulating a clause that effectively prevents disputes: A significant number of disputes over the distribution of profits brought before German courts make reference to a contractual provision in the corporation's articles of association.[41] In a case decided by the Higher Regional Court Hamm in 1991, the corporation's articles of association included a clause that ordered the distribution of at least 25% of the profits; it continued: "75% of the profits shall accrue to the shares of the shareholders if necessary. The decision is made by the shareholders' meeting."[42] Leaving the decision on the distribution of the remaining 75% of the profits to the shareholders' meeting left ample room for conflict. When the majority one year decided to distribute only 35% while retaining 65% of the profits, the minority challenged this decision and the parties ended up in court.

In view of these factors, it has to be considered that disputes over the fair application of profits can hardly be prevented *ex ante*. Hence, a fair and clear *ex post* solution becomes all the more important. German courts seek equitable solutions in the application of the flexible standard provided by the shareholders' *Treuepflicht*.

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[38] *Bachmann/Eidenmüller et al.*, *supra* note 4, 47 et seq. with further references.

[39] Cf. *Vollmer, supra* note 24, 95; on the difficulties of finding an adequate rule also *Fleischer/Trinks, supra* note 1, 296; see also *B. Grunewald*, in: K. Schmidt (ed.), Münchener Kommentar zum Handelsgesetzbuch, Vol. 3 (4th ed., Munich 2019) § 167 marg. no. 5 for the German Partly Limited Partnership (*Kommanditgesellschaft* – KG).

[40] See e.g. *T. Haasen*, Satzung einer kleineren, mehrgliedrigen GmbH, in: Lorz/Pfister/Gerber (eds.), Beck'sches Formularbuch GmbH-Recht (Munich 2010) C.I.2., § 8 para. 3; *Heckschen, supra* note 36, Chapter 4 marg. no. 373 et seq., Chapter 7 marg. no. 28 et seq.; for family firms *O. Habighorst*, A.V.21. Gesellschaftsvertrag einer Familiengesellschaft, in: Meyer-Landrut (ed.), Formular Kommentar GmbH-Recht (4th ed., Cologne 2019) § 24 and marg. no. 469 et seq.

[41] See e.g. OLG Koblenz, 1 February 2018, 6 U 442/17, GmbHR 2018, 1016.

[42] OLG Hamm, 3 July 1991, 8 U 11/91, GmbHR 1992, 458.

III. The Shareholders' *Treuepflicht* and Its Application

The *Treuepflicht* has become a well-established part of German corporation law.[43] It obliges directors to act in the sole interest of the corporation, and it binds shareholders to the interest of their corporation on the one hand, as well as to the interest of their fellow shareholders on the other. It thus also guides shareholders in their decision on how to use the corporation's profits.[44] Generally, the shareholders' *Treuepflicht* provides a flexible standard for policing shareholder behavior (1.). In the context of the decision to distribute or retain profits, it specifically requires shareholders to balance the corporation's self-financing interests against their and their fellow shareholders' interest in receiving payment of a dividend (2.). Scholars and courts however acknowledge that a corporation's financing strategy is a business decision, and they consequently make sure to respect the shareholders' business judgment (3.).

1. The Shareholders' Treuepflicht as a General Clause

Shareholders' rights in the corporation are generally self-interested rights, i.e. shareholders may exercise their rights in a way to foster primarily their own interests. However, when founding or entering a corporation, shareholders commit themselves to a common endeavor, and they may not counteract this commitment by hurting the corporation or their fellow shareholders. Scholars and courts thus see the shareholders under a specific duty of loyalty, a *Treuepflicht*, vis-à-vis the corporation on the one hand, and vis-à-vis their fellow shareholders on the other.[45]

The exact foundation of the shareholders' *Treuepflicht* is still subject to discussion. Some authors reference the statutory obligation to promote the achievement of a common purpose (see § 705 German Civil Code, *Bürgerli-*

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[43] See *M. Hippeli*, Treuepflichten in der GmbH. Aktuelle Entwicklungen in der Rechtsprechung, GmbHR 2016, 1257: "Die seit etwas über 100 Jahren angenommene gesellschaftsrechtliche Treuepflicht ist ein Chamäleon: Nur manchmal sichtbar, äußerst wendig und mit einer Vielzahl an Facetten."

[44] For an application of the *Treuepflicht* to the general partner of a KG who has been declared competent to decide the distribution or retention of profits by the partnership agreement see OLG Stuttgart, 13 June 2007, 14 U 19/06, DB 2007, 2587, 2589.

[45] BGH, 5 June 1975, II ZR 23/74, BGHZ 65, 15, 18 et seq. (*ITT*); BGH, 20 March 1995, II ZR 205/94, BGHZ 129, 136, 142 et seq.(*Girmes*); *W. Bayer*, Lutter/Hommelhoff GmbH-Gesetz Kommentar (20th ed., Cologne 2020) § 14 marg. no. 30; *L. Fastrich*, in: Baumbach/Hueck Gesetz betreffend die Gesellschaften mit beschränkter Haftung (22nd ed., Munich 2019) § 13 marg. no. 21; for a comprehensive summary in English see *J. Lieder*, The Duty of Loyalty in German Company Law, RTDF 3-2014, 33, 37 et seq.; in a comparative perspective *Bachmann/Eidenmüller et al.*, *supra* note 4, 53 et seq.

ches Gesetzbuch – BGB)[46],[47] others see the *Treuepflicht* implied in the position as a shareholder and the rights this position carries[48], or scholars simply point to the *bona fide* principle applicable to all private law relationships as laid down in § 242 BGB[49]. Almost consensually, though, it is admitted that the shareholders' *Treuepflicht*, in its consequences, goes beyond this mere general principle of good faith.[50]

The shareholders' *Treuepflicht* has come to apply to all forms of collective business organizations, from small partnerships to large corporations. In 1988, the German Federal Court (*Bundesgerichtshof* – BGH) explicitly confirmed the existence of a *Treuepflicht* between shareholders of a stock corporation.[51] The intensity of such a duty of loyalty does vary with the degree of confidence between shareholders, confidence on which the corporate firm is built. Where the personal ties between shareholders are strongest, e.g. in a partnership or a closely-knit, family-owned corporation, the standard to which shareholders are held is higher than in large stock corporations where the *intuitus personae* between shareholders is weak. The limitations and obligations drawn from the shareholders' *Treuepflicht* have thus to be adapted to the factual organizational structure of the corporation.[52] Specific manifestations of the *Treuepflicht* then result from a thorough balancing of interests between the parties concerned, which includes not only the shareholders of the corporation, but also the corporation as a business entity itself.[53]

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[46] *Bürgerliches Gesetzbuch in der Fassung der Bekanntmachung vom 2. Januar 2002 (BGBl. I S. 42, 2909; 2003 I S. 738), das zuletzt durch Artikel 1 des Gesetzes vom 12. Juni 2020 (BGBl. I S. 1245) geändert worden ist.*

[47] E.g. *M. Lutter*, Theorie der Mitgliedschaft. Prolegomena zu einem Allgemeinen Teil des Korporationsrechts, AcP 180 (1980), 84, 102 et seq.; also *H. C. Grigoleit*, in: Grigoleit (ed.), Aktiengesetz Kommentar (2nd ed., Munich 2020) § 1 marg. no. 51.

[48] Cf. *G. Bitter*, Scholz Kommentar zum GmbH-Gesetz, Vol. I (12th ed., Cologne 2018) § 13 marg. no. 54: "aus der vertraglichen Bindung der Gesellschafter"; *C. H. Seibt*, Scholz Kommentar zum GmbH-Gesetz, Vol. I (12th ed., Cologne 2018) § 14 marg. no. 71; limiting the *Treuepflicht*'s scope *H. Altmeppen*, in: Roth/Altmeppen Gesetz betreffend die Gesellschaften mit beschränkter Haftung (9th ed., Munich 2019) § 13 marg. no. 30.

[49] *J. Hennrichs*, Treupflichten im Aktienrecht. Zugleich Überlegungen zur Konkretisierung der Generalklausel des § 242 BGB sowie zur Eigenhaftung des Stimmrechtsvertreters, AcP 195 (1995), 221, 229 et seq. For an general overview see also *H. Fleischer*, in: Schmidt/Lutter (eds.), Aktiengesetz Kommentar (4th ed., Cologne 2020) § 53a marg. no. 45.

[50] *Fastrich, supra* note 45, § 13 marg. no. 20; *Seibt, supra* note 48, § 14 marg. no. 71; especially with regard to the shareholders' decision to distribute or retain profits see *Einhaus/Selter, supra* note 24, 1180.

[51] BGH, 1 February 1988, II ZR 75/87, BGHZ 103, 184, 194 et seq. (*Linotype*); see BGH, 20 March 1995, *supra* note 45, 143 on the minority shareholders' *Treuepflicht*.

[52] *Bitter, supra* note 48, § 13 marg. no. 51; *Fastrich, supra* note 45, § 13 marg. no. 22.

[53] *Altmeppen, supra* note 48, § 13 marg. no. 31; *Fastrich, supra* note, § 13 marg. no. 23; also *Lieder, supra* note 45, 38, see further 39: "a collective term and a blanket clause".

Case law and scholarship have tried to organize the different manifestations into categories of typical factual constellations such as the duty to not harm the corporation or its shareholders or to participate in certain essential corporate acts.[54] Prominent amongst these categories is the protection of minority shareholders against the excessive retention of profits.

2. Balancing the Corporation's Self-Financing Interest against the Shareholders' Dividend Interest

The shareholders' *Treuepflicht* allows for the material review of shareholder resolutions as to their actual content.[55] This review usually requires a balancing exercise: courts need to examine whether shareholders, in making their decisions, have adequately respected the interest of the corporation on the one hand, and the interest of their fellow shareholders on the other hand. With regard to protection against excessive profit retention, applying the shareholders' *Treuepflicht* thus asks us to weigh up the corporation's need to retain funds for business and financing purposes against the individual shareholders' interest of receiving payment of a dividend.[56]

While this standard has found wide-spread acceptance in scholarship and is commonly applied by the courts, some authors propose different solutions. Given the lack of a statutory foundation, only few scholars advocate for fixed limits to the shareholders' authority to decide the retention of profits.[57] Legal clarity and predictability are instead sought by rewriting the standard against which shareholder resolutions are measured and limiting judicial review to sanction only the abuse of shareholder rights.[58] This approach promises to also prevent courts from impinging on or overtaking the shareholders' decision-making prerogative when it comes to the distribution or retention of profits.[59] With regard to its outcomes, case law also points towards mainly sanctioning abusive shareholder resolutions; one court has even explicitly

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[54] See the different categories listed by *Seibt, supra* note 48, § 14 marg. no. 89 et seq.; also see also *Hippeli, supra* note 43, 1258; *Lieder, supra* note 45, 39 ff; across the board *Fastrich, supra* note 45, § 13 marg. no. 21: “nur beschreibend, nicht abschließend”.

[55] *Ekkenga, supra* note 28, § 29 marg. no. 167: “Angemessenheitskontrolle”.

[56] BGH, 29 March 1996, II ZR 263/94, BGHZ 132, 263, 276; see also OLG Koblenz, 1 February 2018, *supra* note 41, 1018; OLG Nuremberg, 9 July 2008, 12 U 690/07, DB 2008, 2415, 2417; OLG Hamm, 3 July 1991, *supra* note 42, 459; further *Ekkenga, supra* note 28, § 29 marg. no. 169; *Hueck, supra* note 28, 57; *Kersting, supra* note 28, § 29 marg. no. 32; also *J. Schulze-Osterloh*, Aufstellung und Feststellung des handelsrechtlichen Jahresabschlusses der Kommanditgesellschaft. Zuständigkeit und gerichtliche Durchsetzung, BB 1995, 2519, 2522; *Grunewald, supra* note 39, § 167 marg. no. 5 for the KG.

[57] Cf. already note 29.

[58] *Joost, supra* note 14, 303 et seq.; see also *Liebs, supra* note 27, 2422; *Vollmer, supra* note 24, 94; further *M. Henssler*, in: Lieb/Noack/Westermann (eds.), Festschrift für Wolfgang Zöllner zum 70. Geburtstag. Vol. I (Cologne *et al.* 1998) 203, 206.

announced that "a judicial review of the balancing of interests cannot lead to the result that only one possible decision would adequately respect all relevant interests"[60]. However, from a theoretical point of view, the shareholders' *Treuepflicht* seems to be the more adequate instrument.[61] First, this *Treuepflicht* has become a general principle in German partnership and corporation law, and guides shareholder behavior and the exercise of their rights; second, it allows the consideration of case-specific circumstances beyond the mere abuse of rights by majority shareholders[62].

The flexibility of the *Treuepflicht* standard thus is its boon and its bane. This shows particularly in the determination of which interests may be considered.

From the corporation's perspective, its interest in retaining profits in order to finance its business and future projects constitutes a serious concern. This was acknowledged expressly with the reform of 1986, and in the current wording of § 29 paras. 1 and 2 GmbHG. In order to specify the notion of relevant corporate interest, one can conclude from § 254 AktG, that specifically reasons relating to "the viability and resilience of the corporation" justify the retention of profits.[63] However, this statutory reference needs to be interpreted in the sense of a broad understanding.[64] While the retention of profits with no reason other than the accumulation of liquidity certainly cannot suffice to explain the refusal to pay any dividend,[65] it is also not necessary

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[59] Explicitly OLG Koblenz, 1 February 2018, *supra* note 41, 1018: "nur in eindeutigen Fällen".

[60] OLG Nuremberg, 9 July 2008, *supra* note 56, 2418; see also OLG Stuttgart, 13 June 2007, *supra* note 44, 2590 et seq.: "Die Thesaurierungsentscheidung darf jedenfalls nicht missbräuchlich erscheinen."

[61] *P. Hommelhoff*, Anmerkungen zum Ergebnisverwendungs-Entscheid der GmbH-Gesellschafter, GmbHR 2010, 1328, 1329.

[62] *Hueck, supra* note 28, 56; *K. Schmidt, supra* note 54, § 46 marg. no. 31; *Verse, supra* note 10, § 29 marg. no. 54; on this see also *Leuschner, supra* note 8, § 29 marg. no. 130; for partnerships further *H.-J. Priester*, Stille Reserven und offene Rücklagen bei Personengesellschaften, Zur Bedeutung von § 253 Abs. 4 HGB, in: Westermann/Rosener (eds.), Festschrift für Karlheinz Quack zum 65. Geburtstag am 3. Januar 1991 (Berlin/New York 1991) 373, 393.

[63] While the law-makers' abstention from including a similar provision in the GmbHG makes it difficult to apply § 254 AktG analogously to the GmbH (see already note 28), this is commonly understood to be due to the unwillingness to set a fixed threshold for profit distribution. It does not therefore preclude recourse to § 254 AktG in order to clarify which interests of the corporation are to be considered; see generally *Ekkenga, supra* note 28, § 29 marg. no. 170; *Kersting, supra* note 28, § 29 marg. no. 30; *L. Strohn*, in: Henssler/Strohn (eds.), Gesellschaftsrecht (4th ed., Munich 2019) § 29 GmbHG, marg. no. 44; cf. also *Winter, supra* note 13, 285. Critically, however, *Einhaus/Selter, supra* note 24, 1182.

[64] E.g. *Verse, supra* note 10, § 29 marg. no. 57.

[65] See also the insufficient justification through reference to "tough competition" (*harter Wettbewerb*) in OLG Brandenburg, 31 March 2009, 6 U 4/08, ZIP 2009, 1955, 1958.

to have an already initiated project or immediate need for liquidity. Instead, a plausible business plan for a foreseeable period of time suffices to illustrate the financing needs of the corporation.[66] That courts rather tend to err on the side of the corporation, generously accepting the reasons why the retention of profits would be necessary, is best shown in a decision handed down by the Higher Regional Court of Nuremberg in 2008: in order to determine the corporation's interest in self-financing, the court referred to the object of the corporation, the resources required to pursue this object, the financial situation of the corporation, the amount and availability of existing capital and revenue reserves, its creditworthiness, the amount and maturity of liabilities, the overall state of the economy, the market situation and the prognosis for the corporation's branch of business, the necessary precautions against potential liability claims, the necessity to engage in research activities, and so forth.[67] This list of relevant reasons could hardly be more extensive; it considers more or less any factor related to the corporation's business.[68]

In contrast, scholars and courts restrict the arguments a shareholder can add to the equation. It is evident that any shareholder has an interest in receiving a return on her investment, usually in the form of a dividend. However, this interest is easily outweighed by the abovementioned business reasons for retaining profits. Scholars are wondering whether an interest beyond the mere wish to participate in the corporation's profits can be taken into account.[69] The Higher Regional Court of Nuremberg pointed to the extent and the amount of previous dividends in order to specify the interest in profit distribution, and it further made reference to the shareholders' financial situation.[70] Some authors add that at the very least, tax liabilities arising from or in connection with the shareholding should generally be covered.[71] However,

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Also insufficient are private considerations of shareholders, e.g. tax reasons, see *Seibt, supra* note 35, § 2 marg. no. 415.

[66] *Priester, supra* note 62, 394 (for partnerships); similarly *Mock, supra* note 6, § 29 marg. no. 189; see also on the difficulty of justifying long-term retention policies without a contractual basis in the corporation's articles of association *Ekkenga, supra* note 28, § 29 marg. no. 171.

[67] OLG Nuremberg, 9 July 2008, *supra* note 56, 2418; see also OLG Brandenburg, 31 March 2009, *supra* note 65, 1958; "sämtliche Umstände der Vermögens-, Finanz- und Ertragslage".

[68] See in a similar vein *Kersting, supra* note 28, § 29 marg. no. 32.

[69] In view of the specific legal situation of limited partners see *Schulze-Osterloh, supra* note 56, 2523 et seq.

[70] OLG Nuremberg, 9 July 2008, *supra* note 56, 2418; agreeing to the former but objecting to the latter *Leuschner, supra* note 8, § 29 marg. no. 133; see also stressing the weight of the minority shareholders' expectations *Mock, supra* note 6, § 29 marg. no. 185.

[71] *Liebs, supra* note 27, 2422; further *Hommelhoff, supra* note 61, 1330; *Hommelhoff, supra* note 26, 432 pointing further to the cost of administrating one's shares; *Verse, supra* note 10, § 29 marg. no. 59; also restrictively BGH, 29 March 1996, *supra* note 56, 276 for

these approaches do not go undisputed in scholarship. There is a reticence to take the individual needs of particular shareholders which go beyond the corporate realm into account.[72] What is private, should not concern the corporation nor should it affect fellow shareholders.[73] It does indeed seem difficult to burden shareholders with their fellow shareholders' private problems over which they have neither knowledge nor influence. However, at least in corporations where the personal ties between shareholders are particularly strong, for example in family firms, the shareholders' *Treuepflicht* can gain specific weight.[74] In rare case constellations, it might thus become necessary to consider a shareholders' private situation if, to the knowledge and acceptance of all shareholders, there is a particular link with the corporate project.[75]

With its balancing requirement, the shareholders' *Treuepflicht* thus paves the way for a thorough judicial review of shareholders' resolutions to distribute or retain profits. While the statutory framework betrays no general preference for either decision, courts have proven reluctant to annul shareholder resolutions retaining all profits, largely relegating the decision to the shareholders' business judgment.

3. *Respecting Shareholders' Business Judgment*

In case law, the material review of shareholder resolutions to retain profits seems more lenient than the shareholders' *Treuepflicht* would suggest at first glance. However, the courts' prudence is well justified as it reflects their respect for the shareholders' business judgment and results from the corresponding burden of proof.

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a KG; pointing to § 110 HGB *W. Schön*, Bilanzkompetenzen und Ausschüttungsrechte in der Personengesellschaft, in: Budde/Moxter/Offerhaus (eds.), Handelsbilanzen und Steuerbilanzen. Festschrift zum 70. Geburtstag von Prof. Dr. h.c. Heinrich Beisse (Düsseldorf 1997) 471, 487 et seq.; further *Priester, supra* note 62, 394 (for partnerships). For a more general consideration of the shareholders' private interests see *Einhaus/Selter, supra* note 24, 1183: "Gemein ist diesen Ausnahmen, dass der Gesellschafter gerade aufgrund seines Geschäftsanteils eine Zahlung zu leisten hat."

[72] *Ekkenga, supra* note 28, § 29 marg. no. 169.

[73] Cf. § 122 para. 1 HGB for the commercial partnership; in detail *Schön, supra* note 71, 476 et seq.; also *Hommelhoff, supra* note 26, 426.

[74] See also OLG Frankfurt, 30 January 2002, 13 U 99/98, OLGR Frankfurt 2002, 154, 161 et seq.; further the similar reasoning specifically for family firms in OLG Frankfurt, 22 December 2004, 13 U 177/02, GmbHR 2005, 550, 556.

[75] *Verse, supra* note 10, § 29 marg. no. 59; see also *Kersting, supra* note 28, § 29 marg. no. 33: "Gewinnausschüttung auch ohne Anhalt in der Satzung generell derart zum Bestreiten des Lebensunterhalts der Gfter bestimmt sein, dass das ebenfalls Angemessenheit berührt, dann aber unabhängig vom konkreten privaten Ausgabeverhalten"; further for the KG *Grunewald, supra* note 39, § 167 marg. no. 5.

The countless considerations which can be brought forward to justify the retention of profits already provide some idea of the nature of such decisions as complex business decisions; one could even classify them as the archetype of a business decision.[76] Firstly, the financing of the business operation and its future development go to the very heart of a corporation's activity. The corporation's financial resources generally provide the basis for its business and mark the boundaries of its development. In this, financing issues are also linked to shareholders' expectations and plans for their business endeavor; depending on what they want to achieve, different options are viable. As one court put it: in deciding the retention or distribution of profits, there is no one single decision that would be correct; shareholders can choose from a range of distribution schemes which can all be considered reasonable.[77] Secondly, such forward-looking decisions are based on estimations of future developments and plans. Deciding about the need for a retention of profits requires a prognosis of the evolution of the market, the corporation's position in it and its potential for growth. Risks and opportunities have to be weighed against each other, and uncertainty lingers over all projected numbers.[78] Consequently and thirdly, these decisions are difficult to evaluate.[79] From the standpoint of the shareholders at the time they make their decision, various assumptions may seem plausible.[80] However, reviewers tend to assess such assumptions more strictly once they know the actual outcome of the matter. Courts need to avoid such a hindsight bias in the *ex post* evaluation of business decisions. They need to place themselves in the shareholders' shoes, not considering information and experiences which have only become available after the decision-making process was concluded.

In view of those pitfalls, courts try not to interfere with the concerned parties' business judgment, and they apply this prudence also with regard to the

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[76] *Hommelhoff, supra* note 29, § 29 marg. no. 21: "Im Ergebnisverwendungsentscheid der Gesellschafter prägt sich ihre unternehmerische Entscheidungsfreiheit (insbesondere in Finanzierungsfragen) in ihrem Kern aus."; see also *Fleischer/Trinks, supra* note 1, 292; *Vollmer, supra* note 24, 93: "integraler Bestandteil der unternehmenspolitischen Grundsatzentscheidungen", thereby confirming *P. Hommelhoff*, Vollausschüttungsgebot und Verbot stiller Reserven. Ein Plädoyer für die Novellierung des § 29 Abs. 1 GmbHG, GmbHR 1979, 102, 107.

[77] Cf. OLG Nuremberg, 9 July 2008, *supra* note 56, 2418; see also *Schön, supra* note 71, 484.

[78] Stressing this point *Joost, supra* note 14, 300; see also *Vollmer, supra* note 24, 94.

[79] See also *Einhaus/Selter, supra* note 24, 1182 et seq.

[80] Pointing to the prognostic elements of such decision and acknowledging that the shareholder resolution on the application of profits needs to be evaluated in view of the knowledge held at the time the decision was made OLG Nuremberg, 9 July 2008, *supra* note 56, 2417.

shareholders' decision to retain or to distribute profits.[81] The leeway thus given to shareholders in making business decisions is further complemented with the allocation of the burden of proof in those cases.

As a shareholder resolution to retain profits cannot stand where there is no need at all to save funds, a corporation is required to provide reasons for so doing. Initially, this gives rise to an obligation for the corporation to justify its shareholders' decision.[82] It has been shown, though, that this obligation can easily be fulfilled by naming some plausible business argument.[83] It thus falls to the shareholders challenging the decision to explain why the reasons given do not hold.[84] Considering the courts' deferral to the majority's business judgment, it is very rare for economic considerations and commercial arguments to leave a decision to retain profits untenable. In practice, minority shareholders have retention decisions successfully annulled especially when they provide additional evidence showing how the majority benefitted from cutting off the minority from all income from the corporation.[85]

Thus, in the case mentioned above decided by the Higher Regional Court of Nuremberg, the majority had decided to continue retaining profits for the fourth year in a row. The profits carried forward amounted to approximately 30 million euro while the corporation's share capital didn't even amount to one million euro.[86] Although the court considered the investments planned and the liabilities threatening the corporation wouldn't require retaining profits in the amount of 30 times the share capital, it finally concluded that the retention resolution was not arbitrary and therefore still within the discretionary power of the shareholders. At the same time, the court highlighted that in

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[81] OLG Nuremberg, 9 July 2008, *supra* note 56, 2418; OLG Stuttgart, 13 June 2007, *supra* note 44, 2590; see also *Kersting, supra* note 28, § 29 marg. no. 34; *Leuschner, supra* note 8, § 29 marg. no. 132: "auf eine Plausibilitätsprüfung beschränken", with regard to § 254 para. 1 AktG *Stilz, supra* note 23, § 254 marg. no. 10: "Einfallstor für die Heranziehung der Grundgedanken der sog. Business Judgement Rule".

[82] See OLG Brandenburg, 31 March 2009, *supra* note 65, 1958; *Ekkenga, supra* note 28, § 29 marg. no. 173; *Verse, supra* note 10, § 29 marg. no. 60.

[83] See also *Einhaus/Selter, supra* note 24, 1185; further *Leuschner, supra* note 8, § 29 marg. no. 135; *Verse, supra* note 10, § 29 marg. no. 58.

[84] *Ekkenga, supra* note 28, § 29 marg. no. 173; *Leuschner, supra* note 8, § 29 marg. no. 134 et seq.; *Verse, supra* note 10, § 29 marg. no. 60; slightly different, but with a similar result OLG Stuttgart, 13 June 2007, *supra* note 44, 2591: "Die Darlegungs- und Beweislast […] liegt […] beim Kommanditisten, der behauptet, die Entscheidung des Komplementärs sei missbräuchlich oder sonst treuwidrig und deshalb rechtswidrig." For repercussions of contractual provisions in the corporation's articles of association *Ehlke, supra* note 28, 677.

[85] See also Ekkeng*a, supra* note 28, § 29 marg. no. 174, basing such claims to annulment on an abuse of rights as a sub-category of a breach of the shareholders' *Treuepflicht*; similarly *Kersting, supra* note 28, § 29 marg. no. 29.

[86] OLG Nuremberg, 9 July 2008, *supra* note 56, 2415 et seq.

recent years there had been profits distributed, and at five million euro in total, the sum was not insignificant.[87] It seems that the court found the shareholders' interest in receiving further dividends was reduced by the fact that they already had received payment of some dividends. In a similar case, the Higher Regional Court of Koblenz held both the arguments of the corporation and the arguments of the minority shareholder to be plausible. With regard to the majority's discretion regarding business decisions, the court did not annul the retention resolution.[88]

In contrast, facts beyond mere business reasons for the retention of profits led the Higher Regional Court of Brandenburg to find the continued retention of profits violated the majority shareholders' *Treuepflicht*. The corporation had retained all profits over seven years and the revenue reserves added up to more than twice the amount of the corporation's share capital. At the same time, the minority shareholder had lost his post as a director of the corporation and thus been cut-off from all sources of income from the corporation while the majority shareholders remained in place as directors, increased their remuneration and ordered luxury vehicles as company cars. Under these circumstances, the court held the continued retention of profits to constitute a breach of the shareholders' *Treuepflicht*.[89]

Private benefits taken by the majority and denied to the minority can thus show that the corporation's interest in retaining profits is not all that real.[90] This finding underlines that courts will only assume a violation of the shareholders' *Treuepflicht* in clear-cut cases. As long as the reasons given by the corporation to justify the retention of profits cannot be discarded straightaway, that means as long as there is some plausible explanation for the retention of profits, a shareholder resolution may stand. In the end, what is labeled a material review under the shareholders' *Treuepflicht* thus seems to come close to a mere check against the abuse of rights.[91]

On a last note, calling the shareholders' decision to distribute or to retain profits a business decision, might bring the business judgment rule to mind for corporate lawyers.[92] However, the business judgment rule has been designed to cover the behavior of directors, not of shareholders. As directors' duties and responsibilities are different from those of shareholders, the rule

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[87] OLG Nuremberg, 9 July 2008, *supra* note 56, 2418 et seq.

[88] OLG Koblenz, 1 February 2018, *supra* note 41, 1019.

[89] OLG Brandenburg, 31 March 2009, *supra* note 65, 1955 et seq., also 1959 specifically on hidden profit distributions to the majority shareholders.

[90] Cf. also OLG Frankfurt, 30 January 2002, *supra* note 74, 164.

[91] See also *Fleischer/Trinks, supra* note 1, 296 et seq.; *Verse, supra* note 10, § 29 marg. no. 7: "dass nach geltender Rechtslage das *Ausschüttungsinteresse* der Minderheit nur *schwach geschützt* ist"; similarly *Hommelhoff, supra* note 29, § 29 marg. no. 21.

[92] For the application of this rule see *Hommelhoff, supra* note 61, 1329; also *Hommelhoff, supra* note 29, § 29 marg. no. 21; *Leuschner, supra* note 8, § 29 marg. no. 134.

and its requirements cannot simply be transposed.[93] For instance, shareholders are by definition personally interested in the outcome of the decision to retain or to distribute profits; a disinterested decision can thus not be a precondition to granting the majority leeway in taking this decision. In addition, the information gathering requirement puts an extraordinarily high burden on shareholders as compared to directors. As shareholders are considered to be the residual owners of the corporation and the business entity, their decisions generally do not require a justification, and they therefore do not need to explain their vote or document the reasons which have led them to vote in a specific way. Interestingly enough, one author trying to transpose the business judgment rule to shareholders, imposed the obligation to collect the necessary information on the directors and not the shareholders themselves.[94] Still, it remains unclear to what extent the shareholders in this scenario would have to examine the reliability and integrity of the information given to them. Shareholders' exercise of their voting rights thus cannot be measured against the directorial business judgment rule.

However, the Higher Regional Court of Nuremberg has, in the abovementioned case, explicitly looked for proof that shareholders, in making their decision, have considered and balanced the corporation's interests as well as their fellow shareholders' interests.[95] In light of this decision, shareholders should probably prepare some kind of documentation of the needs and concerns they have taken into account when making the decision to retain profits, even though such documentation seems unwonted and out of place when it comes to shareholders' voting decisions.[96]

IV. A Difficult Choice of Remedies

If a minority shareholder manages to establish a breach of the majority shareholders' *Treuepflicht*, she can obtain an annulment of the resolution to retain profits (1.). However, this hardly ever provides full satisfaction. Quite the contrary, claiming payment of a dividend remains a difficult endeavor[97] (2.).

[93] In more detail also *Einhaus/Selter, supra* note 24, 1183; acknowledging the differences also *Fleischer, supra* note 31, 60: "variant of the classical business judgment rule".

[94] *Hommelhoff, supra* note 61, 1329; putting the informational burden on the majority *Leuschner, supra* note 8, § 29 marg. no. 134.

[95] See OLG Nuremberg, 9 July 2008, *supra* note 56, 2417, 2420, albeit differentiating explicitly between the need to balance the relevant interests and its documentation; further OLG Jena, 10 August 2016, 2 U 500/14, ECLI:DE:OLGTH:2016:0810.2U500.14.0A, marg. no. 221; OLG Frankfurt, 30 January 2002, *supra* note 74, 163; in favor of such a documentation requirement also *Hommelhoff, supra* note 29, § 29 marg. no. 24.

[96] See also *Hommelhoff, supra* note 61, 1329.

[97] *Fleischer, supra* note 31, 58: "a long procedural obstacle chase".

In view of these challenges and the risk of continued disputes, exiting the corporation could afford the minority a clean break, but this is available only under strict preconditions (3.).

1. Annulment of the Retention Resolution

A breach of the majority shareholders' *Treuepflicht* in casting her vote constitutes grounds for the annulment of the resulting shareholder resolution, as that resolution is held to violate the law.[98] Shareholders can thus introduce an action for annulment according to general principles. The court's declaration of the resolution as null and void is retroactive in effect, thus removing the basis for the application of its distributable profits. The shareholder meeting must then decide anew.[99]

Of course, there is a strong risk that the majority shareholder will continue to vote for a retention of profits, in which case the minority shareholder would have to keep on challenging these retention resolutions.[100] The minority might thus try to have the court declare a shareholder resolution which allows for the distribution of profits.

The basis for such a shareholder resolution can be found in the votes of the minority. Some scholars conceptualize the breach of shareholder *Treuepflicht* rendering the votes concerned null and void.[101] Should the shareholders decide on a resolution to distribute profits and the majority votes down this proposal in breach of their *Treuepflicht*, the majority's votes are treated as inexistent. The only valid votes cast on the matter will then be the minority's votes in favor of the distribution of profits; courts could then hold a shareholder resolution to be taken with these minority votes alone.[102]

However, this kind of cherry-picking also raises doubts. It undermines the voting process, breaking the invalid shareholder resolution into its component parts and recycling the votes not affected by a breach of the shareholders'

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[98] See § 243 para. 1 AktG, applied analogously to GmbHs; generally on this *Fastrich, supra* note 45, § 13 marg. no. 30; *Mock, supra* note 6, § 29 marg. no. 201; *Verse, supra* note 10, § 29 marg. no. 66.

[99] In order to have a new decision on the application of profits made, the annulment of previous shareholder resolutions is a necessary prerequisite, see OLG Munich, 28 November 2007, 7 U 2282/07, GmbHR 2008, 362, 363.

[100] See further for the risk that the majority simply avoids taking any resolution *Bork/ Oepen, supra* note 6, 243: "sozusagen ‚auf kaltem Wege' faktisch […] eine Voll-Thesaurierung".

[101] See BGH, 19 November 1990, II ZR 88/89, GmbHR 1991, 62; also *Einhaus/Selter, supra* note 24, 1177; *M. Geißler*, Die Kassation anfechtbarer Gesellschafterbeschlüsse im GmbH-Recht, GmbHR 2002, 520, 525.

[102] See BGH, 26 October 1983, II ZR 87/83, BGHZ 88, 320, 329 et seq.; *Bork/Oepen, supra* note 6, 245. For the difficulties of this approach in view of material grounds for annulment of a shareholder resolution, see *Geißler, supra* note 101, 528.

Treuepflicht.[103] Furthermore, where the articles of association require a quorum for shareholder resolutions, it must be ascertained whether the minority votes suffice to meet this quorum.[104] But first and foremost, practice has proven it difficult to have a shareholder vote on a distribution proposal put on the agenda of the shareholder meeting in the first place. After all, the majority has generally appointed the directors who prepare the shareholder meeting and its agenda.[105]

Shareholders might thus look for different ways to receive payment of a dividend.

2. *Payment of a Dividend*

As a general rule, a shareholder resolution deciding the distribution of profits is necessary to create an enforceable claim to payment of a dividend. This requirement does not result explicitly from § 29 GmbHG, but has been asserted by a majority of authors and confirmed by courts.[106] It explains the need to coalesce minority votes into a valid shareholder resolution for the distribution of profits. However, in view of the above-mentioned difficulties of this line of action, legal scholarship has envisaged alternatives.

A first step would be to have the court order shareholders to take any resolution on the (partial) distribution of profits.[107] In the absence of more specific guidelines, this solution admittedly risks seeing more retention resolutions and more challenges to shareholder resolutions: with each repetition of the

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[103] See also BGH, 12 April 2016, II ZR 275/14, MittBayNot 2016, 535, 537: "Die Unwirksamkeit der abweichend abgegebenen Stimmen ist eine Folge der Pflicht, in einem bestimmten Sinn abzustimmen."; generally further *J. Ekkenga*, Stimmrechtsbeschränkungen und positive Stimmpflichten des herrschenden Unternehmens im GmbH-Konzern. Das Urteil des OLG München in Sachen Media-Saturn, Der Konzern 2015, 409, 410: "trotz nachgewiesener Fehlerhaftigkeit der Ablehnung [verbleiben] regelmäßig diskretionäre Spielräume"; also *Winter, supra* note 13, 170: "letztlich darauf hinausläuft, im Prozeß gegen die Gesellschaft eine positive Stimmpflicht des Gesellschafters zu klären".

[104] *Bork/Oepen, supra* note 6, 249.

[105] On different avoidance strategies and possible remedies *Bork/Oepen, supra* note 6, 246 et seq.

[106] BGH, 14 September 1998, II ZR 172/97, BGHZ 139, 299, 302 et seq.; OLG Koblenz, 1 February 2018, *supra* note 41, 1019 et seq.; *Kersting, supra* note 28, § 29 marg. nos. 38, 42, 44; *Verse, supra* note 10, § 29 marg. no. 36; differently however *Hommelhoff, supra* note 29, § 29 marg. no. 4: "vorläufig gehemmter Auszahlungsanspruch"; in detail on this *Hommelhoff, supra* note 3, 184 et seq.: the claim becomes enforceable either with a shareholder resolution to distribute profits, or with the end of the shareholder meeting in which such a decision should have been made according to the meeting's agenda, or with the expiration of the time limits laid down in § 42a para. 2 GmbHG or § 267 para. 1 HGB.

[107] See *obiter* OLG Düsseldorf, 29 June 2001, 17 U 200/00, NZG 2001, 1085, 1086. On the shareholders' claim to have the corporation take the necessary steps to realize their right to payment of a dividend *Bork/Oepen, supra* note 6, 249 et seq.

shareholder vote, the majority could insist on retaining all profits, thus gaining time and requiring the minority to continue challenging these resolutions.[108] German law so far does not foresee judicial interference with the voting procedure; in particular, naming a third party to exercise the shareholders' voting right has not yet been tried or discussed further.

Instead, some scholars propose having the courts fix an adequate distribution-retention-ratio.[109] Once the court is allowed to determine what part of the profits is to be distributed, it is no longer necessary to have the shareholders take the resolution themselves, but a court order can replace such resolution. Of course, the issue arises whether a court is and should be allowed to decide on the distribution or retention of a private corporation's profits.

Arguments in favor of such an approach suggest that courts already enjoy similar authority in general contract law. Parties to a contract may leave the scope of their obligations to be determined by a third party; where the third party fails to do so in an equitable manner, courts may step in and specify the obligation owed in the third party's stead.[110] Similarly, courts could be allowed to determine the adequate amount of profits to be retained and decide the distribution of the remainder of the profits in a corporate context.[111] It has to be acknowledged, though, that the legal background is different. In this situation, shareholders usually have not left the decision on the retention or distribution of profits to a third party in the first place.[112] Further, the decision to retain or distribute profits is a complex commercial question which has repercussions on the whole business of the corporation. This consideration triggers the traditional hesitation held by scholarship and the courts when it comes to transferring a business decision which requires profound knowledge of the corporation's business and allows for entrepreneurial discretion into judges' hands.[113]

In order to make the judges' task easier, some authors advocate a principle of full distribution of profits. If shareholders do not decide otherwise, these authors want to allow judges to order the full distribution of profits; the court

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[108] For this argument OLG Zweibrücken, 28 May 2019, 5 U 89/18, ECLI:DE:POLGZWE:2019:0528.5U89.18.00, marg. no. 36; see also *Kersting, supra* note 28, § 29 marg. no. 41; pointing further to the risk that no resolution whatsoever will be taken *Hommelhoff, supra* note 3, 173.

[109] *Hueck, supra* note 28, 54 et seq., albeit with a tendency towards a full distribution of profits; further *Heusel/Goette, supra* note 33, 389; *Zöllner, supra* note 9, 417; for decisions regarding the process of establishing the financial statements see also *Schulze-Osterloh, supra* note 56, 2525.

[110] § 315 para. 3 sent. 2 BGB.

[111] *Zöllner, supra* note 9, 416 et seq.

[112] See also *Hommelhoff, supra* note 3, 174: "So nicht; das Prozeßgericht ist kein zur Rechtsgestaltung aufgerufenes Schiedsgericht."

[113] Cf. OLG Düsseldorf, 29 June 2001, *supra* note 107, 1086; on all this *Bork/Oepen, supra* note 6, 255 et seq.; *Gutbrod, supra* note 6, 557; *K. Schmidt, supra* note 54, § 46 marg. no. 33; critically *Leuschner, supra* note 8, § 29 marg. no. 121.

order would thus substitute for a shareholder resolution to distribute all profits.[114] While this principle might seem too rigid at first, its inflexibility would need to be attenuated by applying it cautiously: full distribution of profits might counteract long-term financial plans and could threaten to weaken the corporation's financial cushion. In addition, changes introduced by the BiRiLiG clearly express the legislature's intention to facilitate self-financing for GmbHs. Critics thus argue that the introduction of a principle of full distribution of profits is contrary to the law. However, the so-called principle would in fact remain the rare exception. Before a court would actually mandate the full distribution of profits, majority shareholders would be able to prevent this outcome at any time.[115] As shareholders can decide to retain profits with the sole votes of the majority, majority shareholders can always decide against the full distribution of profits when it comes to making this decision. A risk of full distribution of profits ordered by a court only arises where the majority acts in breach of its *Treuepflicht*. In such an event, however, scholarship allows the majority to take a new shareholder resolution at any point in time, up to the moment the court actually decides. That means that the majority can change its initial stance and arrange for the distribution of at least some part of the profits after it has been warned that there is a risk of its initial resolution being annulled by (i) first, the minority who filed suit and (ii) second, by the judges who might have shown some understanding for the minority's claim during the oral proceedings. Considering that the courts tend to accept virtually any plausible explanation, even for a continued retention of profits, and that they intervene only in extreme cases, the bar a corrected shareholder resolution on the distribution of profits has to pass is not very high. Yet, the threat of seeing the corporation's profits being distributed in full could induce the majority to compromise with the minority or, at least, to grant the minority its due.

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[114] *Bork/Oepen, supra* note 6, 270; *Kersting, supra* note 28, § 29 marg. no. 41; *Leuschner, supra* note 8, § 29 marg. no. 123; *Mock, supra* note 6, § 29 marg. no. 94; *Verse, supra* note 10, § 29 marg. no. 62; similarly *Strohn, supra* note 63, § 29 GmbHG, marg. no. 43; cf. BGH, 29 March 1996, *supra* note 56, 276 for a KG. See also for the automatic coming into existence of an enforceable claim to payment of a dividend once the statutory deadline established in § 42a para. 2 sent. 1 GmbHG is expired *Hommelhoff, supra* note 29, § 29 marg. no. 4; in detail *Hommelhoff, supra* note 3, 184 et seq. Recently ordering payment of a dividend in form of a claim for damages for breach of the *Treuepflicht* OLG Zweibrücken, 28 May 2019, *supra* note 108, marg. no. 36.

[115] *Bork/Oepen, supra* note 6, 269; *Hueck, supra* note 28, 55; *Kersting, supra* note 28, § 29 marg. no. 41; *Leuschner, supra* note 8, § 29 marg. no. 123; *Mock, supra* note 6, § 29 marg. no. 98; *Strohn, supra* note 63, § 29 GmbHG, marg. no. 43; *Zöllner, supra* note 9, 419; further *Verse, supra* note 10, § 29 marg. no. 62, also pointing to the self-restraint of the shareholder claiming profit distribution. Problems remain however where two shareholders or shareholder groups with equal voting rights block any decision, see *Heusel/Goette, supra* note 33, 389.

While scholarship has thus tried to show ways shareholders can achieve payment of a dividend even against the will of the majority, courts have not taken a stand on the issue so far. In order to escape this uncertainty, minority shareholders could be tempted to liquidate their interest by exiting the corporation, although, this continues to prove to be a difficult remedy to exercise.

3. *Right to Exit the Corporation*

Not only are shareholder conflicts over the distribution or retention of profits difficult to solve, but the decision to distribute or retain profits is a recurrent one. This means that as long as there are distributable profits, the question how to proceed with these profits arises every business year anew.[116] Where the majority follows its own agenda with no regard for the minority's needs, the conflict will resurge year after year, suits will be filed and court decisions appealed. One way to end this conflict could be for the minority to exit the corporation. However, this remedy is difficult to assert.

Modern corporations are built to persist. Shareholders' contributions, be they paid in cash or made in kind, are often vital for the corporation's business plans; repaying shareholders often threatens the basis on which a corporation operates. Corporation law recognizes this need for stability and restricts shareholders from one-sidedly withdrawing their contribution in order to safeguard the business.[117] However, especially in close corporations, the separation of shareholders might become necessary where personal cooperation is no longer possible. The German legislature has recognized this specific point, § 61 para. 1 GmbHG grants minority shareholders who (jointly) hold at least 10% of the corporation's share capital a right to claim dissolution of the corporation for good cause.[118] Similarly, German scholarship and courts also recognize good cause as grounds to allow shareholders to exit the corporation.

In 1930, the German Imperial Court (*Reichsgericht*) already developed a shareholders' right to exit from the GmbH for good cause.[119] While this right

[116] See also *Joost, supra* note 14, 301.

[117] E.g. *E. B. Rock/M. L. Wachter*, Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations, J. Corp. L. 24 (1999) 913, 919 et seq., 921 et seq.; on the considerations of the German legislator when drafting the GmbHG *V. Röhricht*, Zum Austritt des Gesellschafters aus der GmbH, in: Goerdeler/Hommelhoff *et al.* (eds.), Festschrift für Alfred Kellermann zum 70. Geburtstag am 29. November 1990 (Berlin/New York 1991) 361, 367 et seq.

[118] On this see *H. Fleischer/J. Trinks*, Gesellschafterstreitigkeiten als Auflösungsgrund in geschlossenen Kapitalgesellschaften. Die Auflösungsklage nach § 61 GmbHG im Vergleich zum französischen Recht, GmbHR 2019, 1209; in English also *H. Fleischer/ J. Trinks*, Court-Ordered Dissolution of Closed Companies in Cases of Shareholder Disputes in Germany and France, RTDF 3-2019, 17.

[119] RG, 7 February 1930, II 247/29, RGZ 128, 1, 17; pointing to this decision's limited scope *Röhricht, supra* note 117, 365.

was first limited to specific cases where shareholders were obliged to provide continuous additional services, the court was already pointing out that dissolution of the corporation cannot suffice as a solution to certain issues. The BGH then based the right to exit for good cause on the general private law principle that a legal relationship which strongly interferes with the private life of the parties involved can be terminated prematurely if there is good cause.[120] Good cause is generally found where remaining a shareholder has become unacceptable for a person while, considering all circumstances, the interest of the corporation and her fellow shareholders in her retaining her shareholding must take a back seat.[121] Again, this requires a balancing act in light of the competing interests involved. One important factor which can tip the balance is the availability of a less invasive remedy; if a shareholder can, for instance, simply sell her shares, there is no scope for her to exercise an exit right instead.[122] The right to exit the corporation for good cause has thus become an important alternative to dissolving the corporation where shareholders can no longer be made to cooperate, but it has to remain an exceptional remedy, to be used only as a means of last resort.[123]

Generally, the shareholder's right to exit the corporation for good cause can be triggered where a majority continuously decides the retention of profits in breach of their *Treuepflicht*.[124] The courts have however highlighted that the mere retention of profits does not constitute good cause in and of itself.[125] Indeed, as has been said, retaining profits is most often justified as part of a

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[120] BGH, 1 April 1953, II ZR 235/52, BGHZ 9, 157, 161 et seq.; in detail on this decision's history *J. Thiessen*, § 3 – Sternbrauerei Regensburg – BGHZ 9, 157, in: Fleischer/Thiessen (eds.), Gesellschaftsrechts-Geschichten (Tübingen 2018) 99 et seq.; cf. further BGH, 16 December 1991, II ZR 58/91, BGHZ 116, 359, 369: "Dieses Recht gehört als Grundprinzip des Verbandsrechts zu den zwingenden, unverzichtbaren Mitgliedschaftsrechten. Es kann dann geltend gemacht werden, wenn Umstände vorliegen, die dem austrittswilligen Gesellschafter den weiteren Verbleib in der Gesellschaft unzumutbar machen."

[121] *Seibt, supra* note 48, Anhang § 34 marg. no. 10; *L. Strohn*, in: Fleischer/Goette (eds.), Münchener Kommentar zum GmbH-Gesetz, Vol. I (3rd ed., Munich 2018) § 34 marg. no. 180; also *Altmeppen, supra* note 48, § 60 marg. no. 105; *D. Kleindiek*, Lutter/Hommelhoff GmbH-Gesetz Kommentar (20th ed., Cologne 2020) § 34 marg. no. 148.

[122] *Kersting, supra* note 28, Anhang nach § 34 marg. no. 22; *Strohn, supra* note 121, § 34 marg. no. 189 et seq.; concisely also *Kleindiek, supra* note 121, § 34 marg. no. 144: "Notrecht (ultima ratio)"; in detail on the possibility to sell her shares *Röhricht, supra* note 117, 383 et seq.

[123] See already RG, 7 February 1930, *supra* note 119, 17.

[124] E.g. *Emmerich, supra* note 13, 148; *Verse, supra* note 10, § 29 marg. no. 60.

[125] OLG Munich, 9 June 1989, 23 U 6437/88, GmbHR 1990, 221, 222; see also *H. Eschenlohr*, Beschränkungen der Austritts- und Kündigungsmöglichkeiten des Gesellschafters einer Familien-GmbH, in: Hommelhoff/Schmidt-Diemitz/Sigle (eds.), Familiengesellschaften. Festschrift für Walter Sigle zum 70. Geburtstag (Cologne 2000) 131, 138; *Kersting, supra* note 28, § 29 marg. no. 34.

valid and desired self-financing policy of the corporation. Persistent minority oppression can however constitute a ground for exiting a corporation.[126] Where the retention of profits thus goes against the shareholders' *Treuepflicht* and comes as an expression of the majority abusing its power, such behavior can make it unacceptable for the minority to hold on to its shareholding. The continuous and excessive retention of profits in breach of the shareholders' *Treuepflicht* can then give rise to a right of the minority shareholder to exit the corporation for good cause. This is illustrated by a decision of the Higher Regional Court of Cologne[127]: the court granted a minority shareholder the right to exit the corporation where the majority had decided to retain profits, while also extracting private benefits on the basis of an over-priced consultancy agreement and handing out loans from the corporation to related parties at an overly modest interest rate and with no securities.

Especially where such obviously abusive behavior cannot be established, the *ultima ratio* requirement can however pose an obstacle to the minority's desire to exit the corporation. Shareholders can generally fight the excessive retention of profits as described above: they can have the shareholder resolution deciding the retention of profits annulled and try to claim payment of a dividend. Taking such steps can be required as a less invasive remedy than exiting the corporation.[128] This was the stance taken by the Higher Regional Court of Munich in an earlier decision.[129]

While a right to exit the corporation might thus be available for the oppressed minority, it is granted even more restrictively than the annulment of a shareholder resolution deciding the retention of profits.[130]

V. In Favor of a Clear-Cut Rule and Generous Exceptions

A corporation's decision on how to proceed with its profits, whether to distribute or to retain them, is complex. While this decision seems, first and foremost, to concern the corporation's (self-)financing policy, it also has to consider the interest of the shareholders in participating in the corporation's proceeds. Within this framework, however, deciding the retention or distribution of profits is an act of discretion, and various outcomes fall into the realm

[126] For a right to exit also in extreme cases of a continuous, but legitimate retention of profits see *Strohn, supra* note 63, § 29 marg. no. 44; also *Eschenlohr, supra* note 125, 139; further *Röhricht, supra* note 117, 363, 383.

[127] OLG Cologne, 26 March 1999, 19 U 108/96, NZG 1999, 1222, 1223.

[128] See *Röhricht, supra* note 117, 382 et seq.

[129] OLG Munich, 9 June 1989, *supra* note 125, 222, confirmed by BGH, 15 January 1999, II ZR 163/89, quoted at GmbHR 1990, 222.

[130] Cf. also *Vollmer, supra* note 24, 95 et seq. advocating for a general exit right; consenting *Emmerich, supra* note 13, 148.

of defensible decisions. Fixing clear thresholds for when this realm is overstepped has proven very difficult, to say the least. Numerous legislative and scholarly efforts to provide a general, but adequate rule illustrate this difficulty: set numbers can hardly capture the multifaceted reality of close corporations, their different organizational structures and business models, and their varying financing needs and economic challenges.

Under German Law, scholarship and courts therefore have recourse to the flexible concept of the shareholders' *Treuepflicht* in order to police shareholder resolutions on the retention of profits. The shareholders' interest to receive payment of a dividend has to be balanced against the corporation's interest in preserving liquidity and establishing an effective self-financing policy in view of the context and the specifics of the case at hand. In this balancing exercise, courts respect the shareholders' business judgment and avoid questioning the commercial and economic rationale behind the financial policy being pursued as long as the reasons given are plausible. Thus, a breach of the shareholders' *Treuepflicht* will only be assumed and the resolution on retaining profits will only be annulled in extreme and rather obvious cases. This is an outcome which reflects the extraordinary nature of interfering with a business decision attributed by law to the shareholders and is in tune with the judicial approach in other jurisdictions.

Merely annulling the shareholders resolution to retain profits only goes half-way when it comes to the minority's interest and potentially even their need for liquidity. Judicially, making a claim to payment of a dividend will proof difficult. Scholarship and courts are reluctant to have judges determine the amount to be distributed when a whole range of decisions would be legally permissible. In order to provide minority shareholders with a manageable way to receive payment of a dividend and take the burden of making business decisions from the courts, a clear-cut rule which might seem excessive at first sight, could look more attractive at a second glance: mandating the full distribution of profits where shareholders do not achieve a valid shareholder resolution on the (partial) retention of profits.

As has been said before, such a principle of full distribution could mainly stand because, in practice, the exception will probably be the rule. Up to the point a court decides, the majority can re-take a resolution allowing for the distribution of at least some profits. Considering that courts annul such resolutions only in extreme cases, it should be no problem for the majority to achieve a defensible solution with some goodwill, or even with mere caution. In practice, there is thus a strong chance that shareholder disputes over the retention of profits will regularly end with an autonomous shareholder decision.

The principle of full distribution would thus be a mere penalty default rule.[131] Unlike most so-called penalty defaults, this one would however not sanction a lack of initial contractual provision, but by leaving room for correction up until a judge's decision, the penalty would only sanction the ma-

jority's persistent use of their voting rights in breach of their shareholders' duty of loyalty. Shareholders indeed can prevent full distribution of profits at several steps along the road and after several warning signs have been passed. The threat a full distribution of profits might pose to the majority's plans and to the corporation's business at first sight, becomes a dimmer prospect on closer inspection.

Furthermore, current scholarship and case-law might not read § 29 para. 1 GmbHG to mandate full distribution of profits – unless at least part of the profits need to be retained according to law, the articles of association, or following a shareholder resolution. The wording of the rule would however allow for such an interpretation, the law granting shareholders a "claim to the annual surplus" minus statutory or individual retention provisions.[132] As long as shareholders do not decide otherwise, a judge might bring this claim into existence deciding to distribute all profits, overriding the shareholder meeting. Similarly, the fact that the 1986 amendment to § 29 GmbHG was intended to facilitate corporate self-financing does not preclude having recourse to the principle of full distribution of profits as a (comparatively weak penalty) default rule.[133] In any case, shareholders could at least introduce such a principle in the corporation's articles of association.[134]

Finally, the threat a principle of full distribution of profits could pose to the corporation's financial stability can be further attenuated through applying the shareholders' *Treuepflicht*. This *Treuepflicht* actually works both ways[135]: it requires shareholders to consider their fellow shareholders interest

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[131] On the concept of penalty defaults see *I. Ayres/R. Gertner*, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, Yale L. J. 99 (1989), 87; *I. Ayres*, Ya-Huh: There Are and Should Be Penalty Defaults, Fla. St. U. L. Rev. 33 (2006), 589.

[132] On the interpretation of § 29 para. 1 cf. *Hommelhoff, supra* note 29, § 29 marg. no. 4; similarly *Gutbrod, supra* note 6, 557; see further critically *Verse, supra* note 10, § 29 marg. no. 10.

[133] See the relatively general justification of the new rule, BT-Drs. 10/317, 109: "Für die Erhaltung und Fortentwicklung der Gesellschaft ist in aller Regel notwendig, den erwirtschafteten Gewinn zumindest zum Teil im Unternehmen zu belassen. Den Gesellschaftern soll daher die Möglichkeit eingeräumt werden, im Rahmen des Beschlusses über die Verwendung des Ergebnisses Beträge in Gewinnrücklagen einzustellen (Absatz 2)"; see also OLG Zweibrücken, 28 May 2019, *supra* note 108, marg. no. 36: "das Gesetz die Gewinnausschüttung als den Regelfall ansieht"; alternatively *Heusel/Goette, supra* note 33, 389.

[134] For potential options consider *Hommelhoff, supra* note 29, § 29 marg. no. 18; *Verse, supra* note 10, § 29 marg. no. 38.

[135] Generally on the obligation to consent BGH, 25 September 1986, II ZR 262/85, BGHZ 98, 276, 278 et seq.; also BGH, 12 April 2016, II ZR 275/14, MittBayNot 2016, 535, 537: "hohe[] Anforderungen"; further *I. Drescher*, in: Fleischer/Goette (eds.), Münchener Kommentar zum GmbH-Gesetz, Vol. II (3rd ed., Munich 2019) § 47 marg. no. 257 et seq.

in profit distribution, and, at the same time, it asks shareholders to accommodate the corporation's need to retain liquidity and profits. Shareholders might thus even be obliged to consent to a retention of profits.[136] In cases where a full distribution of profits would threaten the corporation's existence, judges could thus moderate the principle and, by cautiously applying the shareholders' *Treuepflicht*, mandate the partial – or even full – retention of profits and accordingly order all or only part of the profits to be distributed, or even reject the minority's claim to payment of a dividend.

While shareholder disputes over the distribution or retention of profits can hardly be avoided, scholarship and courts must work to provide consistent solutions and mitigate their negative effects. The shareholders' *Treuepflicht* has proven to be a powerful tool in this endeavor. Shareholders themselves should now step in and specify clear-cut guidelines in their corporation's articles of association.

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[136] *Kersting, supra* note 28, § 29 marg. no. 35: "bei ganz unabweisbarem Bedürfnis im GesInteresse"; *K. Schmidt, supra* note 54, § 46 marg. no. 30; *Schulze-Osterloh, supra* note 56, 2522; *Verse, supra* note 10, § 29 marg. no. 61; in detail on § 29 GmbHG in its previous version *Winter, supra* note 13, 282 et seq.; see also the *obiter dictum* in OLG Stuttgart, 13 June 2007, *supra* note 44, 2590.

Abuse by Majority Shareholders as a Ground for Challenging General Meeting Resolutions

Ascensión Gallego Córcoles[*]

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I. Introduction

Conflicts of interests inside corporations are likely to arise. These conflicts appear not only between directors and shareholders, but are also common among the shareholders themselves. In fact, in closed corporations, which are the focus of this publication, conflicts between majority and minority shareholders are prone to arise. These conflicts can flourish at the general meeting, where the majority may take advantage of its voting power to impose decisions to the unjustifiable detriment of minority shareholders. Since the 2014 Corpo-

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rate Law Reform[1], the Spanish Corporations Act (*Ley de Sociedades de Capital,*[2] LSC) makes express reference to abuse by the majority as a ground for challenging general meeting resolutions. Thus, Art. 204 para. 1 subpara. 2 LSC provides grounds to challenge any decision that, "even not causing damage to the corporate assets, is imposed abusively by the majority" (*aun no causando daño al patrimonio social, se impone de manera abusiva por la mayoría*).

When considering this ground for challenging general meeting resolutions in the context of the 2014 Spanish corporate law reform, there are some ideas that must be borne in mind.

Firstly, the lawmakers behind the Spanish corporate law reform were particularly worried about intra-corporation conflicts of interests that may affect the proper functioning of corporate bodies. The new ground for challenging general meeting resolutions shows the particular concerns of the Spanish lawmaker as regards conflicts between majority and minority shareholders. However, this is not the only point of reform where attention was paid to conflicts of interests inside the corporation. The new regime on directors' duties (Arts. 225 to 231 LSC) or the prohibition on shareholders voting on decisions involving a conflict of interests (Art. 190 para. 1 LSC) should also be mentioned. Thus, Art. 204 para. 1 subpara. 2 LSC is just another example.

Secondly, although the word "abuse" appears in the wording of Art. 204 para. 1 subpara. 2 LSC (decisions "imposed abusively by the majority"), it is important to note that this is not the only point of the reform where the lawmaker was worried about the abusive exercise of shareholders' rights. The reform made two explicit references to the word "abuse" linked to the exercise of shareholder rights. One of them is in Art. 204 para. 1 LSC. The other is Art. 197 para. 6 LSC, which refers to the situation where details obtained by exercising the right to information were used abusively.

Thirdly, it should be pointed out that while challenging abusive resolutions has been facilitated in some aspects of the new regime, it has also been restricted in others. Art. 204 para. 1 subpara. 2 LSC is of particular note in facilitating the challenge of resolutions. A new ground for challenging has been expressly foreseen in this provision, which considers minority shareholders in order to protect them. In contrast, there is now an explicit list of reasons considered insufficient as grounds to challenge any decision (Art. 204 para. 3 LSC) and shareholders should now hold at least 1% of the share capital in order to be able to bring an action to challenge resolutions of the general meeting (Art. 206 para. 1 LSC).

[1] The Spanish Corporations Act was modified by *Ley 31/2014, de 3 de diciembre, por la que se modifica la Ley de Sociedades de Capital para la mejora del gobierno corporativo.*

[2] *Real Decreto Legislativo 1/2010, de 2 de julio, por el que se aprueba el texto refundido de la Ley de Sociedades de Capital.*

This paper aims to put forward some reflections on the abuse of majority power as a new ground for challenging general meeting resolutions in Spain, specifically by comparing the level of protection provided to minority shareholders before and after the LSC was modified in 2014. Although this paper is especially focused on the Spanish regulation, this analysis also lists some differences as regards the situation in Germany.

II. The Situation Prior to the 2014 Spanish Corporate Law Reform

Before analyzing the new ground for challenging general meeting resolutions which resulted from the 2014 Spanish Corporate Law Reform (and the requirements for concluding if a resolution has been imposed abusively), it is convenient to start from the situation prior to the reform. This review of the previous situation will help properly understand the reasons for the new Spanish provision. Before the 2014 Corporate Law Reform, minority shareholders had different means at their disposal to handle these situations. One, based on criminal law. Another, in civil law, where the new ground was founded in. Thus, the reform has led to innovations in the latter (civil field), while the criminal field did not *a priori* experience any change as a consequence of the 2014 Corporate Law Reform.

1. The Abuse by Majority Shareholders in Criminal Law

Imposing abusive resolutions in the corporate bodies can be deemed a criminal offence in Spain. In fact, by virtue of Art. 291 Spanish Criminal Code (*Código Penal,* CP),[3]

> "those who, *availing themselves of their majority at the general meeting of shareholders* or on the governing body of any corporation incorporated or under formation, *impose abusive resolutions, for own profit or that for others*, to the *detriment of the other shareholders*, and *without this providing profit to the corporation*, shall be punished with imprisonment of six months to three years or with a fine of one to three times the profit obtained".[4]

The incorporation of this offence into criminal law raised concerns in legal literature about excessive intervention, as some voices suggested potential inconsistency with the basic *minimal intervention* principle of criminal law.[5]

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[3] *Ley Orgánica 10/1995, de 23 de noviembre, del Código Penal.*

[4] Translation by the Spanish Department of Justice, emphasis added.

[5] *L. Fernández de la Gándara/M. Sánchez Álvarez*, Los Delitos societarios: reflexiones preliminares sobre la imposición de acuerdos sociales abusivos (art. 291 del Código Penal), Actualidad Jurídica Aranzadi, 238 (1996) 3; *M. Sánchez Álvarez*, Los delitos societarios (Pamplona 1996) 122; *J. García de Enterría*, Los delitos societarios: un enfoque mercantil

Regardless, Art. 291 CP has been applied by the Spanish criminal courts to some cases of abusive general meeting resolutions. Although the criminal offence does not require damage to the corporation (beyond the absence of profit), in all cases where it has been applied, the general meeting resolution had caused damage to corporate assets. This is what happened in the case decided by the Spanish Supreme Court in the Judgment N° 172/2010 of 4 March 2010, where the sole director and the majority shareholder of a corporation took advantage of his position at the general meeting to make the corporation authorize the use of corporate assets as a guarantee for a mortgage loan signed in his own personal interest, thus, completely disconnected from the purposes of the corporation's business activity.

To this extent, even if only infrequently applied by the courts, the mere existence of Art. 291 CP is, in practice, a significant deterrent at the minority shareholders' disposal, as it may be invoked as a way to make the majority fear the possibility of prosecution.

2. *The Abuse by Majority Shareholders in Civil Law*

The ability to challenge abusive general meeting resolutions is part of civil law minority protection. Before the 2014 Corporate Law Reform, the minority could base a challenge on two different grounds. Each of them had different potential for success in terms of minority protection. They were also subject to dissimilar regimes for legal standing and timeframes for a challenge. Depending on the ground, the resolution at hand could be deemed void or voidable.

On the one hand, where the general meeting resolution also caused damage to the corporation, the minority could consider the decision detrimental to the interest of the corporation and, thus, the minority could base its challenge on the resolution contrary to the corporate interest. In fact, those decisions caused direct damage to the corporation and, thus indirect damage to minority shareholders. This ground is now foreseen in Art. 204 para. 1 subpara. 1 LSC. According to this provision, decisions that are detrimental to the corporate interest, to the benefit of one or various shareholders or third parties, shall be subject to challenge. They were considered voidable before the reform and the minority could bring action against them within forty days of their being made, provided opposition had been recorded in the minutes where present at the general meeting (Arts. 204 para. 2, 205 para. 2 and 206 para. 2 LSC in the version prior to the reform).

On the other hand, where the resolution of the general meeting was not detrimental to the interest of the corporation, it was difficult for the minority to challenge it. In fact, the regime for challenging general meeting resolutions

(Madrid 1996) 68–76; *P. Faraldo-Cabana*, in: Gómez Tomillo (ed.), Comentarios al Código Penal (Valladolid 2010) Art. 291, 1123.

provided no express reference to the situation where resolution did not negatively affect the corporate interest, but was detrimental to the interest of minority shareholders. It is important to note that such a decision could be neutral or even beneficial from the corporation's perspective.[6]

In this case, the minority could challenge the general meeting resolution as an infringement of law, particularly, as an abuse of rights, as conduct prohibited by Art. 7 para. 2 Spanish Civil Code (*Código Civil,* CC)[7]. The first step was to provide evidence of the existence of an abuse of rights contrary to Art. 7 para. 2 CC. Where this was the case, the decision could be deemed "contrary to the law", which is one the grounds for challenge set forth in the corporate regulation (now foreseen in Art. 204 para. 1 subpara. 1 LSC). The resolution was then void, and the minority could bring action against the decision up to one year after it had been made (Arts. 204 para. 2, 205 para. 1 and 206 para. 1 LSC in the version prior to the reform).

Since the judgment of the Spanish Supreme Court on 14 February 1944, Spanish civil courts have repeatedly pointed out that the following requirements are necessary for an abuse of rights to arise:[8] a) exercise of an outwardly legal right; b) damage to an interest that is not protected by a specific legal prerogative and c) damage that is immoral or anti-social in nature, either subjectively (where there is an intention to damage or where the purpose sought is not serious and lawful) or objectively (abnormal exercise of a right). The main problem the minority faced when seeking to protect its interests using this second ground was that Art. 7 para. 2 CC is considered an exceptional remedy in the civil system and, therefore, is interpreted and applied on a very strict basis.

As a result, regarding general meetings decisions, even if the wording of Art. 7 para. 2 CC apparently covers other situations, the strict interpretation of such provision by the Spanish civil courts leads to an abuse of rights contrary to Art. 7 para. 2 CC only being found where the majority has exercised its voting rights at the general meeting with the *exclusive intention* of damaging minority shareholders (or at least with a clear disregard for the interests of the other shareholders). Prior to the reform, this abuse for *subjective reasons* was usually assumed by the courts from the circumstances under which the decision had been made at the general meeting, since there was usually a context of strong and permanent disagreements among shareholders. Regardless, it is important to point out that, from the analysis of the judgments adopted by the

[6] *L. Hernando Cebriá*, Del socio de control al socio tirano y al abuso de la mayoría en las sociedades de capital, RdS 37 (2011) 173, 181 and 182.

[7] *Real Decreto de 24 de julio de 1889*.

[8] See among others TS, 14 February 2018, N° 73/2018 and TS, 20 July 2018, N° 474/2018; AP Sevilla, 19 February 2019, N° 131/2019, or AP Barcelona, 30 May 2019, N° 126/2019.

Spanish courts when dealing with these situations, it can be concluded that any reason, however minimal and even disproportionate, that justified the decision, was considered to be enough to not declare it void. Judgment N° 221/2011 of 1 July 2011, made by the *Audiencia Provincial de Madrid*, reflects this approach stating “there could be objections to the general meeting resolution only if there is no other interest, apart from damaging the minority, that justifies the decision made”. *Sensu contrario* it could be assumed that, if there were any another reason, however minimal, no objections could be made to the decision, which would remain lawful.

There were some reasons underlying this restrictive approach applied by the Spanish courts. Firstly, as mentioned before, Art. 7 para. 2 CC is an exceptional remedy, which is applied on a very strict basis. Secondly, the Spanish courts are generally reluctant to void corporate decisions, as made in the framework of the freedom of enterprise.

An examination of cases not strictly detrimental to the corporation, but to the minority, either described in the literature[9] or decided by the Spanish courts, where abuse was found to exist, reveals:

a) capital increases *planned to dilute* the position of the minority shareholder, with the result of preventing him from reaching the threshold necessary to exercise the rights granted to shareholders holding at least a 5% of the share capital (as decided by the Spanish Supreme Court in Judgment N° 127/2009, of 5 March 2009);
b) *voluntary* winding-up decisions instigated by the majority in order to acquire the enterprise business in the liquidation phase, as a result of a *preconceived plan* to exclude the minority shareholder;
c) non-distribution of profits in a corporation with a high level of voluntary reserves (as decided by the Spanish Supreme Court in Judgment N° 418/2005, of 26 May 2005);
d) decisions to pay excessive and discriminatory remuneration to directors that happen to be majority shareholders, thus depriving other shareholders

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[9] *M. Sánchez Ruiz*, Conflictos de intereses entre socios en sociedades de capital (Cizur Menor 2000) 201–212; *E. García García*, La invocación del abuso de derecho en los litigios en materia societaria, in: Juste Mencía/Soler et al. (eds.), Cuestiones actuales de Derecho de la Empresa (Castilla-La Mancha 2011) 45–59; *Hernando Cebriá*, *supra* note 6, 199 and 200; *J. Alfaro Aguila-Real/J. Massaguer Fuentes*, in: Juste Mencía (ed.), Comentario de la reforma del régimen de las sociedades de capital en materia de gobierno corporativo (Cizur Menor 2015) Art. 204, 155, 202–214. With a description of very similar cases, see in Italian literature *A. Ferrari*, L’abuso del diritto nelle società (Padua 1998) 72–100; *G. Campobasso*, Diritto commerciale. Diritto delle società (Torino 2010) 337 and *A. Martínez*, Abuso del diritto e violazione del dovere di buona fede and Gli aumenti di capitale strumentali, both in: Ruggiero (ed.), La tutela delle minoranze nella S.R.L. (Milan 2014), 49–53, and 377–379, respectively.

of the profits (as decided by the *Audiencia Provincial de Toledo* in Judgement N° 5/2013, of 14 January 2013).[10]

Thus, actions to challenge based on an infringement of law in particular often led to unsatisfactory results in terms of minority protection. This finding enhanced the creation of a new ground for challenging general meeting resolutions in Spanish law. The committee of experts that compiled the report for the Spanish Corporate Law Reform was aware of this problem and, thus suggested a new ground for challenging corporate resolutions to protect minority shareholders.[11]

The suggestion was made by the committee of experts, with two specific general meeting resolutions in mind, expressly referred to in the report. The first resolution described in the report was a capital increase not necessary to the corporation's business activity. The second resolution taken into consideration by the committee of experts was the non-distribution of profits in a corporation with a sufficient or even with a significant level of reserves. As pointed out in the literature, the first might force minority shareholders to *put more funds into the hands of majority shareholders* (with whom they would probably have strong and permanent disagreements), if they do not want to be diluted.[12] As regards the second, minority shareholders are deprived of the profits corresponding to their stake in the share capital. However, despite being contrary to the interests of the minority shareholders, such decisions may be justified, as they reduce the corporation's dependence on external financing, increase its value, or its solvency, which is *a priori* always desirable. Consequently, these decisions could neither be considered detrimental to the corporate interest nor could they be deemed as an infringement of law. In this context, the new ground for challenging general meeting resolutions, which is described in the next section, was introduced into the Spanish Law.

[10] In the abovementioned judgment adopted by the *Audiencia Provincial de Toledo*, the decision was based on Art. 7 CC. However, prior to the 2014 Reform, the decision to pay excessive and discriminatory remuneration to directors that happened to be the majority shareholders had also been deemed detrimental to the corporate interest, with base on the *traditional* ground (see TS, 5 March 2004, N° 165/2004). After the reform, the AP Soria, 26 February 2018, N° 35/2018, applies the new ground for challenging abusive resolutions to a similar case, but from its reasoning, it seems that the ground that the court mainly takes into consideration is the *traditional* ground.

[11] *Comisión de Expertos en materia de Gobierno Corporativo*, Estudio sobre propuestas de modificaciones normativas, 14 October 2013, 29–31.

[12] *Alfaro Aguila-Real/Massaguer Fuentes, supra* note 9, Art. 204, 203 and 204.

III. The 2014 Corporate Law Reform and the New Ground for Challenging General Meeting Resolutions in Spain: Abusive Resolutions

1. Abusive Resolutions as Decisions Detrimental to the Corporate Interest in Spain

Whereas Art. 204 para. 1 subpara. 1 LSC states that decisions that are contrary to the law, contrary to the by-laws, contrary to the internal regulations of the general meeting, or detrimental to the corporate interest are subject to challenge, Art. 204 para. 1 subpara. 2 LSC makes express reference to general meeting resolutions imposed abusively by the majority. Not only does this second paragraph expressly foresee abusive resolutions as decisions subject to challenge, but it also describes what is to be understood as an abusive resolution. It is however, not the only ground for challenging general meeting resolutions described in the Spanish Corporations Act, as the resolutions that are detrimental to the corporate interest are also detailed in Art. 204 para. 1 LSC.

Here lie the main innovations as regards the grounds for challenging corporate resolutions under the new regulation. Firstly, two further types of resolution are now subject to challenge under Art. 204 para. 1 LSC: resolutions contrary to the internal regulations of the general meeting and resolutions imposed abusively by majority shareholders (abusive resolutions). Secondly, the previous distinction between decisions that are void (contrary to the law) and decisions that are voidable (contrary to the by-laws and detrimental to the corporate interest), has now disappeared from Art. 204 para. 1 LSC. Consequently, the distinctive regime as regards the legal standing and time limits for challenging a resolution have disappeared from the wording of the LSC. Thus, regardless of the ground for challenging and by virtue of this provision, all resolutions mentioned in Art. 204 para. 1 LSC are now simply contestable. Only resolutions contrary to public order are subject to different rules on legal standing and timeframes for a challenge.

However, abusive resolutions, which are expressly listed as contestable in Art. 204 para. 1 LSC, have been incorporated into Spanish Law as a subcategory of decisions contrary to the interest of the corporation. Thus, Art. 204 para. 1 subpara. 2 LSC states: "*damage to the corporate interest is also caused* when the resolution, even not causing damage to the corporate assets, is imposed abusively by the majority".[13] Therefore, taken literally, this provision leads to two different groups of resolutions now to be understood as contrary to the corporate interest under Spanish Corporate Law:

[13] Emphasis added.

- The first group to be considered detrimental to the corporate interest corresponds to general meeting resolutions that, prior to the reform, were affected by the *traditional* ground for challenging (now set forth in Art. 204 para. 1 subpara. 1 LSC). That is to say, it covers decisions made to the detriment of the corporation and to the benefit of one or various shareholders or third parties. They have been traditionally identified as *resolutions causing damage to the corporation.*
- The second group to be considered as detrimental to the corporate interest (where the wording of Art. 204 para. 1 LSC is to be followed literally), consists of general meeting resolutions that are actually unjustifiably detrimental to minority shareholders. This second group corresponds with abusive resolutions, covered by the new ground for challenging general meeting resolutions set forth in Art. 204 para. 1 subpara. 2 LSC. Thus, these resolutions are to be identified as *unjustifiably causing damage to minority shareholders.*

Even if one holds the opinion that minority shareholders were not satisfactorily protected from the abuse by majority shareholders under the previous regime (as explained in the previous section), achieving recognition of the second group of decisions as resolutions subject to challenge by making abusive resolutions a subcategory of decisions detrimental to the corporate interest is questionable. Indeed, it would have been preferable to qualify this group of decisions based on an autonomous ground. This approach is taken in other countries, as for instance, in Portugal or in Germany, where the disjunctive conjunction "or" separates the reference to the decisions detrimental to minority shareholders from the reference to other grounds for a challenge as foreseen in the corporate rules. As regards Germany, § 243 para. 2 German Stock Corporation Act (*Aktiengesetz*, AktG) states that

> "the action for avoidance may also be based on the fact that a stockholder, by exercising the voting right, sought to obtain special benefits for himself or for a third party to the detriment of the corporation *or* of the other stockholders and that the resolution is suited to serve this purpose".[14]

Article 58 para. 1 lit. b Commercial Companies Code (*Código das Sociedades Comerciais*) in Portugal moves in the same vein.

Thus, an initial difference between the Spanish and German regimes on challenging general meeting resolutions emerges: whereas the resolutions at hand are considered subject to an autonomous ground of challenge in Germany, they are a subcategory of decisions that are detrimental to the corporation in Spain. The same distinction exists as regards the comparison between the Spanish and Portuguese regimes.

[14] Emphasis added.

Apart from not being in the line with the regulations of other Member States, the approach taken by the Spanish lawmaker, who followed the suggestions of the committee of experts that reported on the Spanish Corporate Law reform,[15] is not without criticism for a number of reasons. Firstly, the expert committee report stated that the proposal for this ground for challenge was aimed at regulating those resolutions that "do not negatively affect the corporate interest". However, it is paradoxical that abusive resolutions be considered contrary to the corporate interest when, quoting the report of the committee of experts, they "do not negatively affect the corporate interest". Besides, the committee of experts actually highlighted the traditional reluctance of Spanish courts to consider that the resolutions made to the unjustifiable detriment of minority shareholders were resolutions "damaging to corporate assets". After having pointed it out, the committee proposed a specific ground for challenging such resolutions, which were literally identified as detrimental to the corporate interest, even though they did not "cause damage to the corporate assets". *Ergo*, taken all together, what the committee of experts seems to have highlighted and criticized was the fact that the Spanish courts had not considered that resolutions that "do not cause damage to the corporate assets" were resolutions "detrimental to the corporate assets". Apart from the fact that, logically, resolutions that do not cause damage to corporate assets cannot be considered as detrimental to corporate assets, it seems that this approach taken by the committee of experts (and followed by the Spanish lawmaker) reduces the scope of resolutions detrimental to the corporate interest to simply those decisions causing damage to the corporate assets. This approach is to be criticized.

Secondly, if the interest of minority shareholders were to be identified with the interest of the corporation, it would not have been necessary to add a new ground for challenging general meeting resolutions. In fact, prior to the reform it would not have been necessary to base the challenge on Art. 7 para. 2 CC. In other words, if abusive resolutions were considered as resolutions contrary to the corporate interest, a challenge could have been based on the *traditional* ground prior to the reform. Note that it was not the case.

Consequently, the reform has led to an *artificial* (and unnecessary) extension of the concept "corporate interest", which has given rise to some unnecessary doubts as regards its scope. In this sense, it is not clear whether this *supposed* enlargement of the concept "corporate interest" is to take place in the corporate law framework generally (for example, also including the duties of board members) or just for challenging general meeting resolutions.[16]

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[15] *Comisión de Expertos en materia de Gobierno Corporativo, supra* note 11, 29–31.

[16] *M. Sánchez Ruiz*, Perspectivas de reforma en la regulación de los conflictos societarios, in: Morillas Jarillo/del Pilar Perales et al. (eds.), Estudios sobre el futuro Código

Moreover, if it applies only to the latter, it is questionable whether it only covers the categorization of the grounds to challenge or it also covers the rule set forth in Art. 190 para. 3 LSC. Art. 190 para. 3 LSC foresees an inversion of the burden of proof where the vote of a shareholder in a conflict of interest has been decisive in the decision-making.[17]

In short, the erroneous categorization of abusive resolutions in Spanish law as decisions detrimental to the corporate interest has unnecessarily given rise to problems in interpreting corporate law rules. The abusive resolutions should be subject to challenge, not because they are detrimental to the corporate interest, but because they are unjustifiably detrimental to minority shareholders, which is something completely different. Ultimately, the legal basis underlying the two grounds for challenging general meeting resolutions (detrimental to the corporation and detrimental to minority shareholders) also appears to be different. This matter is addressed in the next section.

2. The Duty of Fidelity towards Other Shareholders as the Basis for Challenging General Meeting Resolutions in Spain

The legal basis for the new ground for challenging general meeting resolutions under Spanish Law is to be found in a duty of fidelity among shareholders (in Germany, *Treuepflicht zwischen Gesellschaftern*). A few comments are to be made with regard to this statement.

Firstly, the term *duty of fidelity* is preferred here to describe the duty underlying this ground rather than *duty of loyalty*. The latter is definitely more widespread in literature (even in this field), but for this matter, it seems more accurate to talk about a *duty of fidelity* to make a clear distinction between this duty and that to which directors are subject. The directors, as members of a corporate body, must promote and enhance the corporate interest. Therefore, they are subject to a *duty of loyalty*, which differs greatly in meaning and content from shareholders' duties.[18] With respect to the general meeting decision-making, it is interesting to note that voting rights are granted to be exercised *in the shareholder's own interest* and that the duty of fidelity serves as a limit to the exercise of these rights.[19]

Secondly, while the duty of fidelity among shareholders underlies the new ground for challenging general meeting resolutions in Spanish law (Art. 204

Mercantil: libro homenaje al profesor Rafael Illescas Ortiz (Madrid 2015) 918, particularly 924–926.

[17] *Ibid.*

[18] Under Spanish Law, see Arts. 227 et seq. LSC.

[19] *M. Alcalá Díaz*, El conflicto de interés socio-sociedad en las sociedades de capital, RdS 9 (1997) 89, 115 and 116; *Sánchez Ruiz, supra* note 9, 221; *Alfaro Aguila-Real/ Massaguer Fuentes, supra* note 9, Art. 204, 197.

para. 1 subpara. 2 LSC),[20] the shareholders' duty of fidelity to the corporation underlies the *traditional* ground for challenging general meeting resolutions (Art. 204 para. 1 subpara. 1 LSC).[21]

Long discussions have ensued in legal literature as regards the existence of a shareholders' duty of fidelity, as there is no express recognition of such a duty in Spanish corporate law.[22] Although a consensus has not been reached, it should be considered that not only do these two grounds in Art. 204 para. 1 LSC reflect the existence of a duty of fidelity, but they are also the basis for determining the content of such duty. With respect to the first idea, both Art. 204 para. 1 subparas. 1 and 2 LSC confirm the existence of a duty, which, as a specification of good faith, stems from the relationship arising from the corporate contract.[23] As far as the second idea is concerned, as both grounds for challenging general meeting resolutions are not just mentioned, but also specified in Art. 204 para. 1 LSC, they provide a description of what the corporate lawmaker considers the behavior a shareholder should be pursuant to the duty of fidelity. To this extent, despite the fact that the definition of the duty of fidelity is set forth in the framework of the regime for challenging general meeting resolutions, it refers to more than the exercise of voting rights. This is because the duty of fidelity expands its scope throughout the cooperation relationship stemming from the corporate contract.

Consequently, the conditions under which general meeting resolutions can be challenged by virtue of the grounds in Art. 204 para. 1 LSC are identified by the content of the abovementioned duty of fidelity. However, a distinction should be made between the *traditional* ground (Art. 204 para. 1 subpara. 1 LSC) and the new ground for challenging general meeting resolutions (Art. 204 para. 1 subpara. 2 LSC).

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[20] *J. Pulgar Ezquerra*, Impugnación de acuerdos sociales abusivos y reestructuración societaria homologada, RdS 44 (2015) 69, 77, 74 and 96; *Alfaro Aguila-Real/Massaguer Fuentes, supra* note 9, Art. 204, 196–198.

[21] As regards the *traditional* ground, see *Alcalá Díaz, supra* note 19, 93.

[22] Assuming the existence of a duty of fidelity, see *A. Recalde Castells*, Deberes de fidelidad y exclusiòn del socio incuplidor en la sociedad civil, La Ley 1 (1993) 304, *passim*; *Sánchez Ruiz, supra* note 9, 236; *J. Miquel Rodriguez*, Reflexiones sobre los deberes de fidelidad de socios y accionistas, in: Sáenz García de Albizu/Oleo Banet et al. (eds.), Estudios de Derecho Mercantil en memoria del Profesor Anibal Sánchez Andrés (Cizur Menor 2010) 453–470. Taking the opposite view, see *A. Carrasco Perera*, Tratado del abuso de derecho y del fraude de ley (Madrid 2016) 627–727 and *M. Sáez Lacave*, Reconsiderando los deberes de lealtad de los socios: el caso particular de los socios de control de las sociedades cotizadas, InDret 1 (2016).

[23] *J. Girón Tena*, Derecho de Sociedades Anónimas (Valladolid 1952) 198 and 199.

On the one hand, as the Spanish Supreme Court has repeatedly pointed out,[24] a resolution is considered (strictly) detrimental to the corporate interest (*traditional* ground) when:

- There is a detriment (damage) to the corporate interest.
- There is a benefit to one or various shareholders or to third parties.
- There is a cause-effect relationship between the damage to the corporate interest and the benefit to one or various shareholders or to third parties.

Thus, all these requirements taken together, the duty of fidelity of the shareholders *towards the corporation* prevents shareholders from obtaining advantage (either personally or for a third party)[25] to the detriment of the corporate interest. This confirms that the corporate interest constitutes a *negative* limit on the exercise of shareholder rights, particularly voting rights when it concerns decision-making at a general meeting.

On the other hand, abusive resolutions are covered by the new ground set forth in Art. 204 para. 1 subpara. 2 LSC, which states that "a resolution is imposed abusively where, without responding to a reasonable need of the corporation, it is approved by the majority for its own benefit to the unjustifiable detriment of the rest of shareholders"[26]. It should be concluded from this definition that a resolution is considered abusive when:

- It does not respond to a reasonable need of the corporation.
- It causes an unjustifiable detriment to the other shareholders.[27]
- There is a benefit to the majority.

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[24] See, among others, TS, 27 October 1997, N° 928/1997; TS, 18 September 1998, N° 825/1998; TS, 17 January 2012, N° 991/2012.

[25] It has been pointed out that the express reference to the benefit to a "third party" in the former Art. 115 *Ley de Sociedades Anónimas* of 1989 (now Art. 204 para. 1 subpara. 1 LSC) sought to make the challenge of decisions detrimental to the corporate interests more effective, as it prevented majority shareholders from redirecting benefits to third parties. See *P. Álvarez Sánchez de Movellán*, Estudios sobre el proceso de impugnación de acuerdos sociales (Madrid 2015) 129.

[26] Original: "Se entiende que el acuerdo se impone de forma abusiva cuando, sin responder a una necesidad razonable de la sociedad, se adopta por la mayoría en interés propio y en detrimento injustificado de los demás socios" – translation author's own.

[27] By virtue of Art. 204 para. 1 subpara. 2 LSC, abusive general meeting resolutions are contestable even where they do not damage corporate assets. According to the wording of the provision, a detriment to corporate assets is obviously not required, but such detriment does not seem to be an obstacle to deeming the resolution abusive, provided the requirements set forth in the provision (and thus, an unjustifiable detriment to the minority) are met. In fact, Spanish case law suggests the decision to pay excessive remuneration to directors that happen to be majority shareholders could be considered a decision covered by the *traditional* ground (strictly detrimental to the corporate interest), but it could also be a means to deprive minority shareholders of profits (thus, detrimental to the minority). See judgements quoted in *supra* note 10.

– There is a cause-effect relationship between the damage to the minority and the benefit to the majority.[28]

The next section deals in more depth with these requirements, where they are connected with the judicial review that follows an challenge based on a resolution of the general meeting as abusive. Nevertheless, some comments on such requirements can be made here regarding the content of the duty of fidelity between shareholders, which these requirements help define.

Firstly, the duty of fidelity prevents shareholders from obtaining advantage to the *unjustifiable* detriment of the rest of shareholders. Whereas, as mentioned before, in the case of the duty of fidelity to the corporation the corporate interest represents a *negative* limit on the exercise of shareholder rights (*traditional* ground), in this case (the new ground), the corporate interest is a *positive* condition and the interest of the rest of shareholders is the *negative* limit on the exercise of shareholder rights.[29] Note that the detriment to minority shareholders is required to be *unjustifiable* in the second paragraph of Art. 204 para. 1 subpara. 2 LSC. This specification suggests, *sensu contrario*, that a general meeting resolution can lawfully cause a *justified* detriment to the minority shareholders. If the latter were the case, the decision would not be contestable, as one of the requirements set forth in the provision would not be met (the *unjustifiable* detriment of the rest of shareholders). Any reason that justifies a decision with a potential detriment to minority shareholders must be in the corporate interest. In that sense, as it is further explained in the next section, the corporate interest represents a requirement for the validity of a resolution suspected of having been imposed abusively by the majority. Using corporate interest as a requirement for the validity of the decision made at the general meeting is not completely unknown in Spanish corporate law, as it is also the case where the general meeting decides to exclude the preemptive right in the context of a capital increase. Actually, Art. 308 para. 1 LSC states: "where the corporate interest requires, the general meeting, when approving the capital increase, may decide to wholly or partially exclude the shareholders' pre-emptive subscription right".[30]

Secondly, the benefit to majority shareholders consists of an advantage or benefit that should be linked in a cause-effect relationship with the detriment

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[28] JM Granada (Nº 1), 16 February 2015, N° 1040/2013.

[29] *Pulgar Ezquerra, supra* note 20, 74.

[30] Original: "En los casos en que el interés de la sociedad así lo exija, la junta general, al decidir el aumento del capital, podrá acordar la supresión total o parcial del derecho de suscripción preferente.", translation author's own; *C. Alonso Ledesma*, Algunas consideraciones sobre el juego de la cláusula del interés social en la supresión o limitación del derecho de suscripción preferente, in: Alonso Ledesma (ed.), Derecho Mercantil de la Comunidad Económica Europea. Estudios en Homenaje a José Girón Tena (Madrid 1991), 31, 50–55.

to minority shareholders. As far as the *traditional* ground is concerned (Art. 204 para. 1 subpara. 1 LSC), the Spanish Supreme Court has pointed out that there is no need to ascertain a given intention or purpose in decision-making.[31] In spite of the fact that the wording of Art. 204 para. 1 subpara. 2 LSC is not exactly the same as the wording of Art. 204 para. 1 subpara. 1 LSC, there is no reason to require an element of subjectivity when it is about the new ground for challenging abusive resolutions, as no subjective element is required with regard to the so-called *traditional* ground. Besides, this assertion is consistent with one of the purposes of the 2014 Corporate Law Reform: the idea of effectively protecting minority shareholders. Note that not requiring an element of subjectivity makes it easier to challenge general meeting resolutions.

If compared to German law, this assertion leads to a second difference between the Spanish and the German regimes for challenging general meeting resolutions: in Germany, resolutions detrimental to the minority can be challenged where the resolution is made with the purpose of obtaining a special advantage. Thus, § 243 para. 2 AktG states that the action to challenge "may also be based on the fact that a stockholder, by exercising the voting right, *sought* to obtain special benefits for himself or for a third party to the detriment of the corporation or of the other stockholders and that the resolution is *suited to serve this purpose"*.[32] In fact, the difficulties in providing evidence of a subjective element in the decision-making when challenging general meeting resolutions in Germany limit considerably the scope of the German provision, and it is not frequently applied in practice for this reason.[33] Hence, situations of abuse by the majority in general meeting decision-making are viewed by German literature and by German courts as a violation of law, which covers the violation of general clauses, such as the duty of fidelity.[34] In short, the ground on which the minority bases its action to challenge abusive resolutions in Germany is not the one mentioned in § 243 para. 2 AktG,[35] but the one set forth in § 243 para. 1 AktG,[36] which covers general meeting resolutions contrary to the law.

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[31] See, among others, TS, 27 October 1997, *supra* note 24; TS, 18 September 1998, *supra* note 24; TS, 17 January 2012, *supra* note 24.

[32] Emphasis added, in the original language: "Die Anfechtung kann auch darauf gestützt werden, daß ein Aktionär mit der Ausübung des Stimmrechts für sich oder einen Dritten Sondervorteile zum Schaden der Gesellschaft oder der anderen Aktionäre zu erlangen suchte und der Beschluß geeignet ist, diesem Zweck zu dienen."

[33] *J. Koch*, in: Hüffer/Koch (eds.), Aktiengesetz (14th ed., Munich 2020) § 243 marg. no. 31.

[34] *Koch, supra* note 33, § 243 marg. no. 21, 31.

[35] This German provision is equivalent to the Spanish Art. 204 para. 1 subpara. 2 LSC.

[36] This German provision is equivalent to the Spanish Art. 204 para. 1 subpara. 1 LSC.

This statement emphasizes the different approaches used in the German and the Spanish regimes for challenging general meeting resolutions in this particular field. Whereas the challenge of abusive resolutions may be based on the duty of fidelity in both jurisdictions, the ground on which the action is formally based is not the same in each country. In that sense, while such action (based on the infringement of the duty of fidelity) would be covered by the new ground for challenging general meeting resolutions in Spain (resolutions unjustifiably detrimental to the minority and, thus, abusive), it would not be covered by the *equivalent* German provision in the AktG (§ 243 para. 2), but by a different one, whose *equivalent* is also set forth in the Spanish LSC (resolutions contrary to the law, § 243 para. 1 AktG). Thus, although the action to challenge is materially based on the infringement of the duty of fidelity, the ground *formally* chosen by the minority to challenge abusive resolutions is not the same in Spain as in Germany. It is important to note that, before the 2014 Spanish Corporate Law Reform, minority shareholders' actions to challenge abusive resolutions were based on the grounds of a decision contrary to the law.

Both jurisdictions require the court to conduct a material check when the general meeting resolution is challenged. It implies that the general meeting resolution, probably based (at least, apparently) on the corporate business strategy, is to be re-examined by the court. As German courts are, as in Spain, traditionally reluctant to void decisions under the framework of the freedom of enterprise, the level of judicial review under the ground set forth in § 243 para. 1 AktG of a general meeting resolution suspected of being made with infringement of the duty of fidelity has a very limited scope. Actually, as there is no express reference to this material judicial review in German corporate law under the provision concerning resolutions contrary to the law (which is the ground on which abusive resolutions, contrary to the duty of fidelity, are based in Germany), judicial review is applied very restrictively.[37] Besides, there has actually been discussion on which general meeting resolutions are to be subject to such judicial review in such terms.[38] This is usually detrimental to the minority, which finds protection only in very exceptional cases.

In contrast, the approach is different under Spanish corporate law, as the wording of the provision concerning the new ground for challenging general meeting resolutions leads to a lesser level of uncertainty with regard to this material judicial review. Note that, in Spain, this check could be applied, *a priori,* to any general meeting resolution. Thus, where there is an express reference to this kind of material judicial review in the law, the scope of its

[37] As regards the retention of profits and minority protection, see *H. Fleischer/ J. Trinks*, Minderheitenschutz bei der Gewinnthesaurierung in der GmbH, NZG 2015, 289, 292.

[38] *Koch, supra* note 33, § 243 marg. no. 21–29.

application (in other words, the number of general meeting resolutions that are to be assessed through this judicial review) is apparently larger than where judicial review does not literally stem from the wording of the regime on challenging general meeting resolutions. It is important to mention that the specific level of minority protection depends on the requirements set forth in the regime, on the difficulty (or lack thereof) of providing evidence, and, of course, on the application by the courts in practice. The next section deals with the judicial review on requirements to deem a decision abusive in Spain (Art. 204 para. 1 subpara. 2 LSC).

Before moving on the next section, it is important to point out that just because there is a new ground for challenging abusive resolutions in Art. 204 para. 1 LSC, it does not mean that Art. 7 para. 2 CC no longer applies when challenging general meeting resolutions in Spain. Although it is true that the provision is not to be applied to resolutions now covered by Art. 204 para. 1 subpara. 2 LSC, it still applies as an exceptional remedy where the resolution does not fall within the scope of Art. 204 para. 1 subpara. 2 LSC. Specifically, as an exceptional remedy, Art. 7 para. 2 CC should be applied where there is damage to an interest not protected by a specific legal prerogative (Judgment of the Spanish Supreme Court on 14 February 1944). Although Art. 204 para. 1 subpara. 2 LSC is now clearly a specific legal prerogative, where it does not apply, it still makes sense to base the action to challenge on Art. 7 para. 2 CC. This could be the case where the general meeting resolution is not made to the benefit of the majority (that would mean that one of the required criteria for an abusive resolution would not be met) or where the resolution is not detrimental to the minority, but to a third party. The latter was seen in judgments N° 73/2018, of 14 February 2018 and N° 87/2018, of 15 February 2018, made by the Spanish Supreme Court. In the facts of Judgment N° 73/2018, a third party had been granted a call option on the majority of the shares, which would provide him with control of the corporation. Two days after having announced the exercise of the call option, the general meeting decided unanimously to increase share capital to a level that prevented the third party from obtaining control of the corporation. According to the Supreme Court, the general meeting resolution was contrary to the law, as it represented an abuse of majority voting power. In particular, the shareholders had abusively exercised their rights to attend and vote at the general meeting. Despite the fact that the law applicable to the case was the LSC in the version prior to the reform (the general meeting resolution was made in January 2014), the Spanish Supreme Court pointed out that the general meeting resolution would not fall within the scope of the new provision as, among other things, it had been made unanimously. In the facts of the case decided in the second judgment, the general meeting of a subsidiary company had decided to amend its by-laws, which prevented the majority shareholders of the parent company from extending their control over the subsidiary. These shareholders

had just acquired control over the parent company after a judicial process against the rest of its shareholders. As the claimants were shareholders of the parent company, but not of the subsidiary, they were considered third parties. The other shareholders of the parent company were members both of the board of the subsidiary and the board of the parent company and happened to be pledgees of shares of the subsidiary, with the right to vote at the general meeting. Both the decisions made at the general meeting of the subsidiary and the agreements between the parent company and these other shareholders, through which they had become pledgees of shares in the capital of the subsidiary company, occurred before the abovementioned judicial process ended with a final judgment granting the claimants control over the parent company.

The Spanish Supreme Court states in both Judgments:

> "there are some cases of abuse of rights, particularly where it comes to intra-corporate conflicts of interests, in which the behavior is expressly typified as a ground for challenging corporate decisions. If that is the case, it is not the general regime of Article 7(2) of the Civil Code that is to be applied, but the specific Corporate Law provision […] however, there are cases where the abuse of rights that has arisen in the decision-making does not lead to a decision contrary to the interest of the corporation in the sense of Article 204(1) of the Corporations Act, either before or after the reform […] In that case, the general regime of Article 7(2) of the Civil Code is to be applied".[39]

3. Judicial Review of the Requirements to Deem a Resolution Abusive (Art. 204 para. 1 subpara. 2 LSC)

a) Prior considerations

On the assumption that there is a benefit or an advantage to the majority which arose as a detriment to the minority came to be, two other requirements set forth in Art. 204 para. 1 subpara. 2 LSC (and their relation to each other) are particularly relevant for the purposes of judicial oversight over abusive resolutions. These are the absence of a "response to a reasonable need of the corporation" (*sin responder a una necesidad razonable de la sociedad*) and the "unjustifiable detriment of the rest of shareholders" (*detrimento injustificado de los demás socios*). As explained below, these are separate and different requirements under the wording of Art. 204 para. 1 subpara. LSC. In fact,

[39] Original: "Existen algunos supuestos de abuso de derecho, en especial cuando afectan a conflictos intrasocietarios, en los que la conducta está expresamente tipificada como causa de impugnación del acuerdo social. En tal caso, al supuesto no le es aplicable el régimen general del art. 7.2 del Código Civil sino que ha de estarse a lo previsto específicamente en la norma societaria […] Sin embargo, existen supuestos en los que el abuso de derecho en que se ha incurrido al adoptar el acuerdo social no es reconducible a ese supuesto de acuerdo «lesivo» del interés social específicamente previsto en el art. 204.1 TRLSC, tanto antes como después de la reforma […] En tal caso, el supuesto ha de reconducirse al régimen general del art. 7.2 del Código Civil", translation, author's own.

it is clear from the wording of the Spanish provision that the absence of a "response to a reasonable need of the corporation" and the "unjustifiable detriment" to the minority should be assessed separately. However, they are undoubtedly connected, to the extent that assessment regarding the second (the "unjustifiable detriment"), may be included in the assessment of the first (the absence of a "response to a reasonable need").

Following a literal interpretation of Art. 204 para. 1 subpara. 2 LSC, the judge would first assess whether the resolution is born out of a "reasonable need" of the corporation or not. If the answer to this question is in the negative, and even if the resolution is not born out of a "need" at all, the judge would determine whether the decision leads to an "unjustifiable detriment" to the other shareholders or not. With regard to this second assessment, it should be noted that the Spanish lawmaker has pointed out that the detriment to the minority must be considered "unjustifiable", in order to deem a decision as imposed abusively. Thus, not only does the determination of whether there is a "reasonable need" play a key role, the question of whether the detriment to the minority is "unjustifiable" is also important. In fact, the wording of the provision implies that, *sensu contrario*, the resolution is not contestable where it is not borne out of a "reasonable need" (that is to say, the answer to the first question is in the negative), but where it causes a "justified" detriment to the other shareholders. In other words, from the wording of the Spanish provision it can be concluded that a general meeting resolution may lawfully cause a detriment to the minority, even if it is to the benefit of the majority, provided such detriment is considered to be "justified".

These statements lead to the conclusion that, apart from the assessment regarding benefit to the majority, material judicial review of abusive resolutions in Spain should go through two different tests. Roughly speaking, the first test is linked to the requirement concerning the absence of a "response to a reasonable need". Therefore, the test would be essentially, but not always exclusively a *necessity test*. The second test could be assumed from the explicit mention of "unjustifiable detriment" to the rest of shareholders in Art. 204 para. 1 subpara. 2 LSC. This test centers on the word "unjustifiable", which accompanies "detriment", and would consist essentially, but not exclusively in a *convenience test*. Actually, each test is divided into two different stages, the second stage of each of these tests consisting of a *proportionality* assessment. As explained in the following, the concept of proportionality when assessing abusive resolutions stems from the words "reasonable" and "unjustifiable" in the provision at hand. Thus, it must be determined whether the general meeting resolution suspected of being abusive, is proportionate or not in the context of a given need of the corporation (necessity test) or in the context of a given convenience to the corporation (convenience test), considering the detriment it causes to the minority.

b) The necessity test

It is important to mention that the necessity test has precedence: its results can exclude the application of the convenience test. In fact, as the Spanish lawmaker first defines abusive resolutions as decisions that do not respond to "a reasonable need of the corporation", this condition must be seen as a preliminary requirement.[40] Thus, it is clear that a general meeting resolution is considered lawful where it is determined on "reasonable need", even if there is a detriment to the minority.

Prior to dealing with the two stages of the necessity test, there are some considerations on the wording of Art. 204 para. 1 subpara. 2 LSC. The Spanish original version of the provision states "sin responder a una necesidad razonable de la sociedad". Literally, the translation into the English language would be "without responding to a reasonable need of the corporation". Notwithstanding that such is the meaning to be taken from the original Spanish, the provision should be read in another way, as referring to a need as reasonable makes really little sense: needs may be real or potential or even specific, but not reasonable – they are either required or they are not. An alternative interpretation suggests that, in view of the circumstances, it can be *reasonably* considered that there is a given need of the corporation. However, going further, it can be easily assumed from Art. 204 para. 1 subpara. LSC that the general meeting resolution is a response to a given need of the corporation (note that it states: "without *responding* to a reasonable *need*").[41] Therefore, the provision at hand is to be read in the sense that the resolution is not a reasonable response to a given need of the corporation. Thus, the word "reasonable" should accompany the word "responding", not the word "need", in the text of the provision. In fact, the Spanish Dictionary of the *Real Academia Española* uses the example of "reasonable response" (*respuesta razonable*) for the word "reasonable" (*razonable*). Paradoxically, the English version of the LSC that has been provided by the Spanish Department of Justice moves away from the unclear wording of the Spanish. In fact, the English version states that "an agreement is understood to have been imposed in an abusive manner when, rather than *responding reasonably to a corporate need*, the majority adopts the agreement in their own interests and to the unjustifiable detriment of the other partners".[42]

Having said that, it can be concluded that the necessity test consists of determining whether the decision is a *reasonable response to a need of the corporation*. This requires both an assessment of whether a corporation has a *need* and whether the decision constitutes a *reasonable response* to that need. These two items divide the necessity test into two stages.

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[40] JM San Sebastián (N° 1), 1 February 2016, N° 31/2016.

[41] Emphasis added.

[42] Emphasis added.

Thus, as far as the first stage of the necessity test is concerned, the key is to find out whether the corporation had a need: i.e., whether, considering its situation, the fulfilment of the corporate interest or the development of the business strategy required certain measures be undertaken. If not, then the general meeting resolution is to be assessed according to the second test (the convenience test). If however there was a need, the assessment proceeds to the second stage of the necessity test.

In this sense, the second stage of the necessity test is linked to the idea of the resolution being a *reasonable response* to the need of the corporation identified in the first stage of the assessment. It means that, in order not to be abusive, the general meeting resolution must be adequate and proportionate in the context of such need. To this extent, proportionality is to be assessed with regard to the detriment to the rest of shareholders and the benefit for the corporation. In that sense, the general meeting resolution would be abusive where other, equally efficient solutions, less harmful to the minority were available as a response to the need of the corporation.[43] Additionally, even if there is a genuine need, but the decision is not proportionate in this sense, the convenience test is no longer necessary, as the requirement regarding "unjustified detriment" can already be assumed from this second stage of the necessity test. Then, the resolution could be deemed abusive, assuming there is a benefit or advantage to the majority to the detriment to the minority. On the contrary, where the decision is considered an adequate and proportionate response to a given need of the corporation in the development of its business strategy, the decision is to be deemed lawful.

c) *The convenience test*

As mentioned before, if the general meeting resolution does not pass the necessity test or, more specifically, if the resolution does not pass the first stage of the necessity test, it does not automatically mean that the resolution is abusive in the sense of Art. 204 para. 1 subpara. 2 LSC. This is because there is another requirement in the text of the provision, according to which a resolution is considered to have been imposed abusively where it has been made to the "unjustifiable detriment" of the rest of shareholders.[44] This gives rise to a second test, a convenience test.

Thus, depending on the result of this test, a resolution may not be deemed abusive even if it is not borne out of a "need" of the corporation (having failed the first stage of the necessity test). As explained before, the detriment to the minority is to be deemed "unjustifiable" where the decision is not adequate and proportionate in the context of a given need of the corporation,

[43] Similarly, *Alfaro Aguila-Real/Massaguer Fuentes, supra* note 9, Art. 204, 199 and 203.

[44] AP Barcelona, 14 May 2015, N° 119/2015.

which means that the second stage of the necessity test has not been passed. Once the inadequacy and the disproportionality of a general meeting resolution have been established in the second stage of the necessity test, the examination of whether the detriment caused to the minority is "unjustifiable" or not in the framework of another test is not required. On the assumption that there is a benefit or an advantage to the majority to the detriment to the minority, the general meeting resolution would then be abusive. Thus, by not passing the second part of the necessity test, the general meeting resolution has failed the necessity test as a whole.

However, by virtue of Art. 204 para. 1 subpara. 2 LSC, where a resolution fails the necessity test in the first stage, a second stage in the framework of the necessity test is no longer necessary. Where a need of the corporation does not exist, it makes little sense to determine whether the decision is adequate and proportionate. In this case, the assessment should be moved on to a second test (the convenience test), which determines whether the detriment to the minority is "justifiable" as against the convenience provided to the company. To do so, the convenience test is also divided into two different stages.

On the one hand, the first stage of this test is aimed at determining if there is a *convenience* to the corporation in the decision. Hence, the question at this stage is to identify whether or not the situation of the corporation makes it advisable (convenient), though not necessary, to act in a certain way to fulfil the interests of the corporation or to develop its business strategy. If not, then the resolution is abusive, as there is neither a need (first test) nor a convenience (second test) for the corporation which can justify the resolution. This, again, is on the assumption that there is a benefit or an advantage to the majority while there is a detriment to the minority. If that is the case, the detriment to the minority is unjustifiable, as it cannot be explained by need nor convenience. Nevertheless, even if the answer to the question is positive, the assessment must proceed to the second stage of the convenience test.

Thus, on the other hand, the second stage of the assessment examines whether the *convenience* for the corporation is sufficient to justify the resolution (adequacy and proportionality). If not, then the resolution is abusive, as the detriment to the minority is deemed "unjustifiable", and thus the general meeting resolution is not a "response to a reasonable need of the corporation". This is, again, on the assumption that there is a benefit or an advantage to the majority to the detriment to the minority. However, if the answer to this question is affirmative, then the decision is considered lawful, as the detriment caused to the minority is justified and proportionate to the convenience to the corporation.

Finally, it is important to stress that this convenience test is of particular interest, as in practice, most general meeting resolutions are not made due to "need", but strive for "convenience".

d) A few comments on the application of the necessity/convenience review of abusive resolutions

As explained in the previous section, the wording of Art. 204 para. 1 subpara. 2 LSC leads us to consider that, apart from the assessment to establish both a benefit to the majority and a detriment to other shareholders (the minority), judicial material review of the general meeting resolution suspected of being abusive, consists of two different tests (the necessity test and the convenience test). In addition, as shown before, the provision requires the detriment to the minority to be "unjustifiable", which can be assumed from both tests.

As Art. 204 para. 1 subpara. 2 LSC does not specify the nature of the detriment, beyond that be "unjustifiable", it can be assumed that the provision is referring to "unjustifiable" both from a subjective and an objective point of view. The first (subjective point of view) happens where the decision is born out of an exclusive intention to damage the minority, or at least, where it has been made with a clear disregard for the interests of other shareholders. This is the case where the resolution is neither due to need nor convenience of the corporation. Thus, the "unjustifiable" detriment from a subjective point of view is determined by the first stage of the tests, that is, ascertaining whether the situation of the corporation makes a specific measure necessary or convenient. In fact, as it has been repeatedly pointed out by the Spanish courts, an intention to damage the minority is to be assumed in the absence of any other reason for which the general meeting resolution has been made.[45] The second (objective point of view) means the general meeting resolution is not adequate and proportionate in the context of a given need or convenience for the corporation. Hence, this point of view is related to the second stage of both tests.

Besides, it is important to stress that where a general meeting resolution is a reasonable response to a given need/convenience of the corporation, it cannot be deemed abusive even if there is *also* an intention of majority shareholders to damage minority shareholders. As regards the subjective point of view, any unjustifiable detriment to the minority that would stem from the intention to damage would be *neutralised* because the general meeting resolution is a response to a given *need/convenience*. In that case, it would be considered that the resolution was not made with the *exclusive* intention of damaging minority shareholders. However, even if not abusive for subjective reasons, the general meeting resolution could still be deemed objectively abusive, and minimal justification would not be enough to render it lawful.

Therefore, the judicial material review of the abusive resolutions in Spain seems to be different since the reform. Prior to the 2014 Spanish Corporate Law Reform, the *subjective point of view* was key to considering whether a resolution was imposed abusively. However, Art. 204 para. 1 subpara. 2 LSC

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[45] AP Madrid, 1 July 2011, N° 221/2011.

now imputes an *objective point of view*. The previous position was due both to the restrictive application of Art. 7 para. 2 CC and to the traditional reluctance of courts to assess corporate resolutions. Note that judicial review of abusive resolutions implies a re-examination of the majority's assessment of the corporate interest. As the resolution is made in the framework of the freedom of enterprise, judges have been traditionally cautious in order to avoid undue interference in decision-making. However, judges are now expressly empowered by virtue of Art. 204 para. 1 subpara. 2 LSC to assess the necessity, convenience or adequacy/proportionality of the decisions made in the context of the business strategy for the development of the business activity, when they are made to the benefit of the majority and to detriment of the minority.[46]

It is however important to note that, although judges have been traditionally reluctant to interfere, this kind of judicial review featured in some Spanish court decisions before the reform. This mainly concerned other grounds for challenging general meeting resolutions or even concerning the criminal offence in Art. 291 CP, such as in Judgment N° 99/2002, of 25 November 2002, adopted by the *Audiencia Provincial de Murcia*. This judgment held that "the solution opted for was *neither the only one nor the best*" available as a reaction to the market conditions the corporation was experiencing.[47] Similarly, Judgment N° 195/2015 of 31 July 2015, adopted by the *Audiencia Provincial de Baleares* stated that

> "*the defendant has justified neither the necessity nor the convenience of the change of the registered office* […] this court considers that, even if there is a majority that supports the decision to change the registered office, *it would only lead to disadvantages and to the increase of costs*, to the detriment of the shareholders, and it would be made for mere comfortability and convenience [of some shareholders – the majority], *which finds no justification and has no sense*".[48]

In this case, the decision concerned a change of the registered office which was challenged as contrary to the law, as no report justifying the decision had been issued (Art. 285 LSC, where it is about an amendment of the by-laws in the Public Limited Liability Company, *sociedad anónima*).

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[46] Of course, as *T. Martínez Martínez*, Los acuerdos adoptados con abuso de mayoría en perjuicio de los socios minoritarios, RDM 310 (2018) 4, 10 and 11, warns, this review cannot become a means of solving mere disagreements among shareholders on the business strategy and, therefore, a means for the minority to impose its viewpoint.

[47] Emphasis added. Original : "La solución propuesta por no era la única, ni la mejor", translation, author's own.

[48] Emphasis added. The original language states: "la demandada no ha justificado cabalmente ni la necesidad ni la conveniencia del traslado de domicilio social […] estima este Tribunal que, aunque haya una mayoría social que apoye el cambio de domicilio, ello sólo provocaría desventajas e incremento de costes, en perjuicio de todos los accionistas, y ello se haría por mera comodidad y conveniencia, lo cual ni está motivado ni tiene sentido", translation, author's own.

In addition, it is important to consider the application of these criteria to some general meeting resolutions. Some resolutions adopted at the general meeting are "justified by themselves", such as for instance, the voluntary winding-up of the corporation or the dismissal of a member of the board appointed in the exercise of the minority right to do so (in Spain, Art. 243 LSC, regulating proportional representation). In that case, the decision cannot be assessed with regard to necessity, convenience or proportionality criteria. Hence, the "unjustifiable" detriment can only be assessed from a subjective point of view, that is to say, considering the intention to cause damage and the circumstances under which the decision was made (for instance, in light of previous disagreements among shareholders). Note that proof is easier for the minority to provide if the majority justified the decision with specific reasons, as happened in the cases decided by the Spanish Supreme Court in Judgment N° 653/2008, of 2 July 2008 and Judgment N° 830/2011, of 24 November 2011. In these cases, the court could assess the reasons allegedly used by the majority when adopting decisions at the general meeting. In the end, as the decisions were in fact not based upon those reasons, both cases proved the anomalous exercise of the power to dismiss *ad nutum* directors.

In another vein, as mentioned in the previous sections, the wording of Art. 204 para. 1 subpara. 2 LSC suggests the judicial review of suspected abusive resolutions goes through two different tests, each one divided into two different stages. It is questionable, though, whether this is really what the lawmaker of the Spanish reform wanted. In fact, this question is probably to be answered in the negative, as it seems that the lawmaker only intended to bring to an end the cases of general meeting resolutions considered lawful only because of a minimal (even disproportionate) justification. In practice, one test would be enough to achieve that intent, and bring together all the above mentioned considerations. Assessment would then focus whether there is or is not a "reasonable justification" for the general meeting resolution to be made, as in Judgement N° 79/2016, of 19 February 2016 by the *Audiencia Provincial de Pontevedra.*[49]

As far as the burden of proof is concerned, the Spanish Supreme Court has stressed that the requirements for considering the decision detrimental to the corporate interest (*traditional* ground), the damage, the benefit to one or various shareholders or to a third party and the cause-effect relationship, should be proven by the party making the allegation.[50] In fact, Art. 217 para. 2 of the Spanish Civil Procedure Law (*Ley de Enjuiciamiento Civil,* LEC)[51] stresses

[49] In AP A Coruña, 16 May 2019, N° 191/2019, the Court considers the decision to increase capital as "duly justified". In JM Barcelona, 6 October 2018, N° 50/2018, the decision to distribute 50% of the profits and to retain the rest was deemed to find no justification.

[50] TS, 17 January 2012, *supra* note 24.

[51] *Ley 1/2000, de 7 de enero, de Enjuiciamiento Civil.*

that whereas the claimant should provide evidence of the *constitutive* facts on which the action is based, the defendant should provide evidence of the *impeding* facts. However, if applied to the ground for challenging abusive resolutions, this general rule on the burden of proof in Art. 217 LEC would lead to the claimant having to provide evidence of a *negative* fact (that the general meeting resolution is *not* a reasonable response to a given need or to a given convenience of the corporation). For that reason, it would be convenient to apply the rules in Art. 217 LEC and, therefore, to take into consideration the criteria of availability and proof proximity provided in Art. 217 para. 7 LEC. Ultimately, it is easier for the majority to prove that the decision was justified than for the minority to prove that is not the case.

A different matter is that in some cases, the law requires a justification report be issued for a decision to be made at the general meeting. If so, the minorities could question the reasons for the decision as outlined by the majority in this report. In the Judgment N° 248/2018 of 30 July 2018, adopted by the *Juzgado de lo Mercantil Nº 2 de Bilbao* (upheld by Judgement Nº 694/2019 of 26 April 2019, adopted by *Audiencia Provincial de Vizcaya*), the court expressly stressed that the decision is concluded to have been imposed abusively because the corporation did not provide enough evidence of the need for that decision to be made. The general meeting had decided on a capital increase, based on the supposed need to obtain liquidity to pay short-term debts the corporation was apparently facing. However, once the capital increase took place, the funds raised thanks to the capital increase were not used to pay these supposed debts.

Finally, a review of the reasonableness of the general meeting resolution, as this provision leads to, does not mean that the courts are generally empowered to replace the will of the corporation. Judgment N° 357/2017 of 12 September 2017, adopted by the *Audiencia Provincial de Barcelona*, has clearly pointed out this idea, as it states that

> "it is true that the possibility of judicial interference, when assessing whether the decision that sets the director's pay was detrimental to the minority or not, cannot lead to a substitution of the freedom of shareholders' decision-making, which stems from the freedom of enterprise. *Judicial review cannot lead to the setting of reasonable pay, substituting the will of the general meeting*. The judge can only assess whether the decision is abusive or not […]. To sum up, *it is just a minimum*, not maximum, *reasonableness* review".[52]

[52] Emphasis added. Spanish original: "esa capacidad de interferencia que puede ejercitar el juez a la hora de analizar si el acuerdo fijando la retribución del administrador era perjudicial para la minoría no puede sustituir el libre albedrío de los socios, que deriva del principio de libertad de empresa. El control judicial no debe alcanzar a determinar cuál es la retribución razonable, sustituyendo a la voluntad de la junta general, sino que se debe limitar a examinar si el acuerdo de la junta supone o no un abuso de derecho, esto es, un abuso por parte de la mayoría de su posición en la sociedad. En definitiva, se trata de un

In short, the judicial review set forth in Art. 204 para. 1 subpara. 2 LSC consists of determining whether the general meeting resolution is abusive or not. If that is the case, the court will decide its annulment. Where the general meeting resolution is a so-called "negative decision", the mere annulment of the decision may not lead to satisfactory results in terms of minority protection.[53]

As regards the retention of profits, Judgment N° 116/2019 of 25 March 2019, adopted by the *Audiencia Provincial de A Coruña*, stresses that the retention of profits can never be considered a decision detrimental to corporate assets. It also pointed out that, in some cases, such a decision may be necessary and, in other cases, it might be a reasonable and cautious decision. However, it is also stressed that this decision might be a means of *tunnelling,* where, for instance, it allows majority shareholders to allocate corporate assets for themselves via directors' remuneration, to prepare the conditions to push a minority shareholder to exit or to make use of the accumulated reserves to finance a company of the same group in whose share capital the minority does not participate. In this particular case, the corporation's policy had traditionally been the retention of profits while the minority shareholder was compensated via remuneration as a director. The court considered the dismissal of the minority shareholder as a director had changed this scenario and that, therefore, the continuation of the same policy of retention of profits had become beneficial only to the majority shareholder and detrimental to the minority.

However, in these cases the minority does not find protection in the mere annulment of the decision to retain profits (which might be facilitated thanks to the new ground for challenging general meeting resolutions)[54], but where

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control de mínimos de razonabilidad, no de máximos", translation, author's own. In the same line, see AP Barcelona, 17 April 2019, N° 746/2019, also concluding that the remuneration was disproportionate to the circumstances of the corporation.

[53] On so-called "negative decisions", see in Spanish literature: *F. Marín de la Bárcena*, Proclamación de acuerdos y accíondes declarativas del resultado positivo de una votación, RDM 275 (2010) 197, *passim*; *F. Marín de la Bárcena*, La impugnación de acuerdos negativos, in: Rodriguez Artigas/Farrando Miguel et al. (eds.), El nuevo régimen de impugnación de los acuerdos sociales de las sociedades de capital (Madrid 2015) 277 et seq.; *M. Iribarren Blanco*, La impugnación de los acuerdos negativos de la junta general, RDM 304 (2017) 165, *passim* or *M. B. González Fernández*, Sobre la posibilidad de impugnar los acuerdos negativos de la junta general, in: González Fernández/Cohen Benchetrit (eds.), Derecho de Sociedades. Cuestiones sobre órganos (Valencia 2019) 1370 et seq.

[54] Note that the retention of profits may be the result either of a "positive decision" on the retention of profits (where the proposal submitted at the general meeting is the "retention of profits") or the result of a "negative decision", where the proposal consists in "distributing a given amount of profits", which is later rejected at the general meeting. In addition, it may also be the case that the proposal is set in negative terms (for instance, the proposal consists in "not distributing profits") and the majority votes for such proposal.

the courts order the corporation to distribute the retained profits.[55] In that sense, the Spanish courts have been traditionally reluctant to order a distribution of profits, based on the idea that it would lead to an undue interference in the corporation's decision-making.[56] Exceptionally, there is some precedent ordering a distribution of profits[57] or even where the court has ordered the distribution of profits of (or, at least) a given amount.[58] For example, Judgment N° 418/2005 of 26 May 2005, was adopted by the Spanish Supreme Court[59] and some Courts of Appeal have ruled along these lines in recent years, as in Judgments N° 117/2016, of 1 April 2016 and N° 181/2018, of 16 March 2018, both adopted by the *Audiencia Provincial de Madrid*. Additionally, Judgment N° 116/2019, of 25 March 2019 by *Audiencia Provincial de A Coruña* ordered the distribution of, at least, 75% of the distributable profits. In this case, the corporation had once made a distribution in such amount back in 2012, before the disagreements among the shareholders.

The matter of effective minority protection after a negative decision is declared null and void is still under discussion. Apparently, the new provision,

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[55] See *J. Alfaro Águila-Real / J. Campins Vargas*, El abuso de la mayoría en la política de dividendos. Un repaso por la jurisprudencia, Revista Otrosí 5 (2011) 19, 25 and 26. In the same line, see *Fleischer / Trinks, supra* note 37, 290. At any rate, it is important to note that, regarding the retention of profits, Art. 348 bis LSC, is now in force. This provision foresees an exit right (subject to some conditions) in case of non-distribution of profits. Thus, minorities seem to have a dual protection, in terms of the retention of profits. In fact, Art. 348 bis LSC makes express reference to the possibility of a challenge. Consequently, the existence of an alternative protection to the action to challenge probably leads to a reduction of the actions seeking to void the general meeting resolutions not to distribute profits (*Martínez Martínez, supra* note 46, 14). On Art. 348 bis LSC see *F. Arias Varona* in this book, p. 65.

[56] AP Barcelona, 7 May 2014, N° 154/2014.

[57] In JM Madrid (N°12), 5 March 2018, N° 35/2018, the Judge only declares void the decision not to distribute profits and, therefore, rejects the claim to order the corporation a distribution of profits *in the specific* amount claimed by the minority. The resolution did stress that, as the decision on this point by the general meeting is a binary decision, a distribution of profits is to be decided, since the other alternative, the non-distribution, has been considered abusive.

[58] In JM Barcelona, 6 October 2018, *supra* note 49, the corporation is ordered to distribute all the profits obtained in 2014. In this case, the general meeting had decided to distribute 50% of the benefits obtained in 2014 and to retain the other 50%, which was deemed abusive, as the corporation had an incredibly high level of reserves, which did not justify the retention of 50% of the profits. After having declared the decision void, the judge orders the distribution of *all* the distributable profits obtained in 2014. The judge pointed out that the exceptional circumstances of the facts justified a deviation from the criteria set forth by AP Barcelona, 7 May 2014, *supra* note 56. The reason therefor is that any other distribution, different from the total distribution, would also be abusive in the specific case.

[59] In the Judgment adopted by the Appeal Court, the Court had ordered the distribution of all the distributable profits, which was upheld by the Spanish Supreme Court in its Judgment N° 418/2005, 26 May 2005.

has not changed this scenario, as its effects seem to be limited to simply facilitating the annulment of the abusive resolutions.[60]

IV. Conclusions

The 2014 Spanish Corporate Law Reform, made express reference in the LSC to the abuse of majority as a ground for challenging general meeting resolutions. Thus, after listing the grounds for challenging a resolution in its first paragraph (violation of the law, detrimental to the corporate interest, violation of the by-laws and violation of the internal regulations of the general meeting),[61] Art. 204 para. 1 subpara. 2 LSC states that "damage to the corporate interest is also caused when the resolution, even without causing damage to the corporate assets, is imposed abusively by the majority. A resolution is imposed abusively where, without responding to a reasonable need of the corporation, it is approved by the majority for its own benefit to the unjustifiable detriment of the rest of shareholders". Prior to the 2014 Reform, the minority could base its action to challenge abusive resolutions on two different grounds. Where the general meeting resolution was also *harmful* to the corporation, it was considered detrimental to the corporate interest. On the other hand, where this was not the case, the resolution could still be subject to challenge based on the existence of an infringement of law, as being contrary to Art. 7 para. 2 CC, which contains the prohibition on abuse of rights. However, this option did not lead to satisfactory results in terms of minority protection, as Art. 7 para. 2 CC was (and is) an exceptional remedy, which has

[60] As regards negative decisions, JM Pontevedra (Nº2), 14 June 2019, N° 119/2019, is of particular interest. The Judgment describes the current situation both in the literature and in the case law on the so-called negative decisions. In the case, the business activity of the corporation had changed *de facto* and the minority shareholder submitted to the general meeting the amendments of the by-laws, so that the business activity could be modified in the by-laws and the minority shareholder could make use of his exit right (Art. 346 para. 1. lit. a LSC). The majority shareholders voted against and the proposal was rejected at the general meeting. According to the Judge, the rejection was not justified and the amendments of the by-laws in the sense of the proposal submitted at the general meeting by the minority was the only alternative to the negative decision. However, the claim was rejected in the end, as the claimant had not claimed a judicial declaration of the decisionbe made. In the judgment, it is expressly stated that if the claimant had so claimed, the judge would have declared the decision as made, but that judges cannot decide on what has not been claimed. According to the Judge, this makes the entire claim, which is rejected, have no sense, as it also happens in AP Barcelona, 25 July 2014, N° 280/2014.

[61] In the original Spanish, Art. 204 para. 1 subpara. 1 LSC states: "son impugnables los acuerdos sociales que sean contrarios a la Ley, se opongan a los estatutos o al reglamento de la junta de la sociedad o lesionen el interés social en beneficio de uno o varios socios o de terceros", translation author's own.

only been applied where the decision was made with intent to cause damage or, at least, where a clear disregard for the interests of the other shareholders could be assumed. Therefore, Art. 7 para. 2 CC was (and still is) applied restrictively. Specifically, the 2014 Corporate Law Reform in Spain is aimed at providing better protection to the minority in this field.

Although a consensus has not been reached, it should be considered that the new ground in Art. 204 para. 1 LSC reflects both the existence and the content of a duty of fidelity among shareholders. In fact, Art. 204 para. 1 subpara. 2 LSC provides a description of what the corporate lawmaker considers the behavior a shareholder must verify by virtue of such duty of fidelity. To this extent, despite the fact that the definition of such duty of fidelity is set forth in the framework of the regime for challenging general meeting resolutions, it does not only refer to the exercise of voting rights. This is because the duty of fidelity extends throughout the relationship stemming from the corporate contract.

Assessing whether or not the reform has led to significant changes in terms of the protection of minority shareholders in Spain, the first conclusion is that, compared to the situation prior to the 2014 Corporate Law Reform, minority shareholders now seem to have an easier means of challenging general meeting resolutions. Note that it is not necessary to base the action to challenge on an abuse of rights (Art. 7 para. 2 CC). In other words, it is no longer necessary to base the challenge on a previous infringement of law, as there is now an explicit ground concerning abusive resolutions. In contrast, minority shareholders find protection in Germany by basing their challenge on a previous infringement of law, specifically, on an infringement of a general clause, the duty of fidelity among shareholders (§ 243 para. 1 AktG).

This does not mean that Art. 7 para. 2 CC no longer has a role to play. Although it is true that it no longer applies to general meeting resolutions now covered by the second paragraph of Art. 204 para. 1 LSC, it does still apply as an exceptional remedy where a resolution does not fall within the scope of Art. 204 para. 1 subpara. 2 LSC. This could be the case where the general meeting resolution is not made to benefit the majority (thus, one of the requirements to consider the resolution is abusive would not be met) or where the resolution is not detrimental to the minority, but to a third party.[62]

In addition, the number of resolutions subject to challenge appears greater now than it was before the reform. As mentioned before, Art. 7 para. 2 CC is applied restrictively. Effectively, only those resolutions made with the exclusive intention of damaging the minority were subject to challenge. This meant only a small number of general meeting resolutions were subject to challenge prior to the reform, while the remaining (vast majority) of cases were not

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[62] As regards the latter case, see TS, 14 February 2018, *supra* note 8, and TS, 15 February 2018, N° 87/2018.

contestable. Given the structure of Art. 204 para. 1 subpara. 2 LSC, the reform has changed this approach. According to the requirements under which a general meeting resolution is deemed to have been imposed abusively, the first requirement is that the resolution is not a response to a "reasonable need of the corporation". In other words, there is a *safe harbor* (where the resolution is not subject to challenge), where the general meeting resolution is borne out of a reasonable need of the corporation. As most corporate decisions are not made under circumstances of genuine necessity, this means that, at first glance, the spectrum of general meeting resolutions that can benefit from the *safe harbor* (and cannot be contested) is small. Although the existence of a second test makes such spectrum increase in the end, the possibilities for challenging abusive resolutions has now changed in Spanish corporate law since the reform.

The judicial material review of abusive general meeting resolutions in Spanish corporate law also seems to be different now than it was before. Prior to the reform, a resolution was determined to be abusive or not from a *subjective point of view*. With Art. 204 para. 1 subpara. 2 LSC, review can now take an *objective point of view*. The previous position was due both to the restrictive application of Art. 7 para. 2 CC and to the traditional reluctance of courts to assess decisions made by the corporate bodies. Note that judicial material review implies a re-examination of the assessment of the corporate interest already made by the majority. As the decision is made in the framework of the freedom of enterprise, judges have been traditionally cautious in order to avoid an undue interference in decision-making. However, judges are now expressly empowered by the lawmaker by virtue of Art. 204 para. 1 subpara. 2 LSC, to assess the necessity, convenience or adequacy/proportionality of the decisions made. This assessment considers the context of the business strategy for the development of the business activity, when the resultant decisions benefit the majority to the detriment of the minority. It is however important to note that, although judges have traditionally been reluctant, this kind of judicial review was occasionally done by the Spanish courts before the reform, for other grounds for challenging general meeting decisions or even concerning the criminal offence in Art. 291 CP.[63]

Moreover, in striking a balance between the freedom of enterprise and the protection of minorities, the new provision does not expressly allow judges to replace the will of the corporation. In contrast to the situation prior to the reform, Art. 204 para.1 subpara. 2 LSC implies that judges can do more than just determine whether there is an *exclusive intention to damage or not*. Now Spanish courts are empowered to assess the reasonableness of general meeting resolutions, by determining whether the general meeting resolution is

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[63] See AP Murcia, 25 November 2002, N° 99/2002, or AP Baleares, 31 July 2015, N° 195/2015.

abusive or not. If that is the case, the court will annul the resolution. The possibility of replacing the will of the corporation is a different matter.

Precisely for that reason, the existence of the new ground for challenging general meeting resolutions in Spanish law does not completely solve the question regarding the protection of minority shareholders where it concerns what is referred to as a "negative decision." Note that there are cases where the minority might not be effectively protected by simply challenging the "negative decision", but when obtains a judicial declaration of a given general meeting resolution.[64] As regards the retention of profits, which is one of the most common examples of abuse by majority, the Spanish courts have traditionally been reluctant to order a distribution of profits, based on the idea that it would lead to an undue interference in the corporation's decision-making. Exceptionally, there are some instances where this has occurred, and in fact, some Courts of Appeal are ruling now in this line.[65]

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[64] JM Pontevedra (Nº 2), 14 June 2019, *supra* note 60.

[65] See AP Madrid, 1 April 2016, N° 117/2016; AP Madrid, 16 March 2018, N° 181/2018; AP A Coruña, 25 March 2019, N° 116/2019.

Shareholder Control over Executive Pay

Fernando Marín de la Bárcena[*]

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I. Introduction

Companies falling under the category of 'closed companies' or 'family firms' most commonly have majority shareholders, or companies or individuals related to them, who are also directors of the company. Thus, establishing high, sometimes 'excessive', remuneration for the directors, especially executive directors, is a device frequently used by majority shareholders to expropriate minority shareholders, among other mechanisms that unfairly prejudice against them (for instance, refusing to declare dividends, hindering the exercise of information or voting rights or passing capital increases that the company does not need which result in a dilution of existing shareholdings).

It might be useful to emphasize that, according to Spanish law, minority shareholders do not have a right of exit in cases of "oppression" (such as the 'unfair prejudice remedy' provided in Secs. 994 et seq. of the UK Companies Act [CA][1]). There is a right of exit if, under certain circumstances, the company does not declare a minimum dividend each financial year (Art. 348 bis of the Spanish Corporations Act [*Ley de Sociedades de Capital*, LSC][2]), but,

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[1] *United Kingdom Companies Act*, Chapter 46 2006, <https://www.legislation.gov.uk/ukpga/2006/46/contents>.

in fact, such dividend may not be declared if the operating expenses of the company are inflated by excessive remuneration for the directors.

Consequently, legislation concerning directors' remuneration is a key point in corporate governance for closed companies and protecting minority shareholders must be a key point of such legislation, as remarked by the Spanish Supreme Court in a highly significant ruling given on 26 February 2018.[3]

This paper analyzes Spanish legislation concerning directors' remuneration, both procedural and substantive rules, in connection with the principle of "adequate remuneration." After explaining the legal regulation, deeply reformed in 2014, we will focus on the consequences of the infringement of such regulation from a tax and company law perspective.

II. Regulation of Directors' Remuneration in Spain

1. Nature and Scope of the Regulation

The legislation covering directors' remuneration is mandatory in nature, so a company's articles of association or bylaws may differ only if expressly authorized by law. Such legislation applies to any remuneration paid for the performance of the duties inherent to the position of director, regardless of the form of payment chosen by the parties, so it is important to start by highlighting the scope of application of the legal regime.

According to the so-called "corporate approach", created by the Employment Law Division and developed by the Civil Law Division of the Spanish Supreme Court, a director cannot have multiple contractual relationships with the company for the performance of the duties inherent to the position of director. Contracts such as "senior management labor contracts", "commercial consulting agreements" or "work for hire agreements", if related to the management of the company, form part of the corporate relationship and are subject to the legal requirements of directors' remuneration. In other words, the company law relationship absorbs contractual relationships under employment or commercial law. The above case law reached its climax in two famous judgments of the Supreme Court (Judicial Review Division) of 13 November 2008,[4] where the established legal doctrine of the Supreme Court's civil and labor law divisions was collected and applied to a matter concerning the tax deductibility of remuneration paid by a company.[5]

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[2] *Real Decreto Legislativo 1/2010, de 2 de julio, por el que se aprueba el texto refundido de la Ley de Sociedades de Capital*.

[3] TS, 26 February 2018.

[4] TS, 13 November 2008, RJ 2009, 59 and 453.

[5] As a result, the legal regime, established for the protection of minority shareholders, cannot be circumvented by concluding a senior management "employment" contract or a

On the contrary, legislation concerning directors' remuneration does not apply to the director's performance of other services for the company that are external to his position as director, for example contracts for *legal* or *engineering* services. In private limited companies (but not in public limited companies) the establishment of these kinds of contracts between the company and its director require a resolution of the general shareholder meeting (Art. 220 LSC). All shareholders, including directors of the company are allowed to vote (Art. 190 para. 1 LSC).

In order to offer a complete picture of the legal regime concerning directors' remuneration, it must be also stressed that the regulation applies only to the remuneration paid to the director by the company managed by him and not, for example, to remuneration paid to the director by a member who has designated the director to defend his interests in the company (nominee directors). Such "external remunerations", are regulated under the perspective of the directors' duties of loyalty. According to Art. 229 para. 1 lit. e LSC, it is illegal to obtain advantage or remuneration from third parties other than those received from the company and its group for the discharge of directorial duties, except for small gifts. The rationality of such a prohibition is to protect the directors' independence but the general meeting may adopt a resolution to exempt directors from this prohibition.[6]

After explaining the nature and scope of the legislation, we will analyze its content, which is based on two sets of rules concerning: (i) recognizing and approving remuneration for all kinds of directors (Arts. 217 paras. 1 to 3) while respecting some special rules which apply to executive directors (Art. 249 para. 3 LSC) and (ii) establishing some limits and guidelines to guarantee that the remuneration is adequate for the corporate interest (Art. 217 para. 4 LSC). A special body of rules applies to listed companies, which will be briefly explained in order to facilitate a better comprehension of the entire system (Arts. 529 sexdecies et seq. LSC).

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freelance "work for hire" agreement with a director under which the board of directors and the "engaged" director had free rein to agree amongst themselves the latter's remuneration and benefits, see *F. Marín de la Bárcena*, Compatibilidad de la retribución como administradores y altos cargos de sociedades de capital: comentario a la STS 1ª de 24 de abril de 2007 (RJ 2007, 2418), RdS 30 (2008) 421, 435. For afurther explanation of a different perspective, *C. Paz-Ares*, El enigma de la retribución de los consejeros ejecutivos, InDret 2 (2008) 15, 88.

[6] See *C. Paz-Ares*, Identidad y diferencia del consejero dominical, in: Juste Mencía/Espin Gutiérrez (eds.), Estudios sobre órganos de las sociedades de capital. Liber amicorum Fernando Rodríguez Artigas y Gaudencio Esteban Velasco, Vol. I (Cizur Menor 2017) 39, 113 who points out that indemnities granted by the shareholders to the directors may be a sort of external remuneration, which threatens the directors' independence and therefore must not be authorized by the general meeting.

2. Procedural Issues

a) Rules applicable to all kinds of directors

In the first place, it must be taken into account that, according to the law, in closed companies "the position of director is not remunerated, unless the articles of association provide otherwise when establishing the remuneration system" (Art. 217 para. 1 LSC). On the contrary, the position of director of listed companies, which must be ruled by a Board of Directors, will be necessarily remunerated (Arts. 529 bis and 529 sexdecies LSC).

For closed companies, the law also contains a list of items which may be used in the articles of association in order to define this remuneration system (Art. 217 para. 2 LSC). These include: a) fixed fees; b) per diem; c) profit-sharing; d) variable remuneration with general benchmark indicators or parameters which may be external (CPI, GDP, etc.) or internal (profits, corporate income tax base, cash flow, etc.) or by referral to other amounts (e.g. three times the collective bargaining agreement salary for area managers, a multiple of the national minimum wage, etc.); e) remuneration in shares or pegged to their performance (such as an "exit bonus"); f) compensation for loss of office, unless the director is removed for non-performance before expiry of the term of office; and g) savings or pension schemes the company deems appropriate. It is a non-comprehensive list so, in practice, it is common to include more items, such as, post contractual non-competing payments or D&O insurance payments (although it is not completely clear if such payments constitute remuneration).

There is a general consensus, and several decisions of the Directorate-General for Registers and Notaries of the Ministry of Justice (DGRN), determining that the articles of association cannot authorize the general meeting to decide whether or not paying remuneration is appropriate, nor authorize the general meeting to freely choose among several alternative items. If several remuneration items are determined, these apply cumulatively but not in the alternative.[7]

The second issue which must be taken into account is that the general shareholder meeting must pass a resolution approving the maximum amount of annual remuneration to be paid to the directors "*as a whole*" and the resolution shall remain in effect until an amendment of that amount is approved (Art. 217 para. 3 LSC). As will be explained later, holding this general meeting and, if needed, challenging the resolution which establishes the total amount of remuneration, is the principal protection for minority shareholders

[7] The aim of these decisions was to protect directors from a unilateral decision of the general meeting, see DGRN, 7 June 2014. This should however not be a problem, the company and the directors usually sign a directors' service contract, to prevent the general meeting infringing unilaterally on the remuneration items stipulated in the contract.

from majority decisions establishing an excessive remuneration, usually in the context of a conflict between them.

If there are several directors (whether joint, joint and several directors, or members of the board of directors), unless the general shareholder meeting has already determined the specific amount to be paid to each director, directors shall resolve the distribution of the remuneration amongst themselves. In any case, according to the law, such distribution must take into consideration the duties and responsibilities assigned to each director (Art. 217 para. 3 sent. 2 LSC).

A special regulation applies to remuneration by way of profit sharing or based on stock options. Pursuant to Art. 218 LSC, if the remuneration is based on profit sharing, the articles of association of a public limited company must specify the participation or maximum percentage of profit sharing. In the latter case, the general shareholder meeting will determine the applicable percentage, up to the maximum provided in the articles of association. By contrast, in private limited companies, the maximum percentage of participation may not exceed 10% of the profits payable to the shareholders. In addition, in public limited companies, participation may only be subtracted from net profits once the reserves required by law or by the articles of association have been funded and a dividend of 4% of the nominal value of the shares or the percentage set by the articles of association, has been declared.

Pursuant to Art. 219 LSC, public limited companies with remuneration systems that include share incentive or stock option schemes, or which are pegged to the share price, must be included in the articles of association and approved by the general meeting. The general meeting resolution must include the maximum number of shares that may be allocated each year through this remuneration system; in the case of options, the call price or the system for calculating the call price; or the share price to be used, as the case may be, as a benchmark and the period fixed for the duration of the plan. There is no similar legal provision for private limited companies, although it would be possible to establish a share incentive scheme by way of a provision in the articles of association, provided an evaluation system is established and approved by the general meeting on an annual basis.

b) Special rules for executive members of the board

Some additional rules apply if the governing body of the company is organized as a Board of Directors and the Board decides to assign executive functions to one or more members of the board in addition to supervisory or control functions inherent to the position of board member ("mere directors"), and to remunerate these executive functions separately.

In the first place, it is important to identify if there is a real conferment of executive functions. The mere granting of a power of attorney to a director

does not constitute an assignment of executive functions. Executive directors are considered to be those that only perform executive functions at the highest level of business management and who are subject only to the supervision of the board. If there are intermediaries between the board and the executive director, the relationship between the company and the director as executive is subject to labor law (for example, when a board member acts simultaneously as CFO, when the role reports to, and is managed by a CEO).

In the second place, according to Art. 249 para. 3 LSC, executive directors (i.e., managing directors, members of executive committees etc.) must sign a director's service contract with the company, previously approved by a two-thirds majority vote of the company's board of directors (and the affected director is not allowed to vote). Such contracts must list all the amounts and items of remuneration to be earned by the executive director for the performance of the executive functions and must be attached to the minutes of the board meeting (although the contract need not be registered with any public register)[8].

There has always been some scholarly debate concerning the legal nature of the relationship between the executive directors and the company. Some authors argue that, unless the director is at the same time a shareholder of the company, such relationship is purely contractual and falls under labor law. As a consequence, this relationship would not be regulated by company law.[9] Others claim that it is a commercial law contract or a typical service contract under the Companies Act, an opinion espoused in the judgment of the Supreme Court of 26 February 2018.[10]

The practice of a director signing a service contract has been accepted by Spanish practitioners, and not only for executive directors. Such contracts are

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[8] Regarding the approval of this contract in closed companies, note that directors have the duty to abstain from participating in any decision to be adopted by the Board of Directors if they (or individuals related to them) have a direct or indirect conflict of interest. For family firms, where members of the board are usually related persons, if a majority of the members of the board are in a conflict of interest situation, there will be a deadlock of the board and the approval of the directors' service contract will probably have to be referred to the general shareholder meeting.

[9] *Paz-Ares, supra* note 5; *J. Brenes Cortéz*, La retribución de los consejeros ejecutivos de las sociedades de capital. Comentario de la Resolución de la Dirección General de los Registros y del Notariado de 30 de Julio de 2015, RDM 299 (2016) 455 et seq.; *J. Alfaro*, Adiós a la teoría del vínculo, Almacén de Derecho, 16 December 2015 (<https://almacendederecho.org/adios-a-la-teoria-del-vinculo>).

[10] TS, 26 February 2018, *supra* note 3; *J. Juste Mencía/A. Campins Vargas*, La retribución de los consejeros delegados o de los consejeros con funciones ejecutivas. El contrato entre el consejero ejecutivo y la sociedad, in: Roncero Sánchez (ed.), Junta general y consejo de administración en la sociedad cotizada, Vol. II (Cizur Menor 2016) 757, 782; *F. J. León Sanz*, in: Juste Mencía (ed.), Comentario de la reforma del régimen de las sociedades de capital en materia de gobierno corporativo (Ley 31/2014) (Cizur Menor 2015) Art. 249, 508.

used to define certain terms and conditions of the relationship between the director and the company which are not covered by company law provisions and which tend to be disregarded in practice, such as details of the provision of services, duties of confidentiality, the prohibition of post-contractual competition, retention clauses in the event of change of control, reinforcement of the competition prohibition, use of company property etc. According to the decision of the DGRN of 12 December 2018, a contract must also be signed if the executive director does not receive any remuneration for performing the executive functions or powers assigned by the board.[11]

Finally, as declared by the Spanish Supreme Court in an important decision passed on 26 February 2018, the remuneration of the executive members of the board must be: (i) within the items of remuneration established in the articles of association according to Art. 217 para. 2 LSC and (ii) within the maximum amount of the annual remuneration to be paid to all the directors as set by the general meeting according to Art. 217 para. 3 LSC. As a result, were the board to sign an executive directors' service contract which was not covered by the articles of association (or which was beyond the limits established by the general shareholder meeting), it would be considered illegal and an abuse of the powers of the board.[12]

For listed companies, the law establishes two systems of different rules based on the distinction, between the remuneration of directors performing executive functions and remuneration of mere directors or directors "in such capacity" whose role is basically one of oversight or supervision. As established for non-listed companies, the remuneration of such directors must be within the remuneration provided for in the articles of association (Art. 529 septdecies LSC), but the items of the remuneration of executive directors will be only established in the remuneration policy adopted by the general meeting (Art. 529 octodecies LSC).

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[11] DGRN 12 December 2018. The decision appears to be clarfying the relationship between the company and the director, see *J. S. Calero Guilarte*, La retribución de los consejeros ejecutivos, in: Juste Mencía/Espin Gutiérrez (eds.), Estudios sobre órganos de las sociedades de capital. Liber amicorum Fernando Rodríguez Artigas y Gaudencio Esteban Velasco, Vol. II (Cizur Menor 2017) 353, 359 and *León Sanz, supra* note 10, 508. For us, it seems obvious that, unless the parties want to regulate some other issues of their contractual relationship, it makes no sense to sign a contract in order to stipulate exclusively that the executive function is not remunerated because Art. 217 para. 1 LSC establishes such gratuity as a general rule. Nevertheless, decisions of the DGRN are binding for Registrars, and practitioners tend to avoid problems by registering Board of Directors resolutions conferring powers of attorney for such directors. As a result, legal praxis consists of signing a short contract establishing that there is no remuneration.

[12] The Supreme Court judgement was harshly criticized by *C. Paz-Ares*, Perseverare diabolicum. A propósito de la STS 26-II-2018 y la retribución de los consejeros ejecutivos InDret 2 (2018) 1; and supported by *F. Marín de la Bárcena*, La retribución de los consejeros ejecutivos, RDM 309 (2018) 17 et seq.

The remuneration policy must necessarily include the maximum amount of annual remuneration payable to the directors as a whole in their capacity as members of the board (which does not include the performance of executive functions). The determination of the remuneration to be earned by each director lies with the board of directors, considering the duties and responsibilities assigned, membership of board committees and other objective factors deemed relevant (Art. 529 septdecies LSC). By contrast, the remuneration of directors with executive functions (executive directors) of listed companies must be established in the director's service contracts approved by the Board of Directors according to the remuneration policy for directors approved by the general meeting (Art. 249 para. 3 LSC). In this case, the remuneration policy includes the maximum amount of the fixed remuneration (not the total amount of all remuneration) and the "various parameters for fixing variable components and the main terms and conditions of their contracts, paying particular attention to their duration, compensation for early severance or termination of the contractual relationship and exclusivity, post-contractual non-competition, permanence and loyalty pacts" if any (Art. 529 octodecies para. 1 LSC). Any remuneration earned by directors for holding or losing their office and the performance of executive functions must be in accordance with the remuneration policy in effect, except for remuneration expressly approved by the general shareholder meeting (Art. 529 octodecies para. 2 LSC).

The remuneration policy must be prepared and evaluated by the remuneration committee composed exclusively of external or non-executive directors, two of which must be independent directors. The committee must also be presided over by an independent director (Art. 529 quindecies para. 1 LSC). The policy must be approved by the general shareholder meeting at least every three years as a separate item on the agenda, in accordance with Art. 529 novodecies LSC.

In addition, but restricted to listed companies only, the board of directors must approve and publish the annual report on director remuneration every fiscal year, providing full, clear and comprehensible information regarding the director remuneration policy for the current year, an overall summary of the application of this remuneration policy during the last fiscal year, and a breakdown of the individual remuneration received by each of the directors in that fiscal year. The report must refer to the remuneration that directors receive or should receive in their non-executive capacity, as well as the remuneration, if any, to which they are entitled for the performance of executive duties (Art. 541 paras. 1–2 LSC).

Every year, this annual report on director remuneration must be put to the vote at the general shareholder meeting as a separate item on the agenda for a consultative vote (Art. 541 para. 4 LSC). If the report is rejected in the consultative vote, the remuneration policy for the subsequent fiscal year must be submitted to the shareholders for approval at the general meeting prior to its application, even if the period of duration established for the policy has not yet lapsed.

The policy need not be approved for a second time if it was approved at the same general shareholder meeting at which the annual report on director remuneration was rejected in the consultative vote (Art. 529 novodecies para. 4 LSC).

Finally, for listed and non-listed companies, remuneration of any kind and for whatever reason accrued during the financial year by company directors must be included in the annual report accompanying the annual accounts (Art. 260 para. 11 LSC), unless the company is authorized to present an abbreviated report, as is usually the case for small and medium-sized enterprises.

c) *Policy matters and practical issues*

The judgment of the Supreme Court of 26 February 2018, quoted above, ended with a controversy that must be explained in order to fully understand the Spanish legal regime and how this regime could evolve in the future. The ruling dealt with the legal regime that applies to executive directors, which has always been controversial amongst scholars and practitioners.

Some scholars considered that the legal rules concerning directors' remuneration differed in terms of the complexity of the governing body. According to this opinion, there were rules which applied only to sole directors or two or more directors with joint-signature or sole-signature authority (simple structures) and special rules which applied only to the board of directors (complex structure). As a consequence, the duty to establish the items of remuneration in the articles of association (Art. 217 para. 2 LSC) and the attribution of the power to set the total amount of directors' remuneration to the general shareholder meeting (Art. 217 para. 3 LSC) would only apply to the sole director, several directors, and members of the board of directors for the performance of the supervisory and control functions inherent in the position of members of the board. In contrast, remuneration of executive members of the board would be established in their directors' executive contracts approved by the board of directors (Art. 249 para. 3 LSC). This opinion was endorsed by the DGRN in its decisions of 30 July 2015 and 16 June 2016.[13]

This approach is based on the view that the assignment or delegation of executive functions to one or several of the members of the board is a purely managerial decision and created a contractual relationship between the executive director and the company which is different from the relationship between the company and the member of the board as such. The executive director relationship would be governed by the director's service contract formed under Art. 249 para. 3 LSC. The duty to establish items of remuneration in the articles of association and assign the general shareholder meeting the power to approve the total amount of the remuneration to be paid to the directors only applies to the members of the board in charge of supervisory functions and not to execu-

[13] DGRN, 30 July 2015; DGRN 16 June 2016.

tive members of the board directors. As with any managerial decision, shareholders of the company could influence the board in deciding the remuneration of the executive directors through instructions (Art. 161 LSC).[14]

Conversely, some scholars consider that the distinction between rules which apply to the members of the board as such and rules applying to members of the board with executive functions only acquire legal meaning for listed companies where special rules apply to remuneration for board members with supervisory functions (Art. 529 septdecies LSC) and board members with executive functions (Art. 529 octodecies LSC).

The special rules for listed companies ensure a certain level of shareholder protection because: (i) the latter have a voice on executive pay (approving the remuneration policy for directors and, on an advisory basis, the annual report on directors' remuneration) and (ii) remuneration is designed, prepared and evaluated by a special committee composed exclusively of external or non-executive directors, two of whom must be independent directors. For closed companies however, it makes no sense to exclude the executive directors' remuneration from the legal controls established by the law to protect the position of the shareholders, i.e., by establishing the items of the remuneration in the articles of association (Art. 217 para. 2 LSC) and conferring the power to approve the maximum amount to be paid to all the directors, including executive directors to the general meeting (Art. 217 para. 3 LSC). As a result, in accordance with the purpose of the amending Act of 2014[15] (which improved shareholder control over directors' remuneration), executive directors' remuneration must be within the rules established in the articles of association (Art. 217 para. 2 LSC) and within the quantitative limits fixed by the general meeting (Art. 217 para. 3 LSC) for all directors (including executive directors), as was ultimately stated by the Supreme Court.[16]

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[14] See *Paz-Ares, supra* note 5, 15–88.

[15] *Ley 31/2014, de 3 de diciembre, por la que se modifica la Ley de Sociedades de Capital para la mejora del gobierno corporativo*.

[16] This was the position defended by *L. Fernández del Pozo*, El misterio de la remuneración de los administradores de las sociedades no cotizadas. Las carencias regulatorias de la reforma, RDM 297 (2015) 199–248; *C. Guerrero*, La retribución de los consejeros ejecutivos en sociedades cerradas, in: Juste Mencía/Espin Gutiérrez (eds.), Estudios sobre órganos de las sociedades de capital. Liber amicorum Fernando Rodríguez Artigas y Gaudencio Esteban Velasco, Vol. II (Cizur Menor 2017) 985; *A. Roncero*, Retribución de los Consejeros Ejecutivos. Adecuación de la retribución y deberes de actuación de los administradores, in: Olmedo Peralta/Galacho Abolafio (eds.), Derecho de sociedades. Revisando el derecho de sociedades de capital (Valencia 2018) 1061, 1070–1071 and note 21; *F. Marín de la Bárcena*, La reforma de la retribución de los administradores de sociedades de capital, Análisis Gómez-Acebo & Pombo, Abril 2015, 4–5 (<https://www.ga-p.com/wp-content/uploads/2018/03/la-reforma-de-la-retribucion-de-los-administradores-de-las-sociedades-de-capital.pdf>).

Nevertheless, it is clear that establishing the items of the remuneration for executive directors in the articles of association of the company presents some practical disadvantages that practitioners have had to deal with.

The first concerns the need to amend the articles of association if, for example, a new executive director wants to be paid with an item which was not previously established. Repeated amending of the articles is expensive because of the fees that must be paid to the notary and the companies registrar. This problem can be resolved by establishing in the articles of association that the board of directors is authorized to select from a list of alternative items which could be included in the directors' service contract. This type of clause (called "a menu clause") is generally accepted in the Register of Companies.

The second practical problem is to determine what happens if, during the term of the director's service contract, the shareholders decide to amend the items of remuneration to be paid to directors in the articles of association or to reduce the total amount to be paid to directors in the financial year. Usually the contracts establish that an amendment of this kind to the articles of association or the remuneration to be paid in the financial year, would allow the executive director to resign with compensation for loss of office, although in our opinion there is no need to establish any express clause in the contract: the solution would be the same and the director could file for damages.

Finally, it is still unclear if the articles of association of the company, instead of establishing the items of remuneration and giving the board the right to choose among such items, could just give the board the power to negotiate and fix not only the items but also the total amount to be paid to executive directors. According to preceding decisions of the DGRN, such a provision would probably not be permitted, as it potentially undermines the intent of providing a minimum basis of protection for minority shareholders. Therefore, not even the shareholders themselves could dispense with such protection.

3. *The Principle of Adequate Remuneration*

Having explained the issues concerning the procedural requirements to be met in order to pay remuneration, we will focus on the so-called "principle of adequate remuneration" established by Art. 217 para. 4 LSC.

The law states that directors' remuneration must be proportionate to the size of the company, its financial situation at the time and the market standards of comparable companies. In addition, the remuneration system must: (i) encourage the company's long-term profitability and sustainability and (ii) include necessary precautions to prevent assuming excessive risk and rewarding poor performance (clawback provisions).

It is evident that in a context of conflict between majority and minority shareholders, considering the amount and configuration of the remuneration paid to the former is useful for determining if remuneration is adequate for

the corporate interest or not. As a result, it is a helpful guideline for challenging a resolution of the general shareholder meeting approving the amount of annual remuneration, or resolutions passed by the board of directors approving director service contracts for executive directors. Nevertheless, as all these legal requirements were introduced into the Spanish legal system for the first time in 2014, there is not yet a sufficient body of case law differing from that formed by the Supreme Court in 13 and 25 June 2012[17], labeling remuneration contrary to the corporate interest and social ethics as toxic.

III. Consequences of the Infringement of the Legal Regulation

1. Tax Law Perspective

The most important practical consequence for infringement of the procedural regulation, is that the remuneration paid to directors may not be considered tax deductible by the tax authorities. The Corporate Income Tax Act states that the expenses of actions "contrary to the legal system" are not tax deductible as expenses.[18] This is controversial because, at the same time, the Corporate Income Tax Act establishes that paying a director for the performance of executive director duties will not be considered a "gratuity" (which means that it would be tax deductible). Although this might be the correct solution, as there are no judicial precedents on this matter, tax experts recommend caution and fulfilling all the legal requirements to pay the remuneration by: (i) establishing the items of remuneration in the bylaws; (ii) approving the total amount of remuneration in the general shareholder meeting and (iii) for executive members of the board, approving a contract as per Art. 249 para. 3 LSC.

In any case, from a tax law perspective, the payment of excessive remuneration (which infringes on the principle of adequate remuneration established in Art. 217 para. 4 LSC), could be considered a "gratuity" and therefore "non-deductible" by the company.

2. Company Law Perspective

Regardless of the tax considerations, from a company law perspective, minority shareholders have several remedies available to defend their position from infringement of the regulations concerning directors' remuneration.

The first one consists of having any illegal remuneration or compensation reimbursed to the company. A director who has been paid without the items of remuneration being established in the articles of association, without a resolution of the general meeting to establish the total annual amount, or

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[17] TS, 13 June 2012, and TS, 25 June 2012.

[18] Art. 15 lit. e *Ley 27/2014, de 27 de noviembre, del Impuesto sobre Sociedades*.

without approval of the executive directors' contract, as appropriate, may be compelled to reimburse such amounts to the company. In addition, the payment of illegal remuneration would trigger director liability to the company for members of the board or joint directors who, despite not earning remuneration, did not prevent the payment of the illegal remuneration. Such liability would be joint and several (Art. 237 LSC).

Considering the enforceability of this reimbursement duty or the directors' liability, it must be pointed out that, according to Spanish law, the company must be indemnified by means of corporate action and, in order to bring forth such an action, a resolution must be passed at the general shareholder meeting (Art. 238 LSC). As the majority shareholder is not prohibited from voting in such resolution (even if also the affected director), the law recognizes that minority shareholders (with a five per cent or more stake) may file a derivative claim if the general meeting decides not to approve the corporate action (Art. 239 LSC). If this derivative action is based in the infringement of the duties of loyalty, as might be the case if a director pays himself a remuneration without authorization of the general meeting, minority shareholders may file a derivative claim without needing to call a general meeting (Art. 239 paras. 1, 2 LSC). In any case, the company must reimburse the expenses incurred by any shareholder who has instigated a derivative claim, if that shareholder has been unable to obtain reimbursement from the defendants and the court has ruled, in full or in part, in favor of the company (Art. 239 para. 2 LSC).

As explained above, instigating a derivative claim is theoretically possible and the reimbursement of expenses is an incentive for minority shareholders, but it must be recognized that the legal system is far from being effective in practice. In closed companies or family firms, majority shareholders are usually also directors of the company or are related to them: even if the corporate action is successful and the director who earned the illegal remuneration (and/or the members of the governing body which didn't prevent it) is ordered to repay the illegal remuneration, these amounts would continue to be under the control of the director (and indirectly of the majority shareholder).[19]

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[19] There is an additional issue which must be addressed here. At least in limited liability companies, if majority shareholders are at the same time directors, and once such directors have been sentenced by a final judgment to indemnify the company, the minority shareholder could request them to convene a meeting in order to decide on their exclusion of the company. As majority shareholders are prohibited from voting in such resolutions, the minority shareholder could pass a resolution alone. Finally, if it is a limited liability company and if the majority shareholder has a 25% stake, they should bring an action in order to obtain a judgment declaring the exclusion of the shareholder paying the reasonable value of their stake. So, at the end of the day, minority shareholders may control the company (Arts. 350 et seq. LSC). In any case it must be clearly said that, as far as we know, there are no judicial precedents of minority shareholders who have succeeded in this long process, which means that it is not at all effective.

Derivative claims have occasionally been used in an abusive way, leading the Supreme Court to accept the claim of an "abuse of rights exception" by the defendants in these proceedings. According to Supreme Court doctrine, the determination of the remuneration system in the articles of association is intended to give shareholders effective control over the amount of directors' remuneration and the remuneration policy, so the infringement of procedural rules becomes irrelevant when shareholders are sufficiently informed, have had the final say on the decision in question and have invoked the formal requirement simply to avoid paying remuneration (or compensation for loss of office).

This situation arises when the articles of association do not establish the items of remuneration and for example: (i) the board of directors (not the general shareholder meeting) approved the amount of the remuneration and every shareholder had a representative on the board which voted in favor of paying the remuneration;[20] (ii) the general meeting unanimously approved the report attached to the annual accounts which specified the remuneration paid to the director in several financial years and the shareholders did not even issue a protest;[21] (iii) a sole shareholder knew remuneration had been paid, although he did not approve a specific contract;[22] (iv) the general meeting ratified *ex post* the payment of remuneration by a unanimous vote;[23] (v) the shareholders accepted the payment of remuneration in a shareholders' agreement signed by all members of the company;[24] in contrast, this type of abuse of right exception cannot be applied to a new sole shareholder who did not know former shareholders had signed a director's service contract with compensation for loss of office.[25]

The second remedy to protect shareholders offered by Spanish law consists of challenging the resolution of the board of directors which approved a director's service contract for executive members of the board (according to Art. 249 para. 4 LSC) and/or challenging the resolution of the general meeting which fixed the total amount to be paid annually to the directors (according to Art. 217 para. 3 LSC) because it is inappropriate (generally speaking, excessive). Such resolutions might be challenged alleging that they are contrary to the law, the articles of association, or the interests of the company (Arts. 204 and 251 LSC). In this kind of proceeding, the claimant (generally a minority shareholder) will benefit from a shift of the burden of the proof if the votes of the majority shareholder or shareholders were decisive in reaching the majority needed to pass the resolution (Art. 190 para. 3 LSC). Thus, if

[20] TS, 24 April 2007.
[21] TS, 29 May 2008.
[22] TS, 31 October 2007.
[23] TS, 20 November 2018.
[24] TS, 18 June 2013.
[25] TS, 17 December 2015.

a minority shareholder challenges the contract (alleging the remuneration is illegal and contrary to corporate interest), the company as defendant will have to prove that the remuneration was indeed appropriate. As a result, minority shareholders will have at least a chance of winning the proceedings which might be accumulated to a derivative claim in order to obtain reimbursement to the company for the illegal remuneration, as explained above.

IV. Conclusions

1. Spanish legislation concerning directors' remuneration, as interpreted and applied by the Spanish Supreme Court, is a complete system that, at least in theory, offers enough protection to minority shareholders of closed companies.
2. The items of remuneration paid to directors, including executive directors, must be established in the articles of association and the total amount to be paid to the directors as a whole, including executive directors, must be approved at the general meeting.
3. Minority shareholders holding a 1% stake may challenge the general meeting resolution if the remuneration was inappropriate (infringement of Art. 214 LSC) and, with a 5% stake required to file a derivative claim in order to obtain reimbursement to the company of any sums illegally paid and/or to obtain damages for the company from such directors who should have prevented the company from paying the illegal remuneration.
4. The problem is that all the amounts obtained from a judgement in a derivative claim will be returned to the company which is controlled by the majority shareholders. In addition, if paying excessive remuneration is only part of an oppressive strategy designed by majority shareholders to expropriate minority shareholders, it is probable that, once completed (restriction of the payment of dividends, dilution of share capital raises, etc.) the minority shareholder has no further real interest in the company.
5. Hence, in our opinion, European Union countries should address the issue of oppression of the minority in closed companies, offering minority shareholders a withdrawal right and/or judicial proceedings such as those stipulated in Secs. 994 et seq. of the UK Companies Act 2006 to protect their position in the company.

The Duty to Honor a Shareholders' Agreement as an Ancillary Obligation in the Articles of the Company

David Pérez Millán[*]

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I. Introduction

Shareholders' agreements are common both in listed and closed companies. In listed companies, these agreements mainly give rise to questions related to the information available to investors and the markets, as this can affect the control of the company and the price of the shares. In closed or family companies, the key question instead is how the agreement should be enforced.

In this regard, shareholders' agreements were traditionally considered to have the effect of any other contract. In recent times, however, there has been

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a trend towards recognizing some corporate effects from shareholders' agreements, especially when all the shareholders are party to the agreement.[1] Legal scholars and practitioners also try to use the articles of the company to extend some of their typical effects to shareholders' agreements.

This paper focuses on the inclusion of an ancillary obligation (a *Nebenleistungspflicht*) in the articles of a company as a mechanism of corporate enforcement, which compels the parties to honor a shareholders' agreement. The purpose of this clause is to make the agreement enforceable against the company and future shareholders, but it raises many doubts about its legal consequences.

It is convenient to start by highlighting some general ideas about shareholders' agreements in Spain, in order to show just how similar the problems in other jurisdictions can be, exploring how the proposal to use a company's articles to enforce shareholders' agreements was developed, both in theory, and in subsequent legal practice. We will then be in a position to analyze in detail the obligations shareholders really assume, and their corporate effects, as well as the rules and limitations originating in company law to which the shareholders' agreement is subject once connected to the articles of the company through an ancillary obligation.

II. Regulation of Shareholders' Agreements in Spain

Spain, like Germany, has no special or *ad hoc* regulation on shareholders' agreements, which are subject instead to general contract law. In this sense, the Spanish Supreme Court has, in several resolutions, admitted the general validity of shareholder's agreements following the principle of contractual freedom within the limits of law, ethics and public order (Art. 1255 of the Spanish Civil Code [*Código Civil,* CC][2]).[3]

When a company is involved, such agreements are simply referred to by various rules. There is no legal framework on shareholders' agreements, in

[1] See *C. Paz-Ares*, El enforcement de los pactos parasociales, Actualidad Jurídica Uría & Menéndez 5/2003, 19 et seq.; *I. Sáez Lacave*, Los pactos parasociales de todos los socios en Derecho español. Una materia en manos de los jueces, InDret 3 (2009) 1 et seq.; *J. Noval Pato*, Los pactos omnilaterales: su oponibilidad a la sociedad (Cizur Menor 2012) 75 et seq., 109 et seq. In Germany, see *U. Noack*, Der allseitige Gesellschafterbeschluss als "schuldrechtliche Abrede" und dessen korporationsrechtliche Folgen, NZG 2010, 1017 et seq. In Italy, see *G. B. Portale*, Patti parasociali con "eficacia corporativa", Riv. soc. 2015, 1 et seq.

[2] *Real Decreto de 24 de julio de 1889 por el que se publica el Código Civil.*

[3] Among others, see TS, 24 October 1987, RJ 1987/6194; TS, 26 February 1991, RJ 1991/1600; TS, 10 February 1992, RJ 1992/1204; TS, 18 March 2002, RJ 2002/2850; TS, 19 December 2007, RJ 2007/9043; TS, 10 December 2008, RJ 2009/17; TS, 5 March 2009, RJ 2009/1633; TS, 6 March 2009, RJ 2009/2793; TS, 6 March 2009, RJ 2009/2794.

terms of their definition, validity, duration, contents or enforcement in general. The Spanish Companies Act (*Ley de Sociedades de Capital,* LSC)[4] simply states that private agreements between shareholders cannot be enforced against the company (Art. 29 LSC) and this rule is mostly understood to be just a manifestation of the general principle of relativity or privity of contract: contracts are effective only between the parties to it and do not impose obligations upon third parties (Art. 1257 CC).[5]

Some legal provisions deal with shareholders' agreements, in so far as they affect the control of a company. On one hand, the obligation to draw up consolidated accounts can be triggered if a group of companies is set up through a shareholders' agreement (Art. 42 para. 1 of the Spanish Commercial Code [*Código de Comercio,* CCom][6]). On the other hand, specific rules are foreseen for shareholders' agreements which are aimed at gaining or keeping control of a listed company (among others, Arts. 128 and 135 of the Spanish Stock Market Act [*Ley del Mercado de Valores*, LMV][7]). But none of these provisions recognize any effect of shareholders' agreements beyond their parties.

Other provisions either demand or allow the disclosure of some shareholders' agreements. Disclosure of shareholders' agreements on voting rights or the transfer of shares in listed companies is mandatory (Arts. 530 et seq. LSC). Disclosure of family agreements in non-listed companies is voluntary (Arts. 5 et seq. of the Royal Decree on the Disclosure of Family Agreements or *Protocolos familiares, Real Decreto 171/2007*),[8] and permits the inclusion of damages or penalty clauses in the articles for the event of a breach (Arts. 114 para. 2 lit. a and 175 para. 2 lit. a of the Regulation on the Mercantile Register [*Reglamento del Registro Mercantil,* RRM][9]). In both cases, disclosure includes filing the agreement with the Mercantile Register (Art. 531 para. 2 LSC and Art. 6 *Real Decreto 171/2007*). Despite this requirement, the agreement is delivered and made public in a similar way to the annual accounts and not like the articles. That's to say, even if the agreement is disclosed, unlike the articles of the company, the agreement doesn't affect third parties, including the company, or shareholders who are not party to the agreement or purchasers of the shares.[10]

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[4] *Real Decreto Legislativo 1/2010, de 2 de julio, por el que se aprueba el texto refundido de la Ley de Sociedades de Capital.*

[5] For instance, see *A. Vaquerizo Alonso*, in: Rojo/Beltrán (eds.), Comentario de la Ley de Sociedades de Capital, Vol. I (Madrid 2011) 400.

[6] *Real Decreto de 22 de agosto de 1885 por el que se publica el Código de Comercio.*

[7] *Real Decreto Legislativo 4/2015, de 23 de octubre, por el que se aprueba el texto refundido de la Ley del Mercado de Valores.*

[8] *Real Decreto 171/2007, de 9 de febrero, por el que se regula la publicidad de los protocolos familiares.*

[9] *Real Decreto 1784/1996, de 19 de julio, por el que se aprueba el Reglamento del Registro Mercantil.*

III. The Differences Between Shareholders' Agreements and Articles or the *Trennungsthese* and Exceptions

As it is widely known, although shareholders' agreements and articles of the company may have similar content imposing obligations on shareholders or including provisions on the decision-making of the company, they achieve this in different ways.

Since shareholders' agreements are subject to general contract law, the legal rules for the articles concerning their formalities or modification do not apply. In this regard, shareholders' agreements can be concluded without any formality and they do not need to be disclosed except in the cases mentioned above. While changes require consent from all parties, they do not need to be approved by the shareholder's meeting.

Accordingly, shareholders' agreements and articles have different effects. Two differences are of particular interest regarding the obligations assumed by shareholders under a shareholders' agreement. Firstly, in the case of a breach of a shareholders' agreement, only contractual remedies are available so that the defaulting shareholder cannot be expelled or removed from the company. Secondly, obligations arising from shareholders' agreements can only be transferred with the consent of the other parties to the agreement and the express consent of the new party: the obligations do not simply transfer with the shares from one shareholder who is party to the agreement to another who is not.[11]

This is logical, since as mentioned above, shareholders' agreements only affect whoever is party to the agreement and therefore, do not affect the company or any third party the way in which the articles do. In other words, they do not have corporate effect and they must be kept separate from the corporate rules which govern the company. The *Trennungsthese,* or separation theory followed in Germany is also the main doctrine in Spain. However, there are also some exceptions.

Firstly, in the late '80s and early '90s the Spanish Supreme Court, like the German Federal Court of Justice, admitted it was possible to challenge the resolutions of shareholders' meetings passed in contravention of shareholders'

[10] For shareholders' agreements in listed companies, see *D. Pérez Millán*, La información a los mercados sobre los pactos parasociales, in: Rodríguez Artigas/Fernández de la Gándara et al. (eds.), Sociedades cotizadas y transparencia en los mercados (Cizur Menor 2019) 1220 et seq. For family agreements in non-listed companies, see *J. Martínez Rosado*, Los pactos parasociales (Madrid 2017) 214 and 219 et seq.

[11] In this regard, see *M. Flores Segura*, Los pactos parasociales a favor de la sociedad, in: Rojo/Campuzano (eds.), Estudios jurídicos en memoria del profesor Emilio Beltrán (Valencia 2015) 302–304.

agreements between all the shareholders.[12] Almost two decades later, other decisions pointed out that the infraction of a shareholders' agreement was not enough on its own to challenge a resolution passed at the shareholders' meeting, it was also necessary for the resolution to be contrary to the law, the bylaws, or the interests of the company as legally stated (Art. 204 LSC).[13] Indeed, it has been suggested that resolutions of the shareholders' meeting in violation of a shareholders' agreement among all shareholders would be detrimental to the interest of the company since that interest could have been previously defined in the agreement.[14] In any case, more recent resolutions confirm the relevance of shareholders' agreements between all the shareholders in relation to the challenge of resolutions passed by the shareholders' meeting.[15]

Secondly, different mechanisms have been proposed in an attempt to make shareholders' agreements enforceable against the company and future shareholders, in particular including an ancillary obligation to honor a shareholders' agreement in the articles of the company.

IV. The Ancillary Obligation for the Corporate Enforcement of a Shareholders' Agreement

1. *The Ancillary Obligation in Theory*

Over the last fifteen years, Spanish scholars have suggested using the articles of the company for the corporate enforcement of shareholders' agreements. These proposals were inspired by German works from the '90s where a similar approach could be found regarding the inclusion of articles of limited liability companies.[16] However, current German commentaries mostly refer to specific agreements contained in the articles, such as voting agreements to appoint someone as director of the company.[17] Furthermore, it seems that such clauses are unusual in practice.[18]

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[12] See TS, 24 October 1987, *supra* note 3; TS, 26 February 1991, *supra* note 3; TS, 10 February 1992, *supra* note 3.

[13] See TS, 10 December 2008, *supra* note 3; TS, 5 March 2009, *supra* note 3; TS, 6 March 2009, *supra* note 3; TS, 6 March 2009, RJ 2009/2794.

[14] See *Paz-Ares, supra* note 1, 41; *Sáez Lacave, supra* note 1, 21–22; A similar argument can be found in *U. Ehricke*, Schuldvertragliche Nebenabreden (Heidelberg 2004) 29–34, 65, for German law; and in *N. Vavrovsky*, Stimmbindungsverträge (Vienna 2000) 124–125, for Austrian law.

[15] See TS, 3 November 2014, RJ 2014/5870; TS, 25 February 2016, RJ 2016/635.

[16] See *M. Winter*, Organisationsrechtliche Sanktionen bei Verletzung schuldrechtlicher Gesellschaftvereinbarungen?, ZHR 154 (1990) 281–282, and *U. Noack*, Gesellschaftervereinbarungen bei Kapitalgesellschaften (Tübingen 1994) 175–176.

[17] See *H. Wicke*, in: Fleischer/Goette (eds.), Münchener Kommentar zum GmbH-Gesetz (3rd ed., Munich 2018) § 3 marg. no. 86, who considers them directly as ancillary

On the contrary, in Spain, a specific clause in the articles for the corporate enforcement of a shareholders' agreement in its entirety has been proposed in the form of an ancillary obligation (a *Nebenleistungspflicht*), which would consist of signing and performing the shareholders' agreement.[19] The introduction of such a clause in the articles would have two effects according to the rules on ancillary obligations. Firstly, the shareholder who fails to honor the agreement could be removed from the company (Arts. 89 para. 2, 350 and 351 LSC). Secondly, the parties to the agreement could not transfer their shares without the authorization of the company (Art. 88 LSC).

The main discussion was whether shareholders' agreements should be disclosed through the Mercantile Register to create these effects. A number of scholars maintained that it would be enough if the articles of the company simply mentioned the agreement with its contents disclosed elsewhere.[20] Others responded that it would be necessary for the agreement to have been made public through the Mercantile Register as is possible for family agreements (Art. 6 *Real Decreto 171/2007*).[21] A small number of scholars considered the contents of shareholders' agreements too heterogenous and argued that the articles should specify the precise obligations assumed by the shareholders.[22]

In reality, registries in Spain were reluctant to register such ancillary obligations, except in the few cases when all shareholders were party to the agreement. However, a recent case has now changed the situation.

2. *The Ancillary Obligation in Practice*

The General Directorate of Registries and Notaries has recently admitted that it was possible to include an ancillary obligation to honor a shareholders'

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obligations (*Nebenleistungspflichten*); or *W. Zöllner/U. Noack*, in: Baumbach/Hueck, GmbH-Gesetz (21st ed., Munich 2017) § 47 marg. no. 112, where they are generically called corporate obligations (*körperschaftsrechtliche Verpflichtungen*).

[18] For limited liability companies, see *K. Schmidt*, in: Scholz (ed.), Kommentar zum GmbH-Gesetz (11th ed., Cologne 2014) § 47 marg. no. 38. For joint stock companies, *K. Heider*, in: Goette/Habersack (eds.), Münchener Kommentar zum Aktiengesetz (4th ed., Munich 2016) § 12 marg. no. 22 (footnote 36).

[19] Although previously suggested, this formula is to be attributed to *Paz-Ares, supra* note 1, 41–42. Afterwards, see also *L. Fernández del Pozo*, El "enforcement" societario y registral de los pactos parasociales. La oponibilidad de lo pactado en protocolo familiar publicado, RdS 29 (2008) 139, 173 and 175 et seq.; *J. Feliú Rey*, Los pactos parasociales en las sociedades de capital no cotizadas (Madrid 2012) 420 et seq.; or *F. J. Martínez Rosado*, Los pactos parasociales (Madrid 2017) 146 et seq., although in the latter case only with regard to family agreements.

[20] See *Paz-Ares, supra* note 1, 41.

[21] See *Fernández del Pozo, supra* note 19, 182–183; *Feliú Rey, supra* note 19, 430–432.

[22] Regards family agreements, see *M. Sánchez Ruiz*, Régimen jurídico de la empresa familiar (Cizur Menor 2010) 42.

agreement in the articles of a company without needing to file the contents of the agreement with the Mercantile Register.[23] The facts of that case can be used as a good example to illustrate the doubts which arise when an ancillary obligation is used for the corporate enforcement of a shareholders' agreement. However, the reasoning found in the decision does not give many clues on how to resolve these doubts.[24]

The shareholders' meeting of a joint stock company had unanimously passed two resolutions:[25] one approving a family agreement, the other including an ancillary obligation in the articles compelling the members of the family to honor that agreement. The articles simply identified the deed in the notary's possession without any disclosure of its terms. Although the resolutions were unanimously passed at the general meeting, the decision did not specifically mention whether all the shareholders were party to the agreement.

According to the decision, what the parties wanted was clear. Firstly, voluntary breach of the agreement would be a cause for expulsion from the company. Secondly, a transfer of shares by the parties to the agreement would become subject to the rules on ancillary obligations. The main problem was whether that ancillary obligation was sufficiently defined according to Art. 86 para. 1 LSC.[26]

The registrar refused to register the modification of the articles because, in his opinion, the obligations assumed by the shareholders were not be sufficiently defined, rendering the shareholders' agreement enforceable against the company as whole.

The notary replied just the opposite. The obligation was in fact sufficiently defined by the reference to the deed in his possession and the agreement was enforceable against the company because the company knew about it and had accepted it, as it had been unanimously approved by the shareholders' meeting.

Like the notary, the General Directorate declared the ancillary obligation was sufficiently defined. Current shareholders knew the contents of the

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[23] See *Resolución de la Dirección General de los Registros y del Notariado de 26 de junio de 2018 (RJ 2018, 3648).*

[24] For a critique to the poor reasoning of the decision, see *J. García de Enterría*, La "mezcla de las especies": el cumplimiento de un acuerdo de socios como obligación estatutaria, Almacén de Derecho, 27 July 2018 (<https://almacendederecho.org/la-mezcla-las-especies-cumplimiento-acuerdo-socios-obligacion-estatutaria/>.

[25] On the two occasions the decision mentions the name of the company, it uses the abbreviation "S.A.", as for a joint stock company (*sociedad anónima*). Similarly, the Spanish words for "shares" (*acciones*) and "shareholders" *(accionistas*) in joint stock companies are to be found. However, both in the title and in the summary the decision begins with, reference is made to the resolutions passed by the general meeting of a limited liability company. Apparently, references to a limited company are simply misprints. In any case, here it is assumed that it was indeed a joint stock company.

[26] According to Art. 86 para. 1 LSC, the articles of a company can establish ancillary obligations different to capital contributions, expressing their precise and defined contents.

agreement and future shareholders were warned in the articles that the agreement existed. However, the resolution didn't mention anything about the effects the ancillary obligation would have on the company, or the rules the agreement would be subject to from that moment on. These are the most relevant questions that need to be analyzed.

V. The Duty Imposed to the Shareholders who Assumed the Ancillary Obligation

To understand the real meaning of an ancillary obligation used for the corporate enforcement of a shareholders' agreement, it is convenient to start by specifying the duty imposed on the shareholders who assumed that obligation. In the case cited above, the clause to be introduced in the articles mentioned explicitly the duty to honor the agreement and not simply to just sign it. That choice is more important than it seems.

In general, when considering in ancillary obligations which imply a contract between shareholders and the company, the nature of the duty imposed on the shareholders is still being discussed. On the one hand, it is argued that this duty would consist exclusively of entering into the contract, so that the ancillary obligation would be fulfilled at the time the contract is signed, whilst a subsequent breach of that contract would not authorize removing the defaulting shareholder from the company.[27] On the other hand, it was upheld that ancillary obligations needing to be paid for or to be performed over a period of time usually require signing a contract with the company, and that the fact that ancillary obligations are corporate obligations would be irrelevant according to the previous opinion.[28] Ultimately, it seems that the question would depend on the will of the shareholders and specifically on the degree of autonomy or dependence they wish to recognize in the contract

[27] In particular, see *J. Barba de Vega*, Las prestaciones accesorias en las sociedades de responsabilidad limitada (Madrid 1984) 252–255, 293, 325–330, 348–353, who distinguishes this kind of ancillary obligation from those consisting of providing the company with goods or services that are based on the statutory or corporate contract itself. See also *M. J. Peñas Moyano*, Las prestaciones accesorias en la sociedad anónima (Pamplona 1996) 79–80, 92–93; *M. Viñuelas Sanz*, Las prestaciones accesorias en la sociedad de responsabilidad limitada (Madrid 2004) 73 et seq.; or *A. Recalde Castells*, in: Arroyo/Embid/Górriz,(eds.), Comentarios a la Ley de Sociedades de Responsabilidad Limitada (2nd ed., Madrid 2009) Art. 22, 349–350, although this case seems to be exclusively considering that the shareholders had unequivocally expressed their will to assume only the duty to enter into the contract.

[28] See *J. Alfaro Aguila-Real*, Prestaciones accesorias, in: Garrido/Fugardo/Garrido de Palma (eds.), El patrimonio familiar, profesional y empresarial. Sus protocolos, Vol. IV (Barcelona 2005) 441–442, where apparently the possibility of the shareholders specifical-

with respect to the statutory or corporate contract (*der Gesellschaftsvertrag*). In any case, if the ancillary obligation embraces the obligations under the contract, those obligations are assumed vis-à-vis the company or the shareholders *uti universi*.[29]

Those ideas are useful when an ancillary obligation for the corporate enforcement of a shareholders' agreement is included in the articles of the company. In fact, if the ancillary obligation only contains the duty to sign the shareholders' agreement, the obligation is fulfilled the moment the agreement is signed. From that moment on, the only remedies available against a breach of the agreement are those foreseen in general contract law. In contrast, if the parties want to remove the defaulting shareholder from the company, the ancillary obligation should specifically contain the duty to comply with the agreement and not simply to just sign it. In other words, the agreement should be connected to the articles, i.e. to the corporate contract, so that the breach of the former becomes at the same time an infraction of the latter.

That is exactly what an ancillary obligation to honor a shareholder's agreement does, and all obligations under the agreement become ancillary obligations under the corporate contract. There is no way to distinguish the ancillary obligation to fulfil the obligations arising from the agreement and these obligations themselves. They are then assumed vis-à-vis the company, i.e. by all shareholders, whether they are parties to the agreement or not. Also, removal of a defaulting shareholder is possible because the obligations under the agreement have been shaped as obligations of the shareholders *qua* members of the company, i.e. as corporate obligations.

Therefore, it seems that the nature of the agreement changes once it is connected through an ancillary obligation to the articles of the company. If the obligations imposed by the agreement are equivalent to obligations imposed by the articles, they are corporate obligations and not just contractual obligations. As such, they are part and parcel of the duties owed by the parties to the agreement as members of the company. From another perspective, if a shareholders' agreement has the same effects that the articles typically have, the agreement is then an extension of the corporate contract between the parties or what in Germany is known as an *Ausführungsvertrag*. If the autonomy of a shareholders' agreement from the corporate contract is lost, their provisions are to be considered as more or less typical provisions of the articles.[30]

This would be sufficient to conclude that from the moment the shareholders' agreement is connected to the articles in that way, the agreement may be subject to rules from outside of contract law. A further analysis will confirm

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ly deciding that the ancillary obligation would consist only of signing the contract is not considered.

[29] See *Alfaro Aguila-Real, supra* note 28, 465.

[30] See *J. Girón Tena*, Derecho de sociedades (Madrid 1976) 54.

this impression. It will be shown in more detail that the corporate effects of a shareholders' agreement depend on the obligations of the parties being linked to their membership and that the agreement is therefore subject to company law and not just to contract law.

VI. Corporate Effects of the Ancillary Obligation to Honor a Shareholders' Agreement

1. Removal of the Defaulting Shareholder from the Company

The first corporate effect of the obligation to honor a shareholders' agreement is removal of the defaulting shareholder from the company. As previously seen, this means that the breach of the agreement would at the same time be a breach of the corporate contract. It also implies that the obligations under the agreement are part and parcel of the duties of the parties as members of the company. Therefore, at least some rules of company law have to be respected.

To begin with, in limited companies, voluntary failure to comply with an ancillary obligation is a legal cause for removal from the company (Art. 350 LSC), whilst involuntary failure would need to be stipulated in the articles with the consent of all the shareholders to authorize the removal of the defaulting shareholder (Arts. 89 para. 2 and 351 LSC). In joint stock companies, such a provision in the articles would be necessary in any case to remove the defaulting shareholder (Art. 351 LSC). Therefore, for most cases, it would not be enough to include an ancillary obligation but another amendment of the articles without the opposition of any shareholder would be required.

Notwithstanding, in Spain discussion arises on whether shareholders can be removed from a company if they fail to perform their obligations, in the same way partners can be expelled from a partnership, or if the causes for their removal must be defined exactly in the articles.[31] A shareholders' agreement would in any case help to specify these causes. At the same time, the removal of a defaulting shareholder would only be possible if the obligations not performed were important for the interest and purpose of the company.[32] In other words, if non-performance constituted a serious breach of the

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[31] For the first opinion, see *J. Alfaro Aguila-Real*, Conflictos intrasocietarios (Los justos motivos como causa legal no escrita de exclusión y separación de un socio en la sociedad de responsabilidad limitada), RDM 222 (1996) 1079 et seq, 1100–1107, 1123–1130; for the second, see *C. Alonso Ledesma*, La autonomía de la voluntad en la exclusión y separación de socios, RDM 287 (2013) III.2 and III.3 (online version).

[32] For the termination of a civil partnership, see *C. Paz-Ares*, in: Paz-Ares/Díez-Picazo et al. (eds.), Comentario del Código Civil, Vol. II (Madrid 1991) Art. 1707, 1514. For the removal from a mercantile partnership, see *Girón Tena, supra* note 30, 671. For the re-

corporate contract. Therefore, the non-performed obligations must, first of all be obligations assumed vis-à-vis the company by the shareholders *qua* members of the company, i.e. corporate obligations.

Consequently, the agreement is not only subject to general contract law but also to some rules of company law. At any rate, mandatory rules on expulsion of shareholders would apply and the proceedings foreseen in the Spanish Companies Act would have to be followed. A resolution of the shareholders' meeting must be passed for the removal of any shareholder (Art. 352 para. 1 LSC). Besides, if the shareholder holds at least 25% of the share capital and does not agree with their removal, a decision by a court is required (Art. 352 para. 2 LSC).

Furthermore, all the shareholders, current or future, have to know the exact terms of the agreement. This includes not only the parties to the agreement who can be removed from the company if they fail to honor their obligations under the agreement, but also potential shareholders who are not party to the agreement. There are at least two reasons for that conclusion. Firstly, they have to decide on how to vote on the removal of the defaulting shareholder (Art. 352 para. 1 LSC). Secondly, the shares of the defaulting shareholder have to be paid for by the company (Art. 356 para. 1 LSC). Furthermore, the directors should also know the contents of the agreement, for they must carry out the removal (Arts. 356 para. 2, 358 para. 1 and 359 LSC).

How all of the shareholders and directors should be able to find out the terms of the agreement is a matter for discussion. Only two options seem to be possible: disclosing the terms or at least allowing access to the deed for any person with a legitimate interest.[33] Thus, the agreement can't be kept confidential the same way a normal contract can because it affects all the members and directors of the company and therefore, they must all be given the opportunity to know its terms.

2. *Transfer of Shares and the Obligations under the Agreement*

Apart from the removal of the defaulting shareholder, transforming the duty to honor a shareholders' agreement into an ancillary obligation included in the articles of the company has two corporate effects regarding the transfer of the shares held by any party to the agreement. First, the company must authorize the transfer of those shares. Second, whoever acquires those shares is automatically bound by the agreement. That is made possible once more by

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moval from a limited liability company due to failure to comply with an ancillary obligation, see *Recalde Castells, supra* note 27, 377.

[33] The Decision of the General Directorate of Registries and Notaries of 26 June 2018 did not require any disclosure of the terms of the agreement, but nor did it declare that any person with a legitimate interest can access the deed. In this regard, see *García de Enterría, supra* note 24.

the obligations under the agreement being connected to the membership of the parties, but also requires that some rules of company law be observed.

In general, the transfer either of shares by shareholders personally bound by ancillary obligations or of shares whose holding is linked to an ancillary obligation must be authorized by the company, whether by the shareholders meeting or the directors, depending on what the articles provide (Art. 88 para. 2 LCS). If the articles do not mention possible reasons for rejection, the company is free to consent to the transfer according to its own interest.[34] In the case of an ancillary obligation to honor a shareholders' agreement, this means that the authorization can be granted, or not, depending on the interest of the company or all the shareholders and not only on the interest of the parties to the agreement. Again, this is because the obligations under the agreement have been assumed vis-à-vis the company in its interest.

In addition, the transfer of shares involving ancillary obligations cannot take place without the approval of the company even if the purchase was in good faith and without the knowledge that the consent of the company was necessary. This is possible because the company itself has limited the transferability of those shares, thus configuring the rights of membership connected to them.[35] Nothing changes if the ancillary obligation consists of honoring a shareholders' agreement. The transfer of the shares held by any party to the agreement without the authorization of the company is avoided, since the rights corresponding to those shares have been limited by the company itself as part of the membership of their holders.

Furthermore, if authorized by the company, the transfer of shares affected by ancillary obligations means the automatic transfer of these obligations. This happens regardless of whether they are attached to certain shares or personally assumed by some shareholders as named in the articles, except in the case of extremely specific obligations that can only be performed by those shareholders personally.[36] The purchaser of the shares is not required to expressly agree. The intent to purchase the shares implies a willingness to assume the ancillary obligations since they are part of the duties as a member of the company or corporate obligations.[37]

In this sense, the articles of a company can include corporate or contractual obligations of the shareholders. Corporate obligations depend on membership and they are automatically transferred with it, while the transfer of con-

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[34] See *A. Perdices Huetos*, Cláusulas restrictivas de la transmisión de acciones y participaciones (Madrid 1997) 91; *Alfaro Aguila-Real, supra* note 28, 470; *Recalde Castells, supra* note 27, Art. 24, 362–363.

[35] See *Perdices Huetos, supra* note 34, 100–101.

[36] See *Alfaro Aguila-Real, supra* note 28, 468; *Recalde Castells, supra* note 27, Art. 24, 366–368; *B. Peñas Moyano*, in: Rojo/Beltrán (eds.), Comentario de la Ley de Sociedades de Capital, Vol. I (Cizur Menor 2011) Art. 88, 750.

[37] See *Barba de Vega, supra* note 27, 432 et seq., 441, 445–446.

tractual obligations requires the consent of the purchaser.[38] Whether obligations of the shareholders included in the articles are corporate or contractual obligations depends on the will of the shareholders, but merely being mentioned in the articles means they are presumed to be corporate obligations.[39] Moreover, if obligations of the shareholders vis-à-vis the company are transferred with the shares like ancillary obligations, they are indisputably corporate obligations.[40]

In the case of an ancillary obligation to honor a shareholders' agreement, the transfer of shares by any party to the agreement provokes the automatic transfer of the obligations under the agreement, as with ancillary obligations in general. This confirms that those obligations are corporate and not just contractual obligations.

For all these reasons, company law also applies to the transfer of the shares and the obligations by the parties of the agreement. For instance, if securities are issued, they have to be certificated securities bearing the name of the holder or DRS (Digital Registration System) securities and they must mention the ancillary obligations attached to the shares (Arts. 113 para. 1, 114 para. 1 lit. f and 118 para. 2 LSC). Otherwise, those obligations and the restrictions to the transfer of the shares are not enforceable against the purchaser (Arts. 120 para. 3 LSC, Arts. 11 para. 3 and 11 para. 4 LMV, and Arts. 13 para. 3 and 13 para. 4 *Real Decreto 878/2015*[41]).[42]

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[38] See *H.-J. Priester*, Nichtkorporative Satzungsbestimmungen bei Kapitalgesellschaften, DB 1979, 685–686. See also *H. Wicke*, Schuldrechtliche Nebenvereinbarungen bei der GmbH – Motive, rechtliche Behandlung, Verhältnis zum Gesellschaftsvertrag, DStR 2006, 1140.

[39] In Germany, see *Priester, supra* note 39, 681 et seq., 684, 687; *Noack, supra* note 16, 63–64; *H. Wicke*, Echte und unechte Bestandteile im Gesellschaftsvertrag der GmbH, DNotZ 2006, 419 et seq., 434. In Italy, see *G. Oppo*, Le convenzioni parasociali tra diritto delle obbligazioni e diritto delle società, Riv. dir. civ. 1987, 522–523; *G. A. Rescio*, La distinzione del sociale dal parasociale (sulle c.d. clausole statutarie parasociali), Riv. soc. 1991, 596, 635 et seq., 639. In Spain, *Noval Pato, supra* note 1, 42 et seq., 46.

[40] In this regard, see *Rescio, supra* note 39, 637 (footnote 96).

[41] *Real Decreto 878/2015, de 2 de octubre, sobre compensación, liquidación y registro de valores negociables representados mediante anotaciones en cuenta, sobre el régimen jurídico de los depositarios centrales de valores y de las entidades de contrapartida central y sobre requisitos de transparencia de los emisores de valores admitidos a negociación en un mercado secundario oficial.*

[42] On ancillary obligations in general see *D. Pérez Millán*, Acción (título), in: Alonso Ledesma (ed.), Diccionario de sociedades (Madrid 2006) 47.

VII. Legal Consequences of the Ancillary Obligation to Honor a Shareholders' Agreement

1. *Rules on Shareholders' Agreements with Corporate Effects*

As already seen, if shareholders' agreements have corporate effects thanks to an ancillary obligation in the articles of the company, they are subject to some extent to company law, at least with respect to rules on the removal of a defaulting shareholder or the transfer of shares by the parties to the agreement. The same has to be said, for instance, about the modification and termination of the agreement, as far as it affects the obligations of the parties.

In general, including, modifying, or terminating any ancillary obligation in the articles must respect the rules foreseen in the Spanish Companies Act. Firstly, the shareholders' meeting must pass a resolution with a special majority (Arts. 86 para. 1 and 89 para. 1 LSC). Secondly, the shareholders who assume the obligation have to consent (Art. 89 para. 1 LSC). Thirdly, any other shareholders who do not agree have the right to exit or withdraw from the company (Art. 346 para. 1 lit. d LSC).

It seems logical that those rules must also apply to changing or terminating the obligations arising from a shareholders' agreement in cases where an ancillary obligation to honor the agreement has been included in the articles. Again, the obligations under the agreement then become ancillary obligations, i.e. obligations vis-à-vis the company in its interest and obligations of the parties to the agreement as members of the company. In other words, corporate obligations.

Yet, some Spanish scholars have suggested that even if such an ancillary obligation has been included in the articles, the shareholders' agreement could be modified in the future according to the rules foreseen in the agreement itself.[43] On the contrary, dynamic references in the articles, meaning references in general to current and future versions of the shareholders' agreement are not possible if the parties want to keep the corporate effects of the agreement: at least the reference to the agreement included in the articles should be changed in order to take into account a new version of the agreement.[44] Even if it were necessary only for that purpose, the amendment to the articles is subject to company law.

Furthermore, since all the obligations under the agreement have become ancillary obligations, the rules of company law on the change or termination of these kinds of obligations have to be respected. These are rules thought to

[43] See *Paz-Ares, supra* note 1, 42 (footnote 85); *Fernández del Pozo, supra* note 19, 180.

[44] In Germany, see *Winter, supra* note 16, 282. In a similar sense, see also *J. Noval Pato*, Comentario a la RDGRN de 26 de junio de 2018, RdS 54 (2018) III.2.2 and III.2.3 (online version).

protect all the interests involved. They must be followed, to ensure all current shareholders, directors, and future shareholders know about any change in the obligations assumed by the parties to the agreement. A resolution of the shareholders' meeting authorized to amend the articles is also needed so that the shareholders who are not party to the agreement can vote on the matter (Arts. 86 para. 1 and 89 para. 1 LSC), challenge that resolution if it is detrimental to the interest of the company (Art. 204 para. 1 LSC), or exit the company if they do not agree with the modification or termination of the obligations assumed by any other shareholder (Art. 346 para. 1 lit. d LSC). As it has been seen, all shareholders, whether party to the agreement or not, can be affected in the future by the removal of a defaulting shareholder or the transfer of the shares by whomever has assumed the ancillary obligation to honor the agreement.

2. Limitations on Shareholders' Agreements with Corporate Effects

Despite all that has been said, some Spanish scholars have also suggested that shareholders' agreements would be subject only to the limitations found in contract law and not those in company law, even when an ancillary obligation to honor the agreement exists in the articles.[45]

On the contrary, shareholders' agreements can only have corporate effects if they respect the mandatory rules of company law, which are intended to protect all the interests involved, i.e. those of the company, current shareholders who are not party to the agreement, future shareholders, the directors, and even the creditors of the company. In other words, shareholders' agreements with corporate effects are subject to the limitations on articles (Art. 28 LSC) and not only to those on contracts in general (Art. 1255 CC). Otherwise, they merely have the effects of any other contract.[46]

Furthermore, a shareholders' agreement connected to the articles through an ancillary obligation can only have corporate effects in relation to the removal of defaulting shareholders and the transfer of shares. In other words, they can only have effects regarding the obligations assumed by the parties to the agreement. Conversely, provisions included in the shareholders' agreement on the decision-making of the company, such as convening, conducting or passing resolutions at the shareholders' meeting cannot affect the company, i.e. the directors and the shareholders who are not party to the agreement.[47]

For instance, even if there is an ancillary obligation to honor the agreement and the agreement contains rules on majorities for the resolutions to be passed, the legal or statutory rules prevail. Firstly, these are the only rules the directors are bound to (Arts. 225 para. 1 and 236 para. 1 LSC). Secondly, the

[45] See *Fernández del Pozo, supra* note 19, 183.

[46] In this regard, see *Oppo, supra* note 39, 527–528.

[47] Similarly, see *García de Enterría, supra* note 24.

resolutions of the shareholders' meeting can only be challenged if they are against the law or the articles, or if they are detrimental to the interest of the company (Art. 204 LSC).

Only when all shareholders are party to the agreement, can a resolution of the shareholders' meeting be challenged on the basis of a breach of the agreement, in as far as the agreement could be considered to some extent equivalent to the articles or it could define the interest of the company and the fiduciary duty (*Treupflicht*) of its shareholders.[48] In these cases, it does not matter whether there is an ancillary obligation to honor the agreement or not, but most importantly, the agreement must also respect the mandatory rules of company law in order to have any corporate effect.[49]

A recent decision by the Provincial Court of Barcelona is an exemplary case.[50] The Court admitted a challenge to a resolution of the shareholders' meeting passed with the statutory majority required but without the majority foreseen in a shareholders' agreement between all the shareholders. However, as was suggested in the decision, things would have been different if the agreement had required unanimity.

Indeed, according to Spanish law, the articles cannot require unanimity for any resolution of the shareholders' meeting to be passed (Arts. 159 para. 1 and 200 para. 1 LSC). Therefore, such a provision in a shareholders' agreement would not have any corporate effects. Specifically, a resolution of the shareholders' meeting cannot be challenged because it has been passed against that provision.

VIII. Conclusions

Agreements between shareholders can result in contractual or corporate obligations. If they are included in or connected to the articles of the company, the only way to distinguish obligations under a shareholders' agreement and obligations under the corporate contract are the effects they have and the rules to which they are subject.[51]

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[48] For more details on these two possible arguments, *D. Pérez Millán*, Presupuestos y fundamento jurídico de la impugnación de acuerdos sociales por incumplimiento de pactos parasociales, RDBB 117 (2010) 254–256. In Germany, see *Schmidt, supra* note 18, § 45 marg. no. 116 and § 47 marg. no. 53; *Zöllner/Noack, supra* note 17, § 47 marg. no. 118.

[49] In this regard, see *C. Rodemann*, Stimmbindungsvereinbarungen in den Aktien- und GmbH-Rechten Deutschlands, Englands, Frankreichs und Belgiens (Cologne/Berlin/Bonn/Munich 1998) 95. See also *Winter, supra* note 16, 278–280.

[50] See AP Barcelona, 12 February 2019, JUR 2019/62839.

[51] In general, comparing shareholders' agreements and articles of the company, see *G. Oppo*, Contratti parasociali (Milan 1942) 2–3 and 21.

As with obligations brought on by some clauses included in the articles, obligations arising from a shareholders' agreement linked through an ancillary obligation to the articles are held to be contractual or corporate in nature depending on the will of the shareholders. But they are corporate obligations if the shareholders want the typical effects of such obligations.[52]

That is precisely what the shareholders look for by including in the articles an ancillary obligation to honor the agreement and not just to sign it. The removal of the shareholder who breaches the agreement and restriction on transferring shares by any of its parties are typical corporate effects. The shareholders intend in this way to make the agreement enforceable against the company, current and future shareholders and the directors. Thus, all the obligations under the agreement become corporate obligations and they are therefore subject to corporate rules and limitations.

Connecting a shareholders' agreement to the articles through an ancillary obligation cannot be a way to get the corporate enforcement of the agreement whilst circumventing the mandatory rules of company law. Corporate effects come at a price.

[52] For obligations or agreements included in the articles, see *Rescio, supra* note 39, 640.

Shareholders' Agreements in Family Firms and Closed Corporations

Sebastian Mock

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Shareholders' agreements are a puzzling phenonemon of corporate law. Although they have traditionally held a significant importance in corporate law in all jurisdictions, there is hardly any specific regulation for them.[1] The

[1] In German law a specific regulation does not exist. In fact, shareholders' agreements are considered as civil partnerships (§§ 705 et seq. German Civil Code, *Bürgerliches Gesetzbuch*, BGB) since the shareholders agree to promote the achievement of a common purpose on the manner stipulated by the contract in particular to make the agreed contributions. For an overview of shareholders' agreements in Germany see e.g. *J. Lieder*, Schuldrechtliche Nebenabreden im deutschen Gesellschaftsrecht, in: Fleischer/Kalss/Vogt (eds.), Aktuelle Entwicklungen im deutschen, österreichischen und schweizerischen Gesell-

great codifications of the late 19th and earlier 20th century in the Western legal systems in particular provide almost no rules for shareholders' agreements,[2] thus shrouding them in mystery (see I.). Nevertheless, shareholders' agreements can be found in every context of corporate life especially in the governance of the corporation and transfers of shares (see II.). The lack of regulation leaves the field open for contract law to provide the major principles and rules for shareholders' agreements based on the principle of the freedom of contract. However, freedom of contract comes at the price of rather limiting the effect of shareholders' agreements as they are generally only binding on the contractual parties themselves. Nevertheless, in several jurisdictions a more general binding effect seems to have been developed by courts and occasionally even by legislators, prompting the question of whether the binding effect of shareholders' agreements is really only contractual (see III.). In addition, this rather limited approach has been put in question by some modern legislators espescially in the "new" legal systems in Eastern Europe giving some fascinating insights into how the regulation of shareholders' agreements should look (see IV.).

I. The Mysterious Shareholders' Agreement

From a conceptual point of view shareholders' agreements are somehow mysterious. They are not disclosed to the public although they can have a significant influence on the governance of a corporation and its shareholders (see I.1.). Despite this fact, most legal systems do not provide any (specific) regulations for shareholders' agreements (see I.2.). These two aspects mean shareholders have a general interest in concluding shareholders' agreements as they provide a means, sanctioned by the legal systems, of influencing the corporation in almost every direction (see I.3.). However, shareholders' agreements offer not only advantages but also several disadvantages for the shareholders (see I.4.).

1. Shareholders' Agreements in the Dark

Shareholders' agreements constitute a common means of addressing the governance of a corporation without being limited to a certain form or type of corporation. They can be found in almost every form of company or corpora-

schafts- und Kapitalmarktrecht 2012 (Tübingen 2013) 231 et seq.; *S. Mock*, Germany, in: Mock/Csach/Havel (eds.), International Handbook on Shareholders' Agreements (Berlin/Boston 2018) 277, 289 et seq. for a comprehensive national report on shareholders' agreements in Germany.

[2] See *S. Mock/K. Csach/B. Havel*, Shareholders' Agreements between Corporate and Contract Law, in: Mock/Csach/Havel*, supra* note 1, 3, 6 et seq.

tion since they can address the different interests and needs of shareholders.[3] Also, they are basically accepted in all legal systems with almost no restrictions despite limitations often found in general corporate law regarding freedom of contract.[4] Probably the most distinguishing aspects of shareholders' agreements are the lack of public availability and the fact that other shareholders have no right to access shareholders' agreements which they are not part of, making these agreements not only interesting for shareholders of large corporations, but especially for family firms and closed corporations due to the (usually existing) need for confidentiality. Therefore, shareholders' agreements can be described as the *dark side of the moon*[5] or being from *two parallel worlds each having their own rules that are not directly related, although they might cross each other.*[6] The most common justification for this confidentiality of shareholders' agreements is their purely contractual background, although this does not sufficiently consider the impact of shareholders' agreements on the corporation, its shareholders and (sometimes) third persons.[7]

2. *The Lack of Regulation*

Generally, shareholders' agreements are neither expressly permitted nor completely forbidden nor even (often) generally addressed in national corporate law.[8] Most legal systems consider shareholders' agreements as simple contracts to which general contract law is typically applied. However, some legal systems also apply general company law with the common limitation that contractual parties to shareholders' agreements are only shareholders and not the corporation itself.[9] Nevertheless, the last few decades have seen a slight shift coming from capital market law and from some (modern) legislators. Traditional capital market law does not address shareholders' agreements. However, capital market legislators have recently become more aware of shareholders' agreements. Although the agreements are not generally forbidden or limited by capital market law, some indirect regulation can be seen in the legal consequences that may be attached to the conclusion of shareholders' agreements. Examples of these developments can be seen in takeover law where shareholders' agreements usually constitute *acting in concert*

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[3] For the economical rationale to close shareholders' agreements see I.3.

[4] For a comprehensive comparison of shareholders' agreements see the numerous national reports in *Mock/Csach/Havel, supra* note 2, 141 et seq.

[5] *P. Forstmoser*, Aktionärbindungsverträge, in: Forstmoser (ed.), Innominatverträge: Festgabe zum 60. Geburtstag von Walter R. Schluep (Zurich 1988) 359, 367.

[6] *Mock/Csach/Havel, supra* note 2, 12.

[7] See *Mock/Csach/Havel, supra* note 2, 9 et seq.

[8] See *Mock/Csach/Havel, supra* note 2, 6 et seq.

[9] See *Mock/Csach/Havel, supra* note 2, 9 et seq.

which can trigger the mandatory bid rule.[10] The same applies to information on major holdings where shareholders' agreements are also considered as *acting in concert*.[11] Moreover, several legislators have introduced specific rules on shareholders' agreements, often based on Model Laws which, unlike traditional western legislators, tend to provide specific rules on shareholders' agreements: such as those from UNCITRAL for a simplified business entity,[12] from the USA for a revised corporation act,[13] and similarly from the

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[10] In the Member States of the European Union this is usually the case since the Takeover-Directive defines in Art. 2 para. 1 lit. d persons acting in concert as "natural or legal persons who cooperate with the offeror or the offeree company on the basis of an agreement, either express or tacit, either oral or written, aimed either at acquiring control of the offeree company or at frustrating the successful outcome of a bid". While it is generally accepted that a shareholders' agreement constitutes acting in concert it is not yet settled which other behavior also meets the conditions of Art. 2 para. 1 lit. d (for the problem see e.g. *U. Wackerbarth*, in: Kalss/Goette (eds.), Münchener Kommentar zum AktG (4th ed., Munich 2017) § 30 WpÜG marg. no. 28 et seq. with further references).

[11] This aspect is also addressed by the European legislator in the Transparency Directive which states in its Art. 10 lit. a that the notification requirement for acquisition or disposal of major proportions of voting rights applies also to "voting rights held by a third party with whom that person or entity has concluded an agreement, which obliges them to adopt, by concerted exercise of the voting rights they hold, a lasting common policy towards the management of the issuer in question".

[12] Art. 36 UNCITRAL SBA (Micro, small and medium-sized enterprises Draft model law on a simplified business entity) states:

"Agreements entered into among shareholders concerning the acquisition or sale of shares, pre-emptive rights or rights of first refusal, the exercise of voting rights, voting by proxy, or any other valid matter, shall be binding upon the simplified business entity, provided that such agreements have been filed with the simplified business entity. Shareholders' agreements shall be valid for any period of time determined in the relevant agreement."

[13] § 7.32 RMBCA (Revised Model Business Corporation Act) states:

"(a) An agreement among the shareholders of a corporation that complies with this section is effective among the shareholders and the corporation even though it is inconsistent with one or more other provisions of this Act in that it:

(1) eliminates the board of directors or restricts the discretion or powers of the board of directors;

(2) governs the authorization or making of distributions, regardless of whether they are in proportion to ownership of shares, subject to the limitations in section 6.40;

(3) establishes who shall be directors or officers of the corporation, or their terms of office or manner of selection or removal;

(4) governs, in general or in regard to specific matters, the exercise or division of voting power by or between the shareholders and directors or by or among any of them, including use of weighted voting rights or director proxies;

(5) establishes the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer or employee of the corporation or among any of them;

(6) transfers to one or more shareholders or other persons all or part of the authority to exercise the corporate powers or to manage the business and affairs of the corpora-

tion, including the resolution of any issue about which there exists a deadlock among directors or shareholders;

(7) requires dissolution of the corporation at the request of one or more of the shareholders or upon the occurrence of a specified event or contingency; or

(8) otherwise governs the exercise of the corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation, or among any of them, and is not contrary to public policy.

(b) An agreement authorized by this section shall be:

(1) as set forth (i) in the articles of incorporation or bylaws and approved by all persons who are shareholders at the time of the agreement, or (ii) in a written agreement that is signed by all persons who are shareholders at the time of the agreement and is made known to the corporation; and

(2) subject to amendment only by all persons who are shareholders at the time of the amendment, unless the agreement provides otherwise.

(c) The existence of an agreement authorized by this section shall be noted conspicuously on the front or back of each certificate for outstanding shares or on the information statement required by section 6.26(b). If at the time of the agreement the corporation has shares outstanding represented by certificates, the corporation shall recall the outstanding certificates and issue substitute certificates that comply with this subsection. The failure to note the existence of the agreement on the certificate or information statement shall not affect the validity of the agreement or any action taken pursuant to it. Any purchaser of shares who, at the time of purchase, did not have knowledge of the existence of the agreement shall be entitled to rescission of the purchase. A purchaser shall be deemed to have knowledge of the existence of the agreement if its existence is noted on the certificate or information statement for the shares in compliance with this subsection and, if the shares are not represented by a certificate, the information statement is delivered to the purchaser at or before the time of purchase of the shares. An action to enforce the right of rescission authorized by this subsection shall be commenced within the earlier of 90 days after discovery of the existence of the agreement or two years after the time of purchase of the shares.

(d) If the agreement ceases to be effective for any reason, the board of directors may, if the agreement is contained or referred to in the corporation's articles of incorporation or bylaws, adopt an amendment to the articles of incorporation or bylaws, without shareholder action, to delete the agreement and any references to it.

(e) An agreement authorized by this section that limits the discretion or powers of the board of directors shall relieve the directors of, and impose upon the person or persons in whom such discretion or powers are vested, liability for acts or omissions imposed by law on directors to the extent that the discretion or powers of the directors are limited by the agreement.

(f) The existence or performance of an agreement authorized by this section shall not be a ground for imposing personal liability on any shareholder for the acts or debts of the corporation even if the agreement or its performance treats the corporation as if it were a partnership or results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement.

(g) Incorporators or subscribers for shares may act as shareholders with respect to an agreement authorized by this section if no shares have been issued when the agreement is made.

OAS[14].[15] Nevertheless, some model laws (e.g. European Model Companies Act)[16] follow a more traditional approach by not dealing with shareholders' agreements at all or by considering them as a simple contract.

3. *Economic Rationale of Shareholders' Agreements*

The enormous importance of shareholders' agreements stems from the economic advantages they provide for shareholders. Effectively these are as follows:

a) *Obtaining (abstract) control over the corporation*

By founding a corporation with several shareholders, each shareholder is limited to the rights provided by corporate law. Consequently, where he or she does not have the majority of the voting power or other super-rights allowing influence over the affairs of the corporation, he or she has no control over the

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(h) Limits, if any, on the duration of an agreement authorized by this section must be set forth in the agreement. An agreement that became effective when this Act provided for a 10-year limit on duration of shareholder agreements, unless the agreement provided otherwise, remains governed by the provisions of this section concerning duration then in effect."

[14] Art. 24 OAS Model Law on the Simplified Stock Corporation (SAS) states:

"Agreements entered into between shareholders concerning the acquisition or sale of shares, preemptive rights or rights of first refusal, the exercise of voting rights, voting by proxy, or any other valid matter, shall be binding upon the simplified stock corporation, provided that such agreements have been filed with the corporation's legal representative. Shareholders' agreements shall be valid for any period of time determined in the agreement, not exceeding 10 years, upon the terms and conditions stated therein. Such 10-year term may only be extended by unanimous consent.

Shareholders that have executed an agreement shall appoint a person who will represent them for the purposes of receiving information and providing it whenever it is requested. The simplified stock corporation's legal representative may request, in writing, to such representative, clarification as regards any provision set forth in the agreement. The response shall be provided also in writing within the five days following the request.

SubArticle 1. – The President of the shareholders' assembly, or of the concerned corporate organs, shall exclude any votes cast in a manner inconsistent with the terms set forth under a duly filed shareholders' agreement.

SubArticle 2. – Pursuant to the conditions set forth in the agreement, any shareholder shall be entitled to demand, before a court with jurisdiction over the corporation, the specific performance of any obligation arising under such agreement."

[15] For a detailed analysis of this provisions in the model laws see *M. Patakyová/ B. Grambličková*, Ratio legis behind the regulation of shareholders' agreements in the model acts: elimination of the application problems or over-regulation?, in: *Mock/Csach/ Havel, supra* note 2, 61 et seq.

[16] In fact, EMCA refers only in the commentary section to shareholders' agreements by simply stating that shareholders can conclude shareholders' agreements in order to coordinate their actions (see Art. 9 which relates to the aspect of group management – see IV.4).

corporation. In order to overcome this limitation, shareholders conclude shareholders' agreements to obtain control over the corporation and to dominate it, not only in relation to the board of directors but also in relation to the other shareholders who are part of the shareholders' agreement. While the first aspect is addressed by the coordination of voting and other shareholders rights,[17] the second is achieved by dealing with the transfer of shares.[18]

b) Remaining in control over certain assets (and obligations) – the shareholders as partners inter sese

This abstract interest of control may be accompanied by a more concrete interest where a corporation has been founded with each shareholder contributing a specific resource. By founding the corporation and distributing the resource to the corporation (e.g. certain things, rights or talents) the shareholder loses control over these resources, as after founding, the corporation as a legal entity is now in control over this resource itself and the shareholder can usually not regain control over it without dissolving the corporation (*asset locking*). The conclusion of a shareholders' agreement constitutes a way to overcome this asset locking by giving one or several shareholders the possibility to control the corporation and therefore to retain control over this resource. The same rationale applies in the case of obligations to make additional contributions to the corporation.[19] In this regard, shareholders' agreements provide the possibility to create a corporation, which is technically independent from its shareholders, and which includes elements of a partnership while keeping the feature of limited liability for all shareholders. This perception was vividly described by Judges *Waterman*, *Moore* and *Tyler* in 1965 in the case *Arditi v. Dubitzky*[20]: "There is little logical reason why individuals cannot be 'partners inter sese and a corporation as to the rest of the world,' so long as the rights of third parties such as creditors are not involved."

c) Establishing family control over the corporation

Another economic rational is the establishment of family control.[21] This scenario also sees the founding shareholders of a corporation facing the problem that they do not have control over the corporation. However, their interest in this case is not gaining control over the corporation but retaining control over their respective share for prospective generations and/or to make sure that the family

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[17] See II.1. for further details.

[18] See II.3. for further details.

[19] See II.2.b) for further details.

[20] *Arditi v. Dubitzky* 354 F.2d 483, 485 (2d Cir. 1965).

[21] For shareholders' agreements especially in family business see e.g. *C. Klein-Wiele*, Der Poolvertrag im Familienunternehmen, NZG 2018, 1401.

or its members will be in control over the corporation.[22] The heirs of the founding shareholders can conclude shareholders' agreements which grant them such control over a share of the company, and as a consequence establish family control. However, since shareholders' agreements bind only the contractual parties[23] the control established by the shareholders might be lost in further generations.[24] Therefore, founding shareholders often split their share into several shares and contribute each (new) share to a new corporation. These corporations, owned by the founding shareholder, then conclude a shareholders' agreement re-establishing control over the respective share(s) of the founding shareholders. After the death of the founding shareholder, his or her shares of the newly founded corporations are passed on to different family members or other heirs which then are bound by the shareholders' agreements binding these newly formed corporations. These shareholders' agreements in family business do not only constitute the basis for an influence on the management of the corporation but also usually limit the transferability of the shares.

4. Legal Advantages and Disadvantages of Shareholders' Agreements

Shareholders' agreements provide all kinds of advantages.[25] They are confidential and can be designed with enormous flexibility since limits are only set by contract law.[26] This contractual origin is also the basis for their simple enforcement.[27] They also provide the possibility of creating specific rights and duties for different shareholders without changing the articles of association and to also potentially include third persons as contractual partners regardless of the limitations often set by corporate law in this respect.[28] However, the contractual nature of shareholders' agreements provides some disadvantages. Shareholders' agreements are not binding on legal successors. Moreover, unanimity is generally needed for amendments or changes.[29] Finally, violation of a shareholders' agreement generally causes no corporate consequences, leaving corporate affairs untouched.[30]

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[22] For a general controlling interest in family business see e.g. *Fleischer*, Das Rätsel Familienverfassung: Realbefund – Regelungsnatur – Rechtswirkungen, in: Vogt/Fleischer/Kalss (eds.), Recht der Familiengesellschaften (Tübingen 2017) 99 et seq.

[23] See III.1. for further details.

[24] This issue depends on numerous factors which are different in most jurisdiction. Under German law a shareholders' agreement is considered as being dissolved in the case of a death of one party (§ 727 BGB). Nevertheless, the shareholders' agreement can deviate from this rule. However, it remains as yet unsettled whether the obligation imposed by a shareholders' agreement is binding for the heirs of the dead shareholder.

[25] See *Mock/Csach/Havel, supra* note 2, 8 et seq.

[26] See III.

[27] See III.3.c) for a detailed analysis of the enforcement problems.

[28] See III.3.a).

[29] See III.3.b).

II. Content of Shareholders' Agreements in Family Firms and Closed Corporations

In the context of family firms and closed corporations, shareholders' agreements are generally used to influence or to establish a certain governance for the corporation (see II.1.) and to address certain aspects of corporate finance (see II.2.). However, they are also used in affairs solely related to shareholders like limiting the transferability of shares (see II.3.).

1. Governance of the Corporation

Regarding the governance of the corporation, shareholders' agreements are mostly used to coordinate the exercise of voting rights and the appointment of members of corporate bodies.[31] Both aspects are often related, although some corporate laws also provide for certain shareholders to appoint members of corporate bodies independent of their voting power.[32] The variety of shareholders' agreements is extremely broad in this context, most vividly described by Judge *Underwood* in the case *Galler v. Galler* in 1964[33]:

> "Where, […], no injury to a minority interest appears, no fraud or apparent injury to the public or creditors is present, and no clearly prohibitory statutory language is violated, we can see no valid reason for precluding the parties from reaching any arrangements concerning the management of the corporation which are agreeable to all."

Probably the most common form of shareholders' agreements addressing the governance of the corporation are voting agreements. These occur not only in large, listed corporations but also in family firms and closed corporations. Generally, most jurisdictions do not impose any limits on voting agreements since they are already hard to enforce, thus making further restrictions largely unnecessary. A notable exception is German stock corporation law which provides a prohibition on vote buying in § 405 para. 3 No. 2 German Stock Corporation Act (*Aktiengesetz,* AktG)[34]. In addition, in some jurisdictions the prohibition on splitting shares seems to become relevant in this context since

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[30] See III.3.

[31] See *Mock/Csach/Havel, supra* note 2, 32 et seq.

[32] This is the case for example in German stock corporation law. According to § 101 para. 2 German Stock Corporation Act (*Aktiengesetz*, AktG) the articles of association can provide the right to appoint members of the supervisory board for shareholders.

[33] *Galler v. Galler*, 32 Ill. 2d 16 (1964).

[34] § 405 para. 3 No. 2 AktG states:
"Anybody shall be guilty of an administrative offence who:
3. […] uses shares of another person which he has acquired by granting or promising special benefits to exercise rights at a shareholders' meeting or a separate meeting."

See *Lieder, supra* note 1, 242 et seq.; *Mock, supra* note 1, 293, 300 et seq. for further details.

according to this rule, shareholders can only transfer voting rights together with the shares. However, in general, there are no specific prohibitions which can be derived from this principle.[35] Finally, the governance of a corporation can be influenced by coordination with other shareholder rights such as the right to challenge shareholder resolutions or to initiate derivative suits.[36]

2. *Corporate Finance*

Shareholders' agreements can also be concluded to address aspects of corporate finance.

a) *Profit sharing*

They can especially be used as a basis for profit sharing.[37] While corporate law often provides a default rule for profit sharing and the basis for the allocation of profits of the corporation, such rules can also be established in the articles of association. Shareholders' agreements provide a third way to address this issue. Settling the matter via shareholders' agreement generally serves the interests of confidentiality and the need or interest in deviating from the allocation rule in the articles of association.

b) *Funding of the corporation*

Finally, shareholders' agreements can also address aspects of the funding of the corporation, for example by creating the obligation for all or certain shareholders to make additional contributions.[38] The advantage of creating such an obligation in the shareholders' agreement and not in the articles of association lies in its limited enforcement. If such an obligation is established in the articles of association it can be enforced not only by the board of directors, but also by the bankruptcy trustee if the corporation goes bankrupt. However, if such an obligation is only established in a shareholders' agreement, neither the board of directors nor the bankruptcy trustee of the corporation can enforce it. This is reserved to the other shareholders who are party to the agreement, and who can only file a claim that the respective shareholder(s) make(s) the distribution to the corporation. In short, by establishing this

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[35] This is the case for example in Germany, where § 8 para. 5 AktG ("Shares shall not be divisible.") is scarcely relevant in the context of shareholders' agreements (see e.g. *Mock, supra* note 1, 293, 301; *S. Mock*, in: Hirte/Mülbert/Roth (eds.), Großkommentar zum AktG (5th ed., Berlin/München/Boston 2016) § 8 marg. no. 202 et seq. with further reference).

[36] For German law see e.g. *Mock, supra* note 1, 302 et seq.

[37] See *Mock/Csach/Havel, supra* note 2, 36; for German law see *Mock, supra* note 1, 304.

[38] See *Mock/Csach/Havel, supra* note 2, 36 et seq.

obligation in a shareholders' agreement the shareholders remain in absolute control of whether they can be forced to fulfil this obligation or not.

3. Transfer of Shares

Another area where shareholders' agreements are usually found is the transfer of shares.[39] However, also in this regard, certain aspects must be distinguished. Shareholders can not only limit the free transferability of shares but also create obligations or rights to buy or to sell shares.

a) Limitation of free transferability

By concluding a shareholders' agreement, shareholders can limit the free transferability of the shares.[40] However, in most jurisdictions such a limitation is rather uncommon due to the contractual nature of shareholders' agreements and the thus limited consequences. Since obligations in shareholders' agreements can only be contractual, a violation of these obligations only entitles the other shareholders to damages and does not make the transfer void. Such damages are often hard to calculate and usually involve broad and difficult questions regarding the valuation of the corporation which themselves often have prohibitive consequences. A stronger effect could only be achieved if a provision establishing a limitation of transfer was provided in the articles of association. However, in some jurisdictions, legal practice seems to try to achieve the same result by including the corporation itself as a signatory to the shareholders' agreement. This approach has also been adopted by some model laws[41] and recent legislation in some jurisdictions.[42]

b) Obligations or rights to buy/sell shares

More common, and of utmost importance, are provisions in shareholders' agreements providing an obligation or right to buy or sell shares.[43] In contrast to the provision dealing with the limitation of free transferability of shares, such provisions are almost only found in shareholders' agreements and not in the articles of association. This is because these provisions only address as-

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[39] For a comparative overview see *Mock/Csach/Havel, supra* note 2, 38 et seq.; *M. Ventoruzzo/C. Malberti*, Limitations on the Shareholder's Right to Transfer Shares, in: Siems/Cabrelli (eds.), Comparative Company Law (2nd ed., Oxford et al. 2018) 429 et seq.; *M. Ventoruzzo/P.-H. Conac/G. Goto/S. Mock/M. Notari/A. Reisberg*, Comparative Corporate Law (Saint Paul 2015) 412 et seq. with an illustration of case law from several jurisdictions. For German law see *Mock, supra* note 1, 305 et seq.

[40] See *Mock/Csach/Havel, supra* note 2, 36 et seq.

[41] See I.2.

[42] See IV.2. for more details.

[43] See *Mock/Csach/Havel, supra* note 2, 41 et seq.

pects of contract law or the law of obligation and there is no need for the establishment of voidance of a transfer in violation of such a provision. As a consequence, there is no need to obtain the absolute effect provided by the articles of association. The specific provisions in shareholders' agreements establishing an obligation or the right to buy or sell shares are diverse and cannot be listed completely here. Common forms include call options, put options, tag along and drag along clauses, price fixation provisions and various forms of the right of pre-emption. An interesting aspect of these provisions, at least from an academic point of view, is that these provisions have almost the same wording regardless of the jurisdiction in which they are used. This phenomenon is probably due to the dominating influence of the Anglo-American legal practice in the world stemming from the lack of regulation of these aspects in most jurisdictions.

III. Shareholders' Agreements as Wanderer between the Contractual and the Corporate World

Probably the most difficult aspect of shareholders' agreements is the extent of their interaction with the corporation (and its different bodies). In this regard basically three different questions must be addressed.[44] The first aspect is whether a shareholders' agreement has a binding effect at all and, if so, who is bound by it (see III.1.). Furthermore, shareholders' agreements can collide with other instruments, particularly the articles of association and shareholder resolutions, which raises the question of whether the shareholders' agreement or the articles of association/shareholder resolutions will prevail (see III.2.). Finally, the dominance of contract law or corporation law is debatable regarding several other aspects (see III.3.).

1. Limited (Contractual) Binding Effect of Shareholders' Agreements

When examining the (limited) binding effect of shareholders' agreements, the starting point must be the rather simple observation that the corporation is (by the articles of association) an arranged structure with various unarranged interests (of shareholders). Although shareholders can arrange or coordinate their interests by concluding a shareholders' agreement, such an agreement cannot change the unarranged structure of the interests of the shareholders in the corporation itself. Therefore, a shareholders' agreement cannot have a binding effect on the corporation and its bodies.[45] This also applies to the

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[44] See *Mock/Csach/Havel, supra* note 2, 12 et seq.

[45] See *Mock/Csach/Havel, supra* note 2, 15 et seq.; for German law see *Mock, supra* note 1, 307 et seq.

shareholders meeting, although this corporate body has the purpose of arranging the (different) interests of the shareholders. Nevertheless, there is a clear tendency in several jurisdictions and in model acts towards a binding effect in the case of notification of the corporation about the shareholders' agreement. However, most jurisdictions do not grant such a notification any legal meaning. Moreover, legal successors of the shareholders concluding shareholders' agreements are generally not bound by it. In this regard, provisions in the articles of association provide a different effect since they bind the shareholder as a shareholder and not the individual person who is the shareholder. Also, shareholders' agreements have a binding effect on all persons signing the agreement. In contrast to the articles of association, the contractual parties are not limited to shareholders. Therefore, third parties who are not shareholders (e.g. creditors, future shareholders, managers etc.) can be a party to a shareholders' agreement.

2. Collisions between Shareholders' Agreements and the Articles of Association and Shareholder Resolutions

A common problem of shareholders' agreements lies in their interaction with the articles of association and/or corporate law in general.[46] Although shareholders' agreements are concluded between shareholders and can therefore generally not interfere with the corporation itself, a clear division of these two worlds (*the world of the shareholders* and *the world of the corporation*) does not exist. Generally, there are three aspects or contradictions between shareholders' agreements on the one hand and the corporation or the articles of association on the other. First of all, it can be difficult to determine whether the shareholders only intend to conclude or change a shareholders' agreement or whether they are seeking to (also) change the articles of association.[47] This problem arises especially if the shareholders' agreement is concluded by all shareholders or by a supermajority of shareholders. Although one could argue that an amendment or change to the articles of association usually has to meet further formal requirements, some jurisdictions also recognize the concept of piercing the articles of association (*Satzungsdurchbrechung*),[48] making it harder to distinguish between the conclusion of a shareholders' agreement and a change of the articles of association.

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[46] See *Mock/Csach/Havel, supra* note 2, 43 et seq.

[47] See *Mock/Csach/Havel, supra* note 2, 29.

[48] See for this phenomenon in German law e.g. *Mock, supra* note 1, 307 et seq.; *S. Mock*, in: Michalski/Heider et al. (eds.), Kommentar zum Gesetz betreffend die Gesellschaften mit beschränkter Haftung (3rd ed., Munich 2017) § 29 marg. no. 216 et seq.; *M. Pöschke*, Satzungsdurchbrechende Beschlüsse zu Gewinnverwendung und -verteilung in der GmbH: ein gesellschaftsrechtlicher Irrgarten, WPg 2019, 533 et seq.

Shareholders' agreements and shareholder resolutions also interact on another level as well.[49] This is a further example of the world of the shareholders' agreement not interfering with the world of the corporation or specifically with the general meeting. Therefore, a shareholder resolution which violates the content of a shareholders' agreement is generally not considered void. Nevertheless, the barrier between these two worlds is challenged in several jurisdictions especially when all shareholders, or at least all those shareholders participating in the general meeting, are also party to the shareholders' agreement. Further complicating matters, the reverse can also be discussed: whether an invalid decision of a general meeting can be considered a valid shareholders' agreement. These questions not only challenge general concepts of corporate law but are also a problem for contract law since shareholder intent can often not be neatly separated into the world of the corporation (= *voting in the general meeting*) and the world of shareholders (= *conclusion of a shareholder meeting*).

3. The Fight for Dominance between Contract and Corporate Law

Besides this collision between the contractual and the corporate world, shareholders' agreements refuse to be regulated solely by contract or corporate law but cause several points of friction between these two worlds.[50] This is particularly true given contract law is generally based on a maximum of flexibility while corporate law often follows a stricter approach.

a) Freedom of contract and the (missing) public interest

The friction becomes obvious when it comes to the limits set by (contract or corporate) law to draft shareholders' agreements and the articles of association.[51] Corporate law does not usually provide the maximum in flexibility regarding the content of the articles of association but sets several limits. These may include limits on which provisions can be included in the articles of association due to a general public interest under corporate law. In addition, courts usually have the discretion to set certain provisions aside, often to protect certain parties. When it comes to contract law, these limitations also exist. However, contract law is more flexible in this regard and provides more freedom to the contractual parties. When it comes to shareholders' agreements, determining the extent of the parties' contractual freedom appears difficult as the corporate regime seems unnecessarily strict, while the contractual regime seems to insufficiently consider the corporate background of the shareholders' agreement as a contract. This unresolved dispute is perfectly illustrated by comparing the dif-

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[49] See *Mock/Csach/Havel, supra* note 2, 28 et seq.
[50] See *Mock/Csach/Havel, supra* note 2, 24 et seq.
[51] See *Mock/Csach/Havel, supra* note 2, 13 et seq.

ferent approaches some legislators have taken in regulating shareholders' agreements.[52] The same general problem exists regarding the formal requirements for concluding a shareholders' agreement and the conclusion of the articles of association. While most jurisdictions provide numerous formal requirements for the conclusion of the articles of association (e.g. registration with the [commercial] register, approval by a notary etc.) these formal requirements usually do not apply to shareholders' agreements.[53]

b) Majority requirement for a change or an amendment of a shareholders' agreement

Another issue in this regard is what appears to be different majority requirements for the change or amendment of a shareholders' agreement.[54] While this question can easily be answered from a contract law point of view with reference to the unanimity rule, the corporate perspective is rather different since corporate law is dominated by the majority rule, although the details of this majority rule can be difficult to determine. To put it in other words: why can a shareholder usually change the articles of association with a ¾-majority but needs a unanimous vote in order to change a shareholders' agreement? Explaining this through a rather formalistic viewpoint, that the former is a matter of corporate law and the latter of contract law is hardly convincing although this is probably in line with the prevailing opinion. Also, in this context, the equally formalistic point of view can be applied that shareholders are usually free to include the unanimity rule in the articles of association thereby justifying the application of the unanimity rule of contract law for shareholders' agreements. However, the question can also easily be turned around asking whether the default rule for shareholders' agreements should be the ¾-majority rule, giving shareholders the choice of adopting the unanimity rule for the articles of association and for shareholders' agreements.

c) Enforcement mechanisms

The same problem occurs when it comes to enforcement.[55] In this regard contract law seems to offer stronger and more efficient enforcement mechanisms since civil procedural law in almost every jurisdiction usually provides a simple and efficient way to enforce contractual obligations. However, a closer look reveals that the enforcement mechanisms of contract law often do not work in the context of shareholders' agreements. Direct enforcement of the obligations of shareholders' agreements often comes too late and is therefore irrelevant.

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[52] See IV.
[53] See *Mock/Csach/Havel, supra* note 2, 13 et seq.
[54] See *Mock/Csach/Havel, supra* note 2, 17 et seq.
[55] See *Mock/Csach/Havel, supra* note 2, 43 et seq.

This is especially the case for voting agreements, since the other parties to a shareholders' agreement may only discover a breach of the agreement by another shareholder at the moment of the vote, making it impossible, even by preliminary rulings, to force that shareholder to vote according to the shareholders' agreement.[56] However, a rather strange exception exists in Germany according to the case law of the Federal Court of Justice from 1983, which states that an agreement of all shareholders has to be considered an agreement of the corporation, although this has probably been overruled since.[57]

Also, the law of damages available under contract and tort law does not provide sufficient mechanisms in this context since damages are often impossible to determine in these cases.[58] Often it is impossible to determine the disadvantage suffered by the other shareholders due to the vote of one shareholder in violation of a shareholders' agreement. In order to address this problem, parties to shareholders' agreements often include contractual penalty clauses. But even this *contractual tool* does not provide a sufficient solution for this problem. While some jurisdictions consider contractual penalties a form of generalized damage requiring that the contractual penalty actually equals the damages the other party suffers[59], many jurisdictions grant judges the discretionary power to lower the contractual penalty.[60] Besides these legal problems, the parties to a shareholders' agreement face a problem determining and agreeing on the right amount for the contractual penalty in advance, given they lack sufficient information on whether this amount will be too high or too low if one shareholder violates the shareholders' agreement. Taking these problems with enforcing shareholders' agreements under contract law into account, one could ask whether the enforcement of shareholders' agreements should instead be addressed by using corporate law and its mechanisms to challenge shareholder resolutions.

d) Termination mechanisms

The clash between corporate and contract law continues in the context of the termination of shareholders' agreements.[61] Often contract law provides more

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[56] For the situation in Germany see *Mock, supra* note 1, 312 et seq.

[57] In this case (BGH, 20 January 1983, II ZR 243/81, NJW 1983, 1910, 1911; BGH, 27 October 1986, II ZR 240/85, NJW 1987, 1890, 1892; see on this case *Ventoruzzo/Conac et al.*, *supra* note 39, 425 et seq. with a translation of the first case) all shareholders were parties of a shareholders' agreement. The court held that in such a case, every shareholder can challenge the shareholder resolution if such a resolution was rendered in violation of the shareholders' agreement.

[58] For German law see *Mock, supra* note 1, 315 et seq.

[59] This is e.g. the case in Austrian civil law *K. Danzl*, in: Koziol/Bydlinski/Bollenberger (eds.), ABGB (5th ed., Vienna 2017) § 1336 marg. no. 2.

[60] This is the case for example in German civil law (§ 343 BGB); see *Mock, supra* note 1, 315 et seq. for further details.

mechanisms for terminating a shareholders' agreement than corporate law in terms of the right to leave the corporation itself. In this context, contract law provides more protection for the parties than corporate law, since contract law generally accepts the principle that contractual obligations have to be limited in time.[62] In contrast, corporations are generally founded without temporal limitations. Therefore, one could also ask in this context whether these two worlds should provide different mechanisms for the termination of the corporation and shareholders' agreements.

e) *Standard of interpretation*

Moreover, the standard of interpretation differs between the contractual and corporate world.[63] While contract law is usually dominated by the concept of subjective interpretation (= *determination of the consistent will of the parties*) corporate law mostly follows the concept of an objective interpretation (= *determination of the understanding of an objective, third party*).[64] When it comes to shareholders' agreements, again, a rather formalistic point of view would suggest that the concept of subjective interpretation applies to shareholders' agreements. But also in this context, this approach is doubtful. It seems somewhat arbitrary for shareholders to face two different standards of interpretation when it comes to the articles of association and shareholders' agreements, even though both instruments can address the same aspects. But should one grant shareholders the possibility to choose the applicable standard of interpretation, the concept of objective interpretation of the articles of association is thrown in some doubt.

f) *Private International Law*

Finally, the fight for dominance between corporate and contract law becomes relevant in the (frequent) case of international shareholders' agreements.[65] While corporate law basically follows the approach of incorporation theory, applying (corporate) law to the incorporation process of the corporation[66] the

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[61] See *Mock/Csach/Havel, supra* note 2, 20.

[62] Several jurisdictions consider contracts concluded for several decades or without temporal limits as void. This is the case for example in German law where contracts for a period of more than 20 years are considered void as they are an unjustified limitation of the economic freedom of the contractual parties (see e.g. *C. Armbrüster*, in: Schubert (ed.), Münchener Kommentar zum BGB (8th ed., Munich 2018) § 138 marg. no. 71 et seq.). However, there are no cases where this principle was applied to shareholders' agreements.

[63] See *Mock/Csach/Havel, supra* note 2, 20 et seq.

[64] See especially for the situation in Germany *Mock, supra* note 1, 307 et seq.

[65] For a detailed analysis of this problem see *K. Csach*, Cross-border Shareholders' Agreements and Private International Law, in: Mock/Csach/Havel*, supra* note 1, 83 et seq. with further references. See also *Mock, supra* note 1, 298 for an analysis of German law.

private international law of contracts is dominated by the freedom to choose the applicable law or to apply the law of the seat of one of the parties[67] but usually not of the matter or item of the contract. By considering shareholders' agreements solely as a matter of contract law, shareholders have tremendous freedom to choose the applicable law, making it very easy to circumvent limitations in jurisdictions with stricter regulations on shareholders' agreements.[68] Consequently, it seems more appropriate to consider shareholders' agreements in general as matter of corporate law with the consequence that the corporate law of the corporation itself applies. Such a result can be achieved in private international law by applying the qualification method and considering shareholder' agreements as a part of the *lex societatis*.

IV. The Unsettled (Modern) Legislator – Observations from a Comparative Perspective

It appears a general mystery common to the legal systems of the Western world that these frictions between the contractual and the corporate world caused by shareholders' agreements have not yet led to a fundamental intervention of the legislator. However, recent developments especially in some jurisdictions show that legislators are becoming more aware of these problems.[69]

1. Permission and Registration of Shareholders' Agreements

In some jurisdictions (e.g. Denmark[70] or Slovakia[71]) legislators have started to expressly permit shareholders' agreements. However, the reason for this legislative permission often remains unclear as freedom of contract usually applies, thus also allowing shareholders to conclude agreements. The answer to this question is probably that shareholders' agreements had become more relevant in all jurisdictions, leading to increasing questioning of rather broad concepts of contract law such as the prohibition on splitting shares. By explicitly permitting shareholders' agreements, some legislators probably would like to

[66] For the problem of the applicable law on corporations see *Ventoruzzo/Conac et al.*, *supra* note 39, 29 et seq. with illustrations of different approaches in the major legal systems.

[67] See e.g. for this general principle Art. 3 et seq. Rome-I-Regulation (593/2008/EC).

[68] For an overview on the tendency of some jurisdictions to impose stricter regulations in the context of shareholders' regulations see IV.

[69] For an overview on the development in several jurisdictions see the numerous national reports in Mock/Csach/Havel, *supra* note 1, 141 et seq.

[70] See especially *M. Neville*, Denmark, in: Mock/Csach/Havel, *supra* note 1, 233 for further details on the legal situation in Denmark.

[71] See especially *Z. Mrázová*, Slovakia, in: Mock/Csach/Havel, *supra* note 1, 551 et seq. for further details on the legal situation in Slovakia.

make sure that courts in particular do not interfere with the common practice of shareholders' agreements. Some legislators (e.g., Brazil[72]) go even further by requiring shareholders to register agreements with the corporation, arguably equivalent to the notification requirement as set out in some Model Laws.[73]

2. Resetting the Relationship between Shareholders' Agreements and the Corporation

Probably the area of greatest activity for national legislators is the relationship between shareholders' agreements and the corporation. Here, a clear tendency can be observed, that sees legislators try to settle the relationship between shareholders' agreements and the corporation by extending the mere contractual *inter partes effect* to the corporation and its bodies, in an *ad hoc* piercing of the articles of association (e.g., Austria,[74] Germany[75]) or by expressly excluding it (e.g., Denmark,[76] Greece,[77] Slovakia[78]). Also, some jurisdictions accept an objective interpretation of shareholders' agreements (e.g., Belgium,[79] Czech Republic,[80] England[81]). Moreover, the cession of shareholders' agreements is often expressly addressed, although usually only by making reference to a consensual amendment of a contract (e.g., Czech Republic,[82] Israel,[83] USA[84]). In some jurisdictions the *inter partes effect* is also extended to third parties like the transferee (e.g., Denmark[85]) or to provisions on the limitation of the transfer of shares in the articles of association (e.g., USA[86]).

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[72] See especially *I. Hübert*, Brazil, in: Mock/Csach/Havel*, supra* note 1, 551 et seq. for further details on the legal situation in Brazil.

[73] See I.2. for further details.

[74] See especially *M. Arlt*, Austria, in: Mock/Csach/Havel*, supra* note 1, 141, 153 et seq. for further details on the legal situation in Austria.

[75] This is particularly the case for the principle of piercing the articles of association (*Satzungsdurchbrechung*). See *supra* note 48 for further references.

[76] For references on Danish law see *Neville, supra* note 70.

[77] See especially *G. Psaroudakis*, Greece, in: Mock/Csach/Havel*, supra* note 1, 305, 317 et seq. for further details on the legal situation in Greece.

[78] For references on Slovakian law see *Mrázová, supra* note 71.

[79] See especially *T. Matthijs*, Belgium, in: Mock/Csach/Havel*, supra* note 1, 167, 179 et seq. for further details on the legal situation in Belgium.

[80] See especially *B. Havel*, Czech Republic, in: Mock/Csach/Havel*, supra* note 1, 207, 219 et seq. for further details on the legal situation in Czech Republic.

[81] See especially *R. Zakrzweski*, England and Wales, in: Mock/Csach/Havel*, supra* note 1, 247, 259 et seq. for further details on the legal situation in England and Wales.

[82] For references on Czech law see *Havel, supra* note 80.

[83] See especially *O. Kimhi/A. Harel/Y. Binestock*, Israel, in: Mock/Csach/Havel*, supra* note 1, 389, 393 et seq. for further details on the legal situation in Israel.

[84] See especially *W. Kaal*, United States of America, in: Mock/Csach/Havel*, supra* note 1, 657 et seq. for further details on the legal situation in the USA.

[85] For references on Danish law see *Neville, supra* note 70.

3. Termination

Regarding the termination of shareholders' agreements, the legislators seem not to have found a common course. While in some jurisdictions the freedom of contract regarding limitations to terminate shareholders' agreements has been extended (e.g., Austria[87]) some legislators have also introduced absolute restrictions for the duration of shareholders' agreements dealing with certain aspects (e.g., USA[88]).

4. Shareholders' Agreements and Corporate Group Law

Finally, in some jurisdictions, shareholders' agreements are often seen in the context of corporate group law considering them as a factor for determining the existence of a corporate group (e.g., Denmark,[89] Germany,[90] Greece[91]) although this is often only the basis for the application for capital market law. Moreover, shareholders' agreements have an influence on the management of corporate groups and are therefore sometimes addressed in this context. As an example, Art. 9 European Model Companies Act provides that members of the management of a subsidiary are not bound by any instruction of the parent company if the directors were appointed due to a shareholders' agreement.

V. Summary

Shareholders' agreements usually serve as a tool to overcome the restrictions imposed by a minority holding or asset locking of corporate law by the means of contract law. However, shareholders' agreements are trapped between the contractual and the corporate world without clear dominance of one legal regime. In this context, a growing awareness of the problems evolved from shareholders' agreements and the application of freedom of contract can be observed in many jurisdictions. The result is a breakdown in the (strict) divisions between the contractual and the corporate world in many jurisdictions.

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[86] For references on US law see *Kaal, supra* note 84.

[87] In Austria the law of civil partnerships was changed, making it possible to restrict the termination of (internal) civil partnerships to extraordinary termination requiring a special reason for the termination. See *Arlt, supra* note 74 for further details on Austrian law.

[88] For references on US law see *Kaal, supra* note 84.

[89] For references on Danish law see *Neville, supra* note 70.

[90] *Mock, supra* note 1, 311 et seq.

[91] For references on Greek law see *Psaroudakis, supra* note 77.

Related Party Transactions in Non-Listed Companies

The Limited Effectiveness of Ex Ante Control

Nuria Latorre Chiner[*]

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I. Introduction to Related Party Transactions. The Current Regulation for Listed and Non-listed Companies

Related party transactions (RPTs) are, in rather imprecise terms, transactions that a company carries out with insiders, that is, with persons capable of controlling, influencing or determining the decisions a company makes; basically, directors and majority partners. The participation or influence that the other party to the transaction has over the decision-making processes of the business means that there is a potential for conflicts of interest, and a heightened risk that the business may execute a transaction that is opposed to its best interests and favorable to those of the counterparty. As is often pointed out, RPTs are not necessarily pernicious. They may bring a benefit to a company, at the cost of the related counterparty, or they might even be advantageous to both parties. However, given that a danger to the company clearly

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Although they are not strictly equivalent terms, this article will use *closed companies* and *non–listed companies* indistinctly, in order to simplify the principal argument.

does exist, it is necessary to introduce preventive measures to check these transactions before a company commits itself contractually.

In Spanish Company Law, the most comprehensive regulation of RPTs is found in the law relating to listed companies. Art. 529 ter para. 1 lit. h of the Spanish Corporations Act (*Ley de Sociedades de Capital*, LSC)[1] grants the board of directors a non-delegable faculty to approve transactions the company concludes with those considered to be related parties. Littera h is not quite clear in its subjective delimitation of a related party, but for the purposes of this article, it can be reduced to two broad groups: directors and the subjects related to them, and majority partners and the subjects related to them. Art. 529 ter para. 1 lit. h LSC takes the same approach irrespective of the related party that enters into a contract with the company: in the director's meeting, the related party shall abstain from participating and voting on the agreement concerning the transaction, as shall any director that represents or is related to the shareholder affected by the transaction.[2]

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[1] *Real Decreto Legislativo 1/2010, de 2 de julio, por el que se aprueba el texto refundido de la Ley de Sociedades de Capital.*

[2] Art. 529 ter para. 1 lit. h LSC was added by *Ley 31/2014, de 3 de diciembre, por la que se modifica la Ley de Sociedades de Capital para la mejora del gobierno corporativo* (Law 31/2014), which modified the Spanish Corporations Act. There have been a number of articles commenting on this change: *J. Alfaro*, Modificaciones necesarias del Derecho español para incorporar la Directiva sobre operaciones con partes vinculadas (<http://derechomercantilespana.blogspot.com.es/2017/09/modificaciones-necesarias-del-derecho.html>); *G. Guerra*, El régimen sobre operaciones vinculadas en la Directiva 2017/828 y su eventual impacto en el ordenamiento español, RdS 51 (2017) 333 et seq.; *L. Fernández Del Pozo*, Las operaciones vinculadas intragrupo. Estado de la cuestión en Derecho español y necesidad de su reforma, RDBB 149 (2018) 11; *L. Fernández Del Pozo*, Transparencia y aprobación de operaciones con partes vinculadas: Directiva UE 2017/828, de 17 de mayo de 2017, La Ley mercantil 50 (2018) 3 et seq.; and *L. Fernández Del Pozo*, Transparencia y aprobación de operaciones con partes vinculadas, in: Rodríguez Artigas/Fernández de La Gándara et al. (eds.), Sociedades cotizadas y transparencia en los mercados, Vol. I (Pamplona 2019) 291 et seq.; *N. Latorre*, Las operaciones vinculadas en las sociedades cotizadas. Especial atención a las operaciones intragrupo, RdS 51 (2017) 129 et seq.; *F. León*, Las operaciones con partes vinculadas en las sociedades anónimas cotizadas, Almacén de Derecho, 5 September 2017 (<http://almacendederecho.org/las-operaciones-partes-vinculadas-las-sociedades-anonimas-cotizadas-segun-la-directiva-200736ce/>).

Just before this article was submitted for publication, the Spanish Ministry of the Economy and Business released the draft version of the Law to modify the consolidated text of the Spanish Corporations Act, passed by *Real Decreto Legislativo 1/2010* (*supra* note 1), and other financial regulations, in order to adapt the existing regulation to Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, 2019 (SRD II). The proposed modifications to RPTs are considerable (a specific chapter, Chapter VII bis LSC containing five articles, Arts. 529 et seq. LSC, is devoted to them).

With regard to unlisted companies, the regulation on RPTs applies only to directors and is contained in Arts. 229 para. 1 lit. a and 230 para. 2 of the LSC. The first of these articles obliges directors to abstain from carrying out certain transactions with the company, while the second establishes an authorization procedure should these transactions require consideration[3]. The authorization procedure in Art. 230 para. 2 LSC is inspired by the same ideas as its counterpart for listed companies: the existence of a conflict of interest, the risk of damage to the company and the necessity for an *ex ante* intervention.

Transactions concluded between the company and majority partners are regulated by Art. 190 LSC, which deals with conflicts of interest for the partners of the company. A limited number of transactions must be submitted to the general meeting for agreement: any transaction involving the essential assets of the company; and any transaction by which a partner of a *Sociedad de Responsabilidad Limitada* (Limited Liability Company) receives any type of financial assistance from the company, including the granting of guarantees in favor of the partner. Art. 190 LSC stipulates that the partner in question cannot vote on whether financial assistance shall be given (Art. 190 para. 1 lit. d LSC), although the partner may vote on whether a transaction involving essential assets should go ahead (applying the general rule contained in Art. 190 para. 3 LSC). It should be noted that transactions concerning essential assets concluded between the company and majority partners normally presume a higher level of risk for the company than those carried out with its directors, but this risk currently seems to be ignored by the legislator.

The modern regulation of RPTs in listed companies is marked by two characteristics: prevention and proceduralism.[4] In this sense, the regulations are notable for obliging companies to intervene to evaluate any transactions to determine whether they are in the interests of the company before they are concluded. They also display a marked proceduralism, founded in the belief that the more rigid the procedures required to authorize such transactions, the lower the risk of any abuse of, or deviation from, the function entrusted to directors to defend the interests of the company.[5] The focus of the legislation is therefore on ensuring an *ex ante* intervention, through an efficient procedure of control, that functions as a filter to discard transactions that could cause prejudice to the company while passing those judged to be fair.

This legislative approach is favored in the context for a number of reasons. Firstly, listed companies expend considerable amounts on risk management

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[3] Both of these precepts were modified by Law 31/2014.

[4] Most European jurisdictions have adopted legislation on this point in the last decade, approximately following the process of promulgation of SRD II. In some countries, such as Italy, the legislation was adopted prior to the Directive and to a great extent served as its inspiration.

[5] *G. Guizzi*, Interessi degli amministratori e operazioni con parti correlate, in: Vietti (ed.), La governance nelle società di capitali. A dieci anni dalla riforma (Milan 2013) 165, 169.

and have sufficient resources, both in terms of money and organizational capacity, to establish adequate procedures of control. Secondly, it is an area in which judicial review is notoriously difficult (due to litigation costs, the lack of incentives to press ahead with a claim, the difficultly of accessing the information necessary to support a legal claim, the statutory requirement to hold a minimum percentage of company capital in order to be able to request judicial review, the reluctance of judges to analyze transactions from an economic-financial perspective, etc.). Finally, the stock market requires that companies' decisions are certain and stable, because the threat of an *ex post* revision and the possible annulment of a transaction would cause unease among investors.

These last two reasons stem from the same central ideas: *ex ante* controls are preferred in listed companies because judicial review is both difficult and unadvisable, while from a practical perspective, it is believed that *a priori* mechanisms of control reduce the chances of litigation. Although control procedures do not prevent access to judicial review, if they are well designed and effective they will result in fair transactions for the company, and it is therefore less likely that the decision will be impugned for being contrary to the company's interests, and less probable that the directors will be held to account for having acted against the interests of the company.

In non-listed companies the need for an *ex ante* control of RPTs also exists, but the context does not favor proceduralism as in the case of listed companies. Although non-listed companies are heterogeneous and difficult to group together by categories of size and structure, it is reasonable to think that the economic and organizational resources that they can dedicate to preventative controls are less than those of listed companies. Two additional considerations may lead one to conclude that the procedural safeguards in place for unlisted companies may be less effective than those at listed companies. The first is that the directors are subject to the decision-making authority of the general meeting, and there is no system of counterweights in place to reinforce their independence, which means that any procedural controls are, to a large extent, under the control of the partners, or, more specifically, the majority partners. The second is that the governing bodies of non-listed companies are, in general, less balanced or plural than those of listed companies. Although the extent of the concentration of power may well be similar in both models, the way in which the governing bodies are composed is not, because non-listed companies, especially if they are closed companies, are seldom willing to incorporate directors appointed by minority partners.

Taking these circumstances into account, the implementation of a control procedure may do nothing to reduce the probability of litigation. This is because, as noted earlier, in order for these procedures to be significant they must be well designed and effective, that is, they must serve the end for which they were created. This end is to neutralize the risk of harm to the

company and enable the company to conclude transactions that are favorable, just, or fair.[6] If the procedure is not effective, the resulting transaction will almost certainly be unjust for the company and will result in a legal claim based on the contravention of company interest.

In the case of closed companies, their idiosyncratic nature renders them prone to being stifled by excessive bureaucracy, which might well be counterproductive to achieving the required result. Their variation also means that even when control procedures are observed, it may not substantially affect the outcome of a judicial review of the transaction.[7]

The aim of this paper is to analyze whether, in the case of closed companies, the controls placed on RPTs are effective at neutralizing the conflicts of interests that these transactions generate. The current state of Spanish legislation, which does not pay specific attention to transactions concluded with majority partners, dictates that the focus of this study shall be on the transactions that the company concludes with its directors or the parties related to them. In this respect, what follows is an examination of the legal framework (II.) and the effectiveness of preventative systems of control (III.).

II. Transactions between the Company and Its Directors. The Legal Framework

1. The Main Points of Art. 230 para. 2 LSC

The duty of company directors to avoid situations of conflict with the company, and, in particular to refrain from concluding transactions with it, does not

[6] The legal mechanisms to achieve this objective are numerous, but, in the case of preventative or *ex ante* controls, they are normally directed towards removing the related party from the decision-making process. The school of legal doctrine that has most thoroughly explored the legal instruments concerning RPTs in listed companies is that of the economic analysis of Law. Without attempting an exhaustive list of such articles one might suggest: *P.-H. Conac/L. Enriques/M. Gelter*, Constraining dominant shareholders' self-dealing: the legal framework in France, Germany and Italy, ECFR 4 (2007) 491 et seq.; *L. Enriques*, Related party transactions: policy options and real-word challenges (with a critique of the European Commission Proposal), ECLI – Law Working Paper No. 267/2014; *L. Enriques/G. Hertig et al.*, Related-party transactions, in: Kraakman/Armour et al. (eds.), The anatomy of Corporate Law (3rd ed., Oxford 2017) 145–169; *Z. Goshen*, The efficiency of controlling corporate self-dealing: theory meets reality, Cal. L. Rev. 91 (2003) 393 et seq. In Spain these articles were circulated by *F. Vives*, Los conflictos de intereses de los socios con la sociedad en la reforma de la legislación mercantil, RDBB 137 (2015) 7 et seq.

[7] The relationship between procedural safeguards and judicial review deserves a specific treatment that is beyond the objective of this paper, but the basic question is whether the observance of such procedures would impede the judicial review of transactions that have been concluded, or, at least, modify the terms of the review.

prevent the company from authorizing such transactions. Art. 230 para. 2 LSC establishes the procedure for this authorization, reserving the competence to decide to the board of directors and the general meeting. The main points can be summed up as follows:

1. Authorization is required for those transactions that the company concludes with a director or a party related to a director.

2. This authorization is reserved for those transactions considered to be relevant. The prohibition against concluding transactions with the company contained in Art. 229 para. 1 lit. a LSC does not apply to transactions that comply with three following prerequisites: a) they are ordinary transactions, b) they are made under standard customer conditions, and c) they are of scant relevance. This is understood to mean that information concerning these contracts is not required in order to fairly express the company's assets, financial situation or profits.

3. Generally, the power of authorization is granted to the Board of Directors. The Director involved in the transaction neither participates in the discussion nor votes on the final decision concerning the transaction (Art. 228 lit. c LSC). The directors charged with the responsibility of either authorizing or refusing to approve the transaction must guarantee: a) their independence with respect to the director affected by the conflict of interest; b) the innocuous nature of the transaction or the fact that it is being concluded under normal market conditions, and c) the transparency of the process. When the competence to approve the transaction is granted to the directors, Art. 249 bis lit. c LSC also comes into play. This article refers to the non-delegable faculty of the board of directors to authorize or allocate the obligations arising from the directors' duty of loyalty.

4. The competence to approve RPTs is granted to the general meeting in certain cases. Art. 230 para. 2 LSC states that this is the case when: a) the value of the transaction exceeds 10% of company assets, b) when the transaction refers to the provision of any form of financial assistance to the director, including the granting of guarantees in the director's favor (this applies only to limited liability companies), or c) when the transaction establishes a work or services contract (this again only applies to limited liability companies). Implicitly, the general meeting also has competence when the board of directors is unable to make a decision on the authorization.

When the authorization is to be granted by the general meeting, Art. 230 para. 2 LSC must be considered in conjunction with Art. 190 para. 1 lit. e LSC, which prohibits a partner/director from voting if the agreement of the general meeting has the objective of "allocating any the obligations arising from the duty of loyalty stipulated under article 230".

Of these four aspects, the following analysis shall be limited to the first and the third: the subjective delimitation of the rule and the duties of the director with respect to the conflict of interest.

2. *Subjective Scope of the Rule*

Article 230 para. 2 LSC requires that transactions the company concludes with its directors or persons related to them (Art. 231 LSC) be authorized. The subjective delimitation for the director in the current regulations covers a variety of situations: transactions the director concludes directly with the company for her own benefit, transactions carried out with subjects to whom the law has extended the directors' duties and liabilities (Art. 236 LSC), transactions the directors have entered into with the company through an intermediary[8], and transactions directors have entered into directly with the company for the benefit of a third-party[9].

The second group is comprised of the operations that the company concludes with parties related to the director, enumerated in Art. 231 LSC. In these transactions, what constitutes a related party is not altogether clear because the terminology employed for the regulation of RPTs in listed companies (found in Art. 529 ter para. 1 lit. h LSC) coincides with the title of Art. 231 LSC. However, it is unimportant whether the party "connected to the transaction" is the director herself or one of the "subjects related to her". What is relevant is which subject has a conflict of interest with the company and which subject has the duty to comply with the duties that the law imposes in order to neutralize the risk of damage to the company. The answer, obvi-

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[8] The contracts entered into through an intermediary represent a fraudulent evasion of the law. If the director is a material party to the transaction but inserts an intermediary as a legal party to the transaction, then it is irrelevant that this intermediary is one of the figures contemplated in Art. 231 LSC. Arguing against this interpretation is: *C. Boldó*, Deber de evitar situaciones de conflicto y personas vinculadas a los administradores: artículos 229 y 231, in: Hernando Cebriá (ed.), Régimen de deberes y responsabilidad de los administradores en las sociedades de capital (Barcelona 2015) 241, 268, 273 and 278; and *V. Ribas*, in: Rojo/Beltrán (eds.), Comentario de la Ley de sociedades de capital, Vol. I (Madrid 2011) Art. 231, 1659, 1660.

[9] When the director enters into a transaction in her own name, the transaction should be classified as an RPT whether she does so for her own benefit or for the benefit of another person. The author agrees with: *A. Díaz Moreno*, Deber de lealtad y conflictos de intereses (observaciones al hilo del régimen de las operaciones vinculadas), Análisis Gómez-Acebo & Pombo, 18 December 2014, 3 (<https://www.ga-p.com/wp-content/uploads/2018/03/deber-de-lealtad-y-conflictos-de-intereses-observaciones-al-hilo-del-regimen-de-las-operaciones-vinculadas.pdf>), that the nature of the third-party is irrelevant in these cases. It is not necessary that the subject be one of the figures referred to in Art. 231 LSC, despite the fact that Art. 229 para. 2 LSC makes an explicit reference to the parties related to the director ("The previous provisions shall also be applied in the event that the beneficiary of prohibited acts or activities is a person associated with the director"). Another author who departs from the literal text of the Arts., *P. Portellano*, El deber de evitar situaciones de conflicto de interés: entre la imperatividad y la dispensa [Arts. 229, 230 y 529 ter para. 1.h) LSC], in: Rodríguez Artigas/Alonso Ureba et al. (eds.), Junta general y consejo de administración en la sociedad cotizada, Vol. II (Cizur Menor 2016) 459, 484.

ously, is that the only subject with a duty of loyalty to the company, who is therefore obliged to avoid conflicts of interest, is the director. The person related to the director who enters into a transaction with the company, does not have a conflict of interest with it, at least, not in the sense that concerns the legislator. The subject in question is placed in a situation of conflict as a counterparty to the transaction, but merely contractually. Only the director, who has a legal duty of loyalty to the company, has a conflict of interest with the company.[10]

Article 230 para. 2 LSC does not include the transactions concluded with third-parties that are not related to the director, but in which the director may have a relevant personal interest. The paradigmatic case is when the transaction is concluded with a subject that promises the director a part of the profits of the transaction, or promises to reward the director in some way if she intervenes in order to guarantee a favorable result. Such transactions are not technically RPTs and are not included in the material scope of Art. 230 para. 2 LSC, which refers expressly to the transactions entered into by directors and related parties. It is the case that, if the director finds herself in the position of a conflict of interest with the company, she is obliged to communicate this fact to the company and abstain from participating in the decision concerning the transaction. However, as the situation described is outside of the material scope of Art. 230 para. 2 LSC, the decision concerning the transaction does not correspond to either the board of directors or the general meeting, and the transaction can be concluded in the name of the company by any entity that has the power of attorney to represent the company. The interest the director has in this type of operation is clear and creates exactly the same risk of damage to the company as an RPT. The director is an insider, and has the capacity to condition, or even predetermine the decision that the company takes with regard to the transaction. This risk justifies the need for a decision to be taken by a corporate body and not simply by any individual that has the capacity to legally bind the company. This parity with RPTs recommends an analogical application of Art. 230 para. 2 LSC to any relevant transaction in which the director may have a personal interest, whoever the subject that enters into a transaction with the company may be.[11]

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[10] The reference that Art. 229 para. 3 LSC makes to the "conflicts of interest" that persons related to the director may have with the company, is incorrect. Of the same opinion, *Díaz Moreno, supra* note 9, 3.

[11] These operations surely explain why various authors defend the open or merely illustrative character of Art. 231 LSC, because the circumstances described in the article do not exhaust all of the relations that can lead a director into a situation of conflict with the company. Among others, *Boldó*, *supra* note 8, 267; *J. M. Embid/C. y Górriz*, in: Arroyo/Embid/Górriz (eds.), Comentarios a la Ley de Sociedades Anónimas, Vol. II (2nd ed., Madrid 2009) Art. 127 ter, 1427, 1443; *A. Emparanza Sobejano*, Los conflictos de intereses de los administradores en la gestión de las sociedades de capital, RDM 281 (2011)

3. The Obligations of the Directors Concerning Related Party Transactions

Competence to authorize an RPT generally goes to the board of directors, and in specific cases, to the general meeting. The competence of the general meeting is clear when the transaction has certain defined objectives or characteristics, i.e.: when the value of the transaction exceeds 10% of the company assets; when the transaction refers to the provision of any form of financial assistance to the director, including the granting of guarantees in the director's favor; or when the transaction establishes a work or services contract (the last two cases only apply to limited liability companies). The competence of the general meeting is less evident in the remaining cases, which derive from the fact that the directors are unable to reach a decision over the transaction, either because they cannot guarantee the conditions required by Art. 230 para. 2 LSC, or because there is a single company director, or because this corporate body is rendered impotent by the abstention of the director or directors that have the conflict of interest.[12] This section of the paper will examine

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13, 36; *M. Gónzalez-Meneses*, Los deberes del administrador en situación de conflicto de intereses, in: Martínez-Echevarría y García-Dueñas (ed.), Gobierno corporativo: la estructura de gobierno y la responsabilidad de los administradores (Cizur Menor 2015) 541, 556; *J. Juste Mencía*, in: Juste Mencía (ed.), Comentario de la reforma del régimen de las sociedades de capital en materia de gobierno corporativo (Ley 31/2014) (Cizur Menor 2015) Art. 228, 377, 384; *J. Megías*, El deber de independencia en el consejo de administración: conflictos de interés, dispensa y *business judgment rule*, RdS 52 (2018) 117, 123–124; *Portellano, supra* note 9, 485; *J. Sánchez-Calero Guilarte*, La reforma de los deberes de los administradores y su responsabilidad, in: Morillas Jarillo/Perales Viscasillas/Porfirio Carpio (eds.), Estudios sobre el futuro Código Mercantil, Libro homenaje al profesor Rafael Illescas Ortiz (Madrid 2015) 894, 910 (available at <http://hdl.handle.net/10016/21008>).

What has not been said openly, from this perspective, is that Art. 230 para. 2 LSC should be applied to all relevant transactions in which the director has an interest; however, the consequence seems obvious. In my opinion, it would be preferable to defend the closed character of Art. 231 LSC (the rule establishes presumptions *iuris et de iure* in which the director has a conflict of interest with the company, an effect which is only compatible with an exhaustive enumeration of causes) and apply Art. 230 para. 2 LSC by analogy to transactions in which there is a conflict of interest comparable to that created by RPTs.

[12] Of course, the general meeting is also competent to take the decision whenever the directors decide that it should do so.

With reference to the impotence of the board of directors, some authors are of the opinion that those that "remain" in the post retain the capacity to take the decision. According to this view, the decision can be adopted by the minority of board members, because the position occupied by the board member or members affected by the conflict of interest, should not be taken into account for the purposes of calculating a quorum or the majority required to approve a decision (*Portellano, supra* note 9, 495; *M. Sánchez Álvarez*, Art. 127 ter para. 3 LSC y quórums de constitución y votación, RdS 24 (2005) 271, 275; *J. M. Serrano Cañas*, El conflicto de intereses en la administración de sociedades mercantiles (Cordoba 2008) 393; *Megías, supra* note 11, 132. The recent judgement of the

the competence of the board of directors and the obligations of the directors with respect to the RTP placed before them.[13]

In order to analyze the duties of the directors it is vital to focus on the meaning of Art. 230 para. 2 LSC and to appreciate that this article simply regulates the authorization, by the company, of a situation that could be potentially damaging to it, and in which one of its directors has a direct interest. The procedure outlined by the article, which is activated by the director communicating a conflict of interest with respect to a transaction to the company, (although as we shall see later this is not the only means of activating the procedure), allows the company to assess the operation and to decide whether or not it is in the company's best interests to go ahead with it. A decision to authorize an RPT serves as the company's answer in this assessment: it has concluded that the transaction poses no danger, or that the risk of damage is minimal, or even that a harmful result could well be compensated for by other, positive aspects.

The duties, which are assumed respectively by the director in the situation of the conflict of interest and the decision makers, do not differ substantially from those in similar situations of conflict which also require authorization. The loyal general manager or agent will communicate to his principal a situation of conflict and provide her with the information she needs in order to make a proper assessment. The authorizing entity, for her part, will employ due diligence in her analysis of the information provided and make a decision according to her discretion, a decision which shall be made freely, without interference, coercion, or undue influence from the subject affected by the conflict of interest. In this way, the contribution of both parties ensures that the authorization granted by the principal is both free and informed, as it can only be considered valid if it is made with full knowledge of the available facts and with freedom of judgement.

The directors affected by the authorization of an RTP clearly also operate within these same parameters.

The law confers the familiar duties of communication and abstention on the director in a position of conflict (Arts. 228 lit. c and 229 para. 3 LSC in reverse order). The duty of abstention has a special importance within the

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Spanish Supreme Court (TS, 16 January 2019, RJ 2019/149) seems to point in a different direction, or at least introduce an important qualification to this view. Although the circumstances of the case are not the same as those commentated on by the authors mentioned (in the case before the Supreme Court one of the directors resigned, which left the board of directors unable to function), the Supreme Court was of the opinion that the collegiate body could meet and function as long as there was still a majority of directors, *a majority not calculated by taking into account those present but a majority in relation to the number contained in the company statutes.*

[13] For the competence of the general meeting, see *J. Boquera*, La dispensa del conflicto de interés de los administradores por la junta general, RdS 57 (2019) 21–83.

field of corporate regulation, as the will of the authorizing subject is made up of the sum of the individual wills of its members, which, were it not for the duty of abstention, would include the person in the situation of conflict. In the specific case of RPTs, the relevance is even greater because the conflict arises directly from the subject's participation in the decision-making bodies of the company. This explains why the mechanisms of control for RPTs are aimed principally at separating the affected party from these bodies, either by removing them completely, as in the case of the directors, or preventing their vote from determining the outcome of the decision in question, as is the case of the partners[14]. The objective in both cases is to keep the will of the company free from influence.

Given the importance of reporting a conflict of interest is unquestionable, it is therefore unnecessary to reiterate or refer to the opinions expressed in the academic literature over this duty. However, it is necessary to point out that, when it concerns a "related party transaction", the duty to communicate the conflict of interest has certain special characteristics.

One of these is that the conflict of interest does not have to be communicated by the director to activate the control procedure. It is not necessary for the director concerned to evaluate or assess the situation in which she finds herself so as to comply with her duties of communication and abstention. The mere presence of a related party makes the situation of conflict an objective legal reality. Whether this party is the director herself or one of the subjects enumerated in Art. 231 LSC, the regulations on RPTs have the advantage of allowing one to conclude that, if there is a related party in the transaction, then there is a conflict of interest.[15]

The presence of a related party can be pointed out by anyone within the company, and this implies that the procedure contained in Art. 230 para. 2 LSC can be activated by persons apart from the director involved, or the other directors.[16] No negative consequence can be derived from this. If the situation is not as serious as supposed, or the potential damage to the interests of the company is not worthy of such consideration, or if, for example, the person identified by Art. 231 LSC does not have any effective relation with a director, the fact that the procedure to check transactions that surpass a certain

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[14] See Art. 9 quarter SRD II.

[15] As is stated by *Enriques, supra* note 6, 14, the regulations on RPTs are easier to apply and require adherence to than those contained in the general rules on conflicts, because the decision as to whether a transaction represents a conflict of interest or not can be based on subjective and diaphanous criteria, while ascertaining who has the condition of a related party requires no judgement at all.

[16] The communication of the situation of conflict to the company by the director remains necessary for those conflicts that are not objectively determined by the presence of a related party, such as those transactions concluded between the company and an unrelated third-party, in which the director has a relevant personal interest (*vid supra* II.2).

threshold of relevance has been activated does not have, obviously, any negative consequences. The company will make a decision concerning the transaction just as it would over any other relevant operation in which no conflict of interest existed.

The creation of an objective legal criteria that establishes the existence of a situation of conflict not only simplifies the monitoring of company transactions but also resolves any lingering doubts in the academic literature concerning the enforcement of the duty of abstention. As the existence of the conflict is not subjective or open to question, the directors that have to make the decision over the transaction can oblige the director affected to abstain from participating in that decision, without generating any debate over the recognition of the cause itself.[17]

The other characteristic of the duty to communicate the situation of conflict is that the director concerned does not merely communicate the situation of conflict itself, for the obvious reason that the company is part of the transaction. What the director communicates to the company is all the information relevant to the transaction and her specific interest in the operation, particularly in those cases in which the counterparty is a third-party related to her. The director has to scrupulously observe the principle of good faith when communicating these details to the company. In her condition as curator of the interests of the company, she cannot adopt the role of an independent, disinterested counterparty.

Article 230 para. 2 LSC is concerned, exclusively, with those directors making the decision independently from the director in the position of a conflict of interest, and who must act with sufficient information to ensure the transaction is carried out in the best interests of the company. The article, which would benefit from clearer wording, is reminiscent of some of the principal duties of the directors, in particular, those that seek to guarantee that the decision on the RPT is the result of a free and informed deliberation, which, obviously, is taken in the best interests of the company[18].

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[17] See the reflections contained in *Juste Mencía, supra* note 11, Arts. 228, 386 and 387, on the imposition of the duty of abstention.

[18] With respect to the "requisites" that Art. 230 para. 2 LSC requires of the board of directors, there has been some debate over whether these should be extended to the general meeting (see, on the innocuousness of the transaction, *Portellano, supra* note 9, 499, and with regard to its transparency, *Juste Mencía, supra* note 11, Art. 230, 413, 421.

In my opinion, there is little point in considering whether the general meeting ought to act with impartiality, and transparency while ensuring the innocuousness of the transaction. It is evident that the company agreement authorising the transaction should ideally be the result of a sincere and informed vote, but this is not always the case. The resulting agreements cannot be challenged because of this, just as they could not be challenged in the hypothetical situation that all the partners decided to conclude a transaction that was contrary to the interests of the company. The LSC has sufficient mechanisms to ensure that the

The Article makes the competence granted to the board of directors' conditional on the guarantee that its members adopt the decision in accordance with the duties mentioned. This raises the question of how these duties can be guaranteed, or, more specifically, how the directors should act so as not to incur liability, and to prevent the transaction being annulled due to a substantial lack of compliance with the procedure. The answer varies according to the exact nature of the duty in question.

(i) In the case of authorization from the board of directors it is crucial that: "the independence of the members that grant it is guaranteed with respect to the director to whom it is granted". The literal nature of the text leaves no doubt as to its meaning, however, it is not easy to specify what the directors should do in order to guarantee their independence. Along with the director involved in the transaction, there may be other directors who also have a duty of abstention, for example, those who are members of her family. In these cases, the situation of conflict is clear and requires their abstention. However, the concept should perhaps be more incisive and distinguish between those directors not in a position of conflict that are *qualified* to take part in the decision-making process and those that are not qualified to do so. In other words, should directors who are not in a position of conflict but who would have difficulty making an impartial judgement on the transaction (and who are therefore not qualified to make a judgement) be required to abstain as well? Situations of this type may occur when, for example, some members of the board of directors owe their appointment to the director facing the conflict of interest. When this type of kinship exists between the majority and the minority members of the board of directors, then, while it cannot be claimed that those belonging to a particular "family" are in a situation of conflict, it is quite probable that their judgement will not be impartial, especially if the director that appointed them has no objection to the RPT.

Although situations such as the one described are common, it does not seem possible to derive from Art. 230 para. 2 LSC an extension of the duty of abstention to the directors who are unqualified to make a decision over the transaction[19]. The guarantee of independence invoked in Art. 230 para. 2 LSC emphasizes the fact that the decision must be adopted in the exclusive interest

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partners are informed (the right of information), that the agreement is not adopted with the vote of the partner-director in the position of conflict (Art. 190 para. 1 lit. e LSC and that the agreement can be challenged if it favours a partner or a third-party in prejudice to the interests of the company (Art. 204 para. 1 LSC). Contemplating whether the requisites of Art. 230 para. 2 LSC can be applied to the general meeting does not change the consequences that the law already determines for cases: in which there is a lack of essential information, regarding the vote of the partner–director in a situation of a conflict of interest, or for agreements made that are contrary to the interests of the company.

[19] Against this contention see *Megías, supra* note 11, 136.

of the company, without considering the interest of the director in the conflict. Art. 230 para. 2 LSC is really only an adaption of Art. 228 lit. d LSC specific to the RPT context and it does not alter the general rules regarding abstention and impartiality. The directors in a situation of conflict must abstain. Those not in a situation of conflict can participate and vote on the decision over the RPT and do so with impartiality and freedom of criteria. However, the legal imperative to guarantee that the decision-making directors act independently from the director in a situation of conflict is difficult to translate into a concrete course of actions (or omissions), although the decision-making directors could voluntarily opt to abstain or vote to pass the question on to the general meeting.[20]

(ii) The article also refers to the need to "ensure that the authorized operation shall not be harmful to corporate assets, and, if relevant, that it is conducted within market conditions and with full transparency". This, rather ambiguous wording is alluding to the duty of the directors to act in the best interests of the company, and ensure that the RPT which has been the subject of the control procedure is fair for the company. The rule establishes the duty to act diligently and in the interests of the company, and, as in the case of any other decision, if the transaction is judged not to be in the best interests of the company, then the directors should reject it.

Two further ideas arise from the requirement that the transaction be innocuous to the company's interests. The first concerns the possibility of making a "global" evaluation of fairness, or one that is not so tied to the particular transaction under consideration. On occasion, it is reasonable to evaluate the fairness of the transaction in a slightly wider context than by merely assessing it in isolation. This can be justified when the company maintains a stable or continuous business relationship with the counterparty, which, when considered overall, is thought to be favorable for the company. In such circumstances, appraising the fairness of the transaction in the context of this ongoing business relationship would almost certainly be a better policy than judging it solely on its own merits. The second idea concerns the near equivalence that the article seems to draw between the innocuousness of the transaction for the company's interests and the conduct of that transaction in a manner consistent with market conditions, an assertion which may be challenged, as the terms or conditions under which a transaction is carried out do not guarantee its innocuousness. The harmful effects of the transaction may come from the contract itself, or they may derive from the moment in which the transaction was completed. Transactions may be harmful because they are too far re-

[20] Should directors decide to give their opinion on the transaction, it could well be expedient for them to request evaluations from third-parties, so as to offer some protection against any possible liability claims made against them.

moved from the company objective, or because they oblige the company to make an investment that had not been planned, or because they require resources that the company did not have when the transaction was first suggested. It is therefore not sufficient for the directors to guarantee that the terms and conditions of the transaction are those which are customarily applied in the market. In order to be able to guarantee that a transaction is fair, it is necessary to show that there is a reasonable probability that the transaction will benefit the company.[21]

(iii) Finally, Art. 230 para. 2 LSC alludes to the transparency of the process, which, it would seem, refers to the necessity that the information is correct, not just in the moment in which the directors analyze the RPT, but also when they justify their decision before the other directors. In this sense, the process is understood to be transparent if the authorization of the RPT corresponds to an informed or conscious decision, and also, if the directors can justify before the general meeting both the operation itself (its nature, content, objective et cetera) and the procedure by which the authorization was granted.

Any lack of transparency would make it advisable for the operation to be rejected. In the analysis of the transaction, the information provided by the director in the situation of conflict is fundamental (although it may well be incomplete if the conflict is indirect, and therefore the director in question is not a counterparty to the transaction). The work done by the other directors in order to complete this information is equally vital. The directors are required to inform themselves, implying they are obliged to do everything in their power to improve upon or complete the data provided by the counterparty. This may involve requesting a meeting with the counterparty, or obtaining the information through their own means. By requiring the board of directors to guarantee the transparency of the process, Art. 230 para. 2 LSC is referring to the need to employ the appropriate level of diligence. Therefore, a lack of transparency implies that the situation has reached a point at which there is no further solution, because the directors have been diligent and have done everything in their power to obtain more information but have not been able obtain it. Under these circumstances, the logical action for the directors to

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[21] The objective reference to market worth or market conditions is not consistent with the ideas that inspired the reform of the duty of loyalty that was effected by Law 3/2014, which, as is explained by *C. Paz-Ares*, Anatomía del deber de lealtad, in: Rodríguez Artigas/Alonso Ureba et al. (eds.), Junta general y consejo de administración en la sociedad cotizada, Vol. II (Cizur Menor 2016) 425 et seq., intended to create a law that was more reflexive or substantial, and not so formal. If one of its aspirations was to prevent judges from mechanically applying the letter of the law or evaluating only the formal validity of the transaction, it does not appear that the reference to the market worth of the transaction will encourage judges to assess the global benefits of the transaction or its fairness for the company.

take is to reject the transaction. Transferring the decision-making responsibility to the general meeting could be an alternative course of action, but it does not seem sensible to trust the decision to another organ that is equally unable to inform itself adequately.

III. The (In)Effectiveness of the Authorization Procedure

1. Reasons for the Ineffectiveness of the Procedure

The procedure for resolving the position of conflict between a director and the company is efficient if certain specific conditions are met, and these are related to the relationship that exists between the director in the situation of conflict and the partners that make up the majority group. The regulation of the authorization in Art. 230 para. 2 LSC, and, in general, the regulation of the conflicts of interest of directors, are based on the classic third-party structure model. This model pre-supposes that the director is an external manager, removed from the interests of the partners of the company.[22] If this separation is clear, then the systems established to control the directors will work as planned, but if these lines of separation are blurred the authorization procedure ceases to function correctly. This separation vanishes when the director is a partner of the company: the factor which means that the director does not share the interests of the partners disappears (the director does not share these interests fundamentally because she has not invested in the company). When the director is also a partner in the company, she no longer exclusively manages the interests of others, and the difference between a director and a partner ceases to be as evident.[23] However, in these cases, the position of the legislator is clear because it grants precedence to the duties of the director. If the general meeting has competence to authorize the RPT, the director-partner affected by the transaction cannot vote (Art. 190 para. 1 lit. e LSC).[24]

[22] For example, *Juste Mencía, supra* note 11, Art. 227, 364.

[23] *Juste Mencía, supra* note 11, Art. 227, 364.

[24] One aspect is of particular interest here. Art. 190 para. 1 lit. e LSC establishes that the partner cannot exercise her vote concerning a transaction when its object is that of "dispensing her from any of the obligations arising from the duty of loyalty stipulated under article 230". The text circumscribes the prohibition on the director that has been authorised, which, in the case of the RPT, could be taken to mean that the prohibition on voting only applies when the director is a counterparty to the transaction, because only in this case can there have been a dispensation from the duty not to enter into contracts with the company. However, the extension of the prohibition against voting for the general meeting coincides exactly with that of the duty of the director in a situation of conflict to abstain from the decision-making process in the board of directors, and so the legal solution does not differ to on the organ that is competent. This means that in the general meeting the following cannot vote: (i) the director/partner that is a counterparty to the transac-

The line of separation between directors and partners is also blurred when there are close links between the director and the controlling partners. In reality, what usually occurs in these cases is that the partners leave aside their supervisory function in situations of a conflict of interest. The coexistence of directors and supervising partners weakens the control procedures for RPTs contained in Art. 230 para. 2 LSC. The explanation is simple: when the director has the support of the controlling partners, the conflict of interest between the director and the company becomes a confrontation between the majority and the minority partners. While Art. 230 para. 2 LSC can help to resolve the first conflict, it cannot help to resolve the second, and preventative legal solutions are not effective. The conversion of the first type of conflict into the second type weakens the *ex ante* control. This weakening can be observed in both decision-making organs: the board of directors (i), and the general meeting (ii).

(i) If the directors are to make the decision, it is probable that any complicity between the director in the situation of conflict with the company and the controlling partner(s) will extend to the rest of the partners. If the company capital is highly concentrated and the minority partners have not been able to designate any members of the board of directors, it is possible all of the directors will owe their posts to the same partner(s) and would be unlikely to challenge the controlling partner(s) by opposing a transaction that they believe would be unfair for the company. The directors charged with the responsibility of making the decision over the transaction will face the dilemma of authorizing the transaction and thus risking the possibility of judicial claims for liability being brought against them or rejecting the RPT and losing their posts as directors. However, if the chance of facing a legal challenge from the minority partners is not that high, then their most probable course of action will be to act to keep their positions.

(ii) If the general meeting is to grant authorization of the RPT, the situation that this creates for the minority partners is not much better. The director in the situation of conflict, if she is a partner, cannot vote on the agreement concerning the RPT (Art. 190 para. 1 lit. e LSC), but nothing prevents the other partners from doing so, which could have significant effects in family businesses or others in which the controlling partners have strong ties. While it is true that any approved transaction contrary to the interests of the compa-

tion, and (ii) the director/partner that is not a counterparty to the transaction but is in a situation of conflict with the company because she is related to a counterparty to the transaction (if A is one of the subjects mentioned in Art. 231 LSC that enters into a contract with the company, and B is a director/partner related to A, B cannot vote in the general meeting, despite not having been "dispensed from" any of the obligations derived from the duty of loyalty).

ny can be submitted to judicial review, in terms of the preventative control under discussion it has to be conceded that it is hardly efficient.

A first conclusion is that Art. 230 para. 2 LSC and the authorization procedure it contains for RPTs is useful if the transaction fits within the parameters of a conflict of interest between the director and the company (the procedure is very efficient, for example, if the director affected by the conflict had been designated by minority partners, if company capital is diffuse, or if there is a weighted representation of the different groups among the board of directors). It ceases to be efficient however when the conflict inherent in the transaction reflects the conflicting positions of the majority and minority partners. As soon as the director affected by the conflict aligns with the majority, the *ex ante* control of the RPT becomes incapable of protecting the minority against transactions that are prejudicial to the interests of the company.

2. Solutions to Make the System More Effective?

There are ways by which the efficiency of this preventative form of control could be optimized. However, even with improvements the control mechanism would still be vulnerable to the circumstances examined in the previous section. In other words, any real improvement would only be produced under the conditions in which the system of control already worked well, but no significant changes would compensate for conditions in which the system works poorly. When the interests of the director in a position of conflict and the controlling partner(s) are aligned, any hope of an improvement in the field of legal protection is unrealistic.

With respect to the board of directors, the obligation to abstain could be extended to all of the "unqualified" directors: those directors which, while not being in a situation of conflict of interest with the company, would find it difficult to make an impartial judgement over the transaction. If the minority partners have had the opportunity to designate one or more directors, allowing only "qualified" directors to take the decision could be a good option. These directors, one assumes, would decide in the best interests of the company, as they would have no bias in favor of the transaction and because, if they rejected the transaction arbitrarily, they would be exposed to the threat of an action for liability initiated by the majority partners.[25]

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[25] *G. Guizzi*, Gestione dell'impresa e interferenze di interessi, Trasparenza, ponderazione e imparzialità nell'amministrazione delle s.p.a. (Milano 2014) 97–98, analyses a similar solution contained in a clause in the company by-laws (the vote in the hands of the directors designated by the minority partners), to counterbalance the power of the controlling partners in the decisions that are the competence of the board of directors. According to this author, the clause would imply providing a power of veto to the directors representing the "minority partners", who could potentially be prejudiced by the transaction. The author presents two objections to this: the first is that while this power of veto formally

If there are hardly any "qualified directors" because company capital is highly concentrated and all, or virtually all of the members of the board have been designated by the majority partner(s), then the result will be unsatisfactory. This is because the decision will almost inevitably be passed on to the general meeting, where, as we have seen, there are insufficient preventative guarantees to protect the interests of the minority partners.

With respect to the general meeting, the possibilities of improving the preventative system of control are also limited. Let us examine the option of prohibiting the vote of those partners related to the director in a situation of conflict. A director that is also a partner in this position does not present any problems, given that she has to abstain from taking part in an agreement of the general meeting which exempts her from any of the obligations derived from the duty of loyalty (Art. 190 para. 1 lit. e LSC). However, if the ineffectiveness of the system resides in the fact that all partners related to the director in the situation of conflict are able to vote, we can consider the feasibility of extending the prohibition to those partners. The law of the United States of America has considered this solution as a safe harbor against the threat of judicial review in the case of transactions in which a director has a conflicting interest: § 8.63 of the Model Business Corporation Act (MBCA)[26] establishes the conditions for preventing judicial review of the agreement. Among these conditions, the most crucial is that the votes in favor of the transaction must come from holders of "qualified shares", which of course implies that holders of "unqualified shares" cannot vote. The directors identify the partners that cannot vote for each transaction, following the list provided in § 8.60 MBCA of "persons related to the director"[27].

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respects the principle of the collective action of the board of directors, in real terms it introduces a requirement for unanimous agreement, which is inadmissible; the second objection is that such a clause would be a simple rule of governance, with only internal effects, the infraction of which would at most give rise to claims for compensation, and not to the possibility of impugning the agreement.

[26] Model Business Corporation Act, 2016 Revision, 9 December 2016, American Bar Association.

[27] See §§ 8.61 MBCA, as an introductory rule to safe harbours, together with the cases of ratification of the transaction that permit the safe harbour to come into play: § 8.62 MBCA for the cases in which the transaction is authorised by the holders of qualified shares and § 8.63 MBCA for the cases in which the question is passed on to the general meeting.

In order for the general meeting to approve those transactions in which the director has a conflict of interest with the company, § 8.63 MBCA requires a majority vote in favour of the transaction by the holders of qualified shares, i.e., those shares that belong neither to the director in the situation of conflict with the company, nor to any of the persons related to her (with the exception of those that belong to the employer of the director – clause (vi) of § 8.60 MBCA).

A number of ideas can be drawn from the answers given by the Model Law. The first is that the conflict of interest rests with the director, and there is an attempt to control this conflict in the general meeting, in order for the prevention to be effective when the decision on the transaction falls to the partners. From the perspective of the partner that is prohibited from voting, it is clear that this prohibition is only established if the conflict concerns the director. Any other indirect conflict, originating from another subject, would not have the same impeding effect. The second idea is that the rule presumes that the vote of the related partners is an unqualified vote, and there does not seem to be any possibility of submitting proof to the contrary. However, ultimately, the effects of the abstention are only palpable in the case of judicial review. The abstention of the partners related to the director in the situation of conflict creates the safe harbor, but their votes would not invalidate the agreement made. If the director and the partners want the protection of the safe harbor, they must abstain from voting. If they decide to use their vote, then they will assume the burden of proof for demonstrating that the transaction was fair for the company. The regulation therefore contains a liability rule by which the partners indirectly affected by the conflict may vote, but if they wish to benefit from the safe harbor they must abstain.

The possibility of copying this solution into Spanish Law should not be entirely rejected, although it is evident that there would be significant obstacles to overcome. The conflict of the director/partner which prevents her from voting in the general meeting (Art. 190 para. 1 lit. e LSC) cannot easily be extended to include the rest of the partners, not even in cases where the relationship with or dependence on that director/partner is manifest. This question was analyzed by the judgement of the Supreme Court of the 2 February 2017,[28] which highlights the clash between the conflict of interest of the director and the right to vote of the partner. In the case of RPTs concluded with directors or persons related to them,[29] there is, on one hand, a relevant transaction, concluded between a subject with the capacity to influence in the decision of the company which is potentially harmful to the company's assets, particularly for minority partners. On the other hand, the partner has the right to vote, which cannot be proscribed outside of the cases contained in

[28] TS, 2 February 2017, RJ 2017/396. In this case the "direct" conflict originated in the person of the partner/director for providing services to both the company and a competitor. In both cases the dispensation from the duty of loyalty to the company had to be granted by the general meeting. The partner-director could not vote (Art. 190 para. 1 lit. e LSC), but the question before the court was not whether this partner-director should have been entitled to vote, but rather whether another partner should have done so, given that he was a partner in a company in which the director in the position of conflict owned a 58.68% share.

[29] While this specific case dealt with by the judgement of the Supreme Court did not concern an RPT, its conclusions can be extrapolated to transactions concluded between a company and its directors.

Art. 190 para. 1 LSC. The interests of the company would justify a qualified vote on the transaction, but at the risk of curtailing the fundamental right of the partner to vote, a price that would seem too high to demand.

The position of the Spanish Supreme Court was resolute:

"neither in the Limited Liability Company Act nor in the current version of the Corporations Act has the so-called indirect conflict of interest been regulated, that is, the situation in which a partner is not in a situation of direct conflict with the company, but there is a strong link between the interests of this partner and those of another, which, in the matter in question, are in open conflict with those of the company".

In the judgement of the Supreme Court, the partner's right to vote was given more weight than the director's conflict of interest and the potential harm that his actions might cause the company. A number of authors felt that by overlooking the conflict, the resulting judgement was unsatisfactory, and they put forward various arguments to defend the thesis that the partner who is related or subservient to the director in the position of conflict should not have voted[30].

However, it is certainly the case that it would not be easy to gain acceptance for any dogmatic construction that deprived the related partner of her right to vote. Legally, there is no other solution to the problem than that provided by the judgement cited. In my opinion, it would be impossible to introduce a legal reform to resolve this problem by prohibiting the vote of the partner who was in an indirect position of conflict[31]. Tackling the director's situation of conflict preventively in the general meeting would have grave repercussions for the right to vote and, additionally, would not be coherent

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[30] *J. Alfaro*, Conflictos de interés del socio y personas vinculadas, Almacén de Derecho, 22 February 2017 (<http://almacendederecho.org/conflictos-interes-del-socio-personas-vinculadas/>); *J. Juste Mencía*, El deber de abstención del socio-administrador en la junta general. Comentario a la STS de 2 de febrero de 2017, RdS 49 (2017) 213–226; *A. Emparanza Sobejano*, Deber de abstención del socio-administrador en la junta general: el conflicto de interés indirecto, in: González Fernández/Cohen Benchetrit (eds.), Derecho de sociedades. Cuestiones sobre órganos sociales (Valencia 2019) 137–156; *M. B. González*, El deber de abstención de un socio en conflicto de interés indirecto con la sociedad, RDM 307 (2018) 455 et seq. The difficulties of applying the prohibition of voting are also highlighted by *J. I. Peinado*, Abnegación y silencio en la sociedad mercantil (apuntes sobre los conflictos de interés entre el socio y su sociedad), in: González Fernández/Cohen Benchetrit (eds.), Derecho de sociedades. Revisando el derecho de sociedades de capital (Valencia 2018) 45, 75, which takes the position that the prohibition on voting imposed by the president of the general meeting would suppose an extrajudicial piercing of the veil for which he has no competence. In the same sense, *A. García Sanz*, Deber de abstención y conflictos de intereses en la junta general de las sociedades de capital, RdS 55 (2019) 55 et seq. On the judgement cited, one can also see, *N. Iraculis*, La prohibición de voto en el grupo de sociedades: el conflicto de intereses directo o indirecto del administrador de la filial, in: González Fernández/Cohen Benchetrit (eds.), *supra* note 30, 189 et seq.

[31] See *Peinado, supra* note 29, 53–55, concerning the reasons why the *ex ante* control mechanism contained in Art. 190 para. 1 LSC should not be extended further.

with the answer that the Spanish legal system provides for a partner's conflict of interest[32]. If the general rule is that the partner that is in a situation of conflict with the company can vote in the general meeting, how could a partner be prohibited from voting in the case of an indirect conflict with the company? Additionally, an adequate assessment of the interests at play would require the legal delimitation of the cases in which the (indirect) conflict of the partner stemmed from the director's conflict of interest, which would not only be complicated but would also be easy to elude.[33]

However, a solution such as that contained in the MBCA could be employed in the company by-laws. Both legal doctrine and case-law admit the possibility of adding new causes to the prohibition of the right to vote through the by-laws, as long as the conflict and the circumstances can be appraised objectively.[34]

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[32] Concerning the partner's conflict of interest and the restrictive interpretation of the restriction of the right to vote see *A. Recalde*, in: Juste Mencía (ed.), Comentario de la reforma del régimen de las sociedades de capital en materia de gobierno corporativo (Ley 31/2014) (Cizur Menor 2015) Art. 190, 67, 73.

[33] The answer provided by the Model Business Corporation Act consists of employing the same article concerning "persons related to the director" (§ 8.60) for cases in which the decision corresponds to the board of directors (the director in a situation of conflict abstains from voting over the transaction) and those in which the agreement is adopted by the general meeting (the persons considered to be related parties, who share the condition of partner, will not vote). In the Spanish legal system this would imply using Art. 231 LSC to determine which partners could not vote in the general meeting due to their relation with the director. It is easy to predict the rejection that such a proposal would generate because the effects over the right to vote are not comparable to the effects of the director's duty to abstain from voting (the reach of the rule would be excessive were it to be applied to the vote of the partners).

[34] See TS, 12 November 2014, RJ 2014/6461. In terms of legal doctrine see, *Recalde, supra* note 32, Art. 190, 74–75, this explores the nuanced differences in joint stock companies and limited liability companies, and considers whether the clause is a foundational clause or a modification of the by-laws; *M. Sánchez Ruiz*, Voto y conflicto de intereses del accionista, Revista Lex Mercatoria 4 (2017) 121, 125 et seq. (also in *M. Sánchez Ruiz*, Prohibiciones de voto por conflicto de intereses del accionista, in: González Fernández/ Cohen Benchetrit (eds.), Derecho de sociedades. Revisando el derecho de sociedades de capital (Valencia 2018) 81, 96; *Peinado, supra* note 29, 71–72; *y García Sanz, supra* note 30. In contrast, the newly introduced Art. 190 para. 3 LSC would impede this possibility, according to *J. M. Embid*, Los supuestos de conflicto de interés con privación del derecho de voto del socio en la Junta General (Art. 190 para. 1 y 2 LSC), in: Rodríguez Artigas/Alonso Ureba et al. (eds.), Junta general y consejo de administración en la sociedad cotizada, Vol. I (Cizur Menor 2016) 89, 97; more trepidatious, *M .A. López Sánchez*, Los supuestos de conflicto de intereses sin privación del derecho de voto: la distribución de la carga de la prueba en caso de impugnación de acuerdos sociales, in: Rodríguez Artigas/ Alonso Ureba et al. (eds.), Junta general y consejo de administración en la sociedad cotizada, Vol. I (Cizur Menor 2016) 121, 130. Before the current versión of the LSC, and also

not assign liability to directors in simple cases of managerial mistakes. If company directors were to be held liable for simple mistakes, people would be reluctant to put themselves forward for the position, or, worse still, directors might be incentivized to adopt decisions that were purely risk-adverse, which could well lead to a fall in profits, or missed opportunity. It is therefore unreasonable to submit the substantial merit of these decisions to judicial scrutiny.

On the other hand, any assessment of the managerial decisions taken by directors will be prone to hindsight bias,[6] as those that resulted in negative outcomes for the company could likely be viewed as misguided even though it may have been impossible to predict these outcomes when the decisions were first adopted.[7]

The ample degree of freedom granted to directors to make managerial decisions and the dominance of these decisions over the judgement of the courts are the foundation of the business judgement rule. The aim is to limit the risk that the directors are held liable for a company's losses occasioned as a result of their managerial decision-making. The courts should not be entitled to review the correctness of these managerial decisions, as it is not their place to interfere in the management of companies, rather, judicial review should only take place in exceptional circumstances.

This rule can be applied to both large public companies with thousands of shareholders and closed companies that formed by contract and whose members are generally linked by family or friendship ties.

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[6] Courts might judge *ex post* the negative effects of a decision as a sign of a previous negligent conduct, *H. Fleischer*, Die "Business Judgment Rule": Vom Richterrecht zur Kodifizierung, ZIP 2004, 685, 686.

[7] Among the arguments made in favor of the non-accountability of directors, is the scant knowledge of judges concerning business management and even, the absence of a *lex artis*, in managing a business (*C. Paz-Ares*, La responsabilidad de los administradores como instrumento de gobierno corporativo, ius et veritas 27, 202 et seq.). But it could be argued that judges also lack technical knowledge of medicine or architecture, which does not prevent them from judging the diligence of doctors or architects, *A. Recalde Castells*, Modificaciones en el régimen de diligencia de los administradores; la *business judgement rule*, in: Emparanza Sobejano (ed.), Las nuevas obligaciones de los administradores en el gobierno corporativo de las sociedades de capital (Madrid 2016) 271 et seq.; *A. Roncero*, Protección de la discrecionalidad empresarial y cumplimiento del deber de diligencia, in: Roncero Sánchez (ed.), Junta general y consejo de administración en la sociedad cotizada, Vol. I (Cizur Menor 2016) 383, 389; this paradox is also pointed out in *S. Bainbridge*, The new Corporate Governance in Theory and Practice (Oxford 2008) 107: "the business judgement rule says that courts must defer to the board of director's judgement absent highly unusual exceptions, compare the liability of physicians who are also held to a duty of care, but whose medical judgement gets no such reference. Why are directors of an incorporated business due a deference that physicians are denied? The question becomes all the more pressing when one recognizes that the business judgement rule is corporate law's central doctrine".

2. However, if we are searching for a rule that establishes *a priori* the correct way to take managerial and business choices, a second idea arises. Although it is not possible to predetermine what would be the correct decision (that is, whether in a specific situation the best choice would be a conservative or a seemingly riskier option), the focus can be put on the way these managerial decisions could be made. From this perspective the business judgement rule embodies a procedure that contains the conditions that the directors must comply with when making managerial decisions.

This leads to three questions: (a) What are the specific criteria which determine the correct procedure for taking diligent managerial and commercial decisions? (b) Is there a general set of rules that apply to the management of all types of companies, regardless of their size and structure, so that the same rules apply to both joint stock companies and limited liability companies? (c) What would be the legal effect of compliance with these criteria? Would it be a safeguard against judicial scrutiny and review of directors' behavior or would it simply lead to the presumption that the directors had acted diligently?

a) It is difficult, and perhaps even impossible to provide an *ex ante* general response to the question of what the criteria for the business judgement rule should be. However, the U.S. Courts have proposed a number of general principles that might serve as an approximation. These principles indicate a formal pathway to managerial decision-making that should be followed. These principles were transplanted to other jurisdictions and in some cases have subsequently been incorporated into their positive law. As shall be explained later, this occurred in both German Law (§ 93 para. 1 sent. 2 Stock Corporation Act [*Aktiengesetz*, AktG][8]) and Spanish Law (Art. 226 LSC) in 2014.

b) The content of any protocol concerning the business judgement rule would depend on a wide number of circumstances. One of these circumstances would obviously be the legal structure of a company's governing body.[9] Another would be the specific functions assigned to the directors, which can

[8] *Aktiengesetz vom 6. September 1965 (BGBl. I S. 1089), das zuletzt durch Artikel 1 des Gesetzes vom 12. Dezember 2019 (BGBl. I S. 2637) geändert worden ist.*

[9] Under Spanish law, there are four types of management structures: (i) one sole director, (ii) several directors acting independently or (iii) several directors acting jointly at the same time, and (iv) a board of directors (Art. 216 LSC). According to the statistics published by the Central Commercial Register (*Registro Mercantil Central*) for year 2018, the most common structures in the *sociedad anónima* are the board of directors (40%) and a sole director (45%), while the case of several directors (12%) and joint directors (3%) are minor options. In *sociedades de responsabilidad limitada* the sole director is clearly the most preferred option (73%), followed by several directors (19%), while joint directors (5%) and the board of directors (3%) are very exceptional choices (<http://www.registradores.org/wp-content/estadisticas/mercantil/estadistica%20mercantil/Estadistica_Mercantil_2018.pdf>).

As long as the minority partners have sufficient negotiating capacity to include a clause of this type in the by-laws, there does not appear to be any obstacle to delimiting indirect conflicts concerning RPTs concluded with directors. From an objective perspective, this delimitation is simple as it concerns the conclusion of a transaction between the company and one of its directors. However, to avoid the by-laws containing a general prohibition on voting, it would be expedient to limit this prohibition to the most important transactions, or those which potentially pose the greatest risk to the company, or even, to make the prohibition dependent on an independent report on the operation. From a subjective perspective, the clause in the by-laws should clearly delimit the type of relationship that would have to exist between the director in a situation of conflict with the company and the partner, in order for the partner's right to vote on the transaction to be curtailed. One option would be to define related partners by a remission to Art. 231 LSC, although it would be better to draw up a specific list, perhaps limited to cases of subjugation and/or close family ties that would take into account the specific needs and composition of the company.[35]

However, this solution has a notable deficiency. Preventing the holders of unqualified shares from voting and thus leaving the decision in the hands of the minority partners is an inefficient remedy. There is no guarantee that the vote of the minority partners will be a sincere vote or that the decision taken will be in the best interests of the company. The desire for revenge, or an unsuccessful policy of blackmail could sometimes lead to the minority rejecting a transaction that would be beneficial for the company, or even essential for its survival.[36] This rejection, which could be termed an abuse of power,

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arguing against this option, *J. Boquera*, La regulación del conflicto de intereses en la Ley de sociedades de responsabilidad limitada, RDM 217 (1995) 1007, 1024.

[35] Conversely, the extension of the list contained in Art. 231 LSC would, in my opinion, be unacceptable.

[36] The "majority of the minority partners" can only guarantee a positive result given a series of conditions: that the minority partners have a genuine opportunity to vote, that the minority vote is sincere (which cannot take place if they receive some type of compensation for voting in a particular way) and that the vote be the result of a decision-making process in which the information available has had a relevant role (one can appreciate the irony of the words of *Enriques, supra* note 6, 19, when he says he prefers a disinterested partner with less information to a partner with more information but with a specific interest). A criticism of the MOM system is that the result is contingent upon the composition of company capital: so that, for example, if the company is controlled by the same family group then the abstention of the partner involved will not prevent the majority from continuing to support the transaction, even when they know that it is not in the best interests of the company. If, however, the other partners are not in agreement with the partner who is unable to vote, this would then block the company's decision-making ability (for an extensive commentary on this point see *Goshen, supra* note 6, 309 et seq.).

could not be easily remedied because the agreement not to conclude a particular transaction cannot be overturned in court.

IV. Conclusions

In the light of the preceding analysis, it is possible to affirm that the preventative control of transactions between the company and its directors is not very effective if the director in the situation of conflict is in collusion with the majority or controlling partners. In these cases, the conflict of the director with the company transmutes into a conflict between the majority and the minority partners, which no legal provision can neutralize effectively. This is because the benefits that might be obtained for the protection of the minority partners would not compensate for the damage that may be done, resulting in radical transformation of principles strongly rooted in the traditional legal framework of company law or in the normal dynamic of closed companies in which the majority partner has the decision-making power. In other words, the a priori control of the conflict between majority and minority partners would clash with legal obstacles which would then become untenable or simply not worth saving. For this reason, it is better that the solution to the conflict and the protection of the minority partners in the case of RPTs that are unjust be trusted to *ex-post* judicial review.

When the conflict that is inherent in an RPT is not only a conflict of interest between the director and the company, the preventative measures need to take the form of contractual solutions, that, in some cases, may be reflected in the by-laws, but which are probably better suited to shareholder agreements.[37]

Contractual solutions should be drawn up, when the minority partners have the ability to negotiate, which is when the majority partners require their investment. In any other context the possibility of negotiation is unrealistic.

The control mechanisms may be preventative or designed to be applied *ex post*. It is clear that contractual solutions will normally be designed to prevent the conclusion of transactions that could damage the interests of the company. However, the recognition of the right of separation of the minority partner due to a transaction concluded in prejudice to the interests of the company, is a measure that, although agreed upon and introduced as a remedy, also has an important preventative effect. If the majority partners require the investment of the minority partners, they will refrain from using the RPT as a way to make personal gains. Shareholder agreements designed to this effect must guarantee

[37] Although this article has concentrated on RPTs with directors, the same conclusion concerning contractual solutions is applicable to the transactions that the company concludes with one of the majority or controlling partners, because the inherent conflict is also a conflict between the majority and the minority partners.

that the minority partner can leave the company and receive a fair price for her participation, either by returning her investment, with or without interest payments, or by paying her a proportionate part of the worth of the company, calculated in the moment before the conclusion of the harmful RPT.

Preventative solutions will be designed, basically, to modulate the composition of the board of directors and the exercise of the right to vote.[38] They will try to prevent the party involved from taking advantage of her special position of domination within the company to influence the decision on the RPT in her favor.

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[38] In the joint-stock Company it is possible to determine the number of votes that a shareholder or companies belonging to the same group may cast on a particular matter, for example, the decision to appoint a company director or the decision over an RPT (the allusion in Art. 188 para. 3 LSC to the "general character" of the limitation, does not refer to the subject matter, but rather to impossibility of establishing subjective discrimination against some partners and not others; in this sense see, *A. Recalde Castells*, Limitación estatutaria del derecho de voto en las sociedades de capital, (Madrid 1996) 101; *M. Curto*, in: Rojo/Beltrán (eds.), Comentario de la Ley de sociedades de capital, Vol. I (Madrid 2011) Art. 188, 1339, 1345.

The same occurs with limited liability companies, in which there is a wide ranging freedom to use proportional representation in the voting system. The Regulation of the Commercial Registry (Reglamento del Registro Mercantil, RRM [*Real Decreto 1784/1996, de 19 de julio, por el que se aprueba el Reglamento del Registro Mercantil*]) states expressly that a change to the use of the principal of proportionality may be carried out generally with respect to all issues, or specifically for one or more issues (Art. 184 para. 2 RRM). This could give rise to a twofold situation in relation to the composition of the board of directors and the approval of certain RPTs reserved to the competence of the general meeting, by which the vote of the partners affected could be limited or the adoption of an agreement could be made dependent on the favourable vote of the minority partners or those not affected.

The Significance of the Business Judgement Rule in Closed Companies

Andrés Recalde Castells[*]

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I. Director's Duties and the Liability for Infringement

By assigning rights and duties, company law aims to establish a fair balance between the interests involved in a company. It imposes two main obligations on company directors: the duty to promote the interests of the company with loyalty to shareholders (fiduciary duty), and the duty to manage the company with diligent care. Directors of the company are held liable for any damages they may cause to the shareholders or the company itself by infringing these duties. The threat of becoming responsible for non-compliance encourages adherence to these obligations.

As these obligations are defined in the law by general and indeterminate clauses, their contents require specification. Sometimes shareholders establish the specifics of these obligations by incorporating them in the articles of the company.

In comparative law there is a common understanding of the content of both these duties and how to treat breaches. The legal definition of the duty of loyalty

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is normally very thorough, and compliance with it is vigorously enforced. The aim of the legislator is to punish severely the most reprehensible types of conduct that directors may indulge in, so as to dissuade them from putting their personal interests before those of the company and the shareholders, which are the only interests that they are permitted to promote. In contrast, the wording of the duty to manage the company with diligence is less exact and, generally, directors that breach this obligation are treated with a certain degree of indulgence.

Spanish Law regulates the duty of loyalty in great detail in the Consolidated Text of the Spanish Corporations Act (*Ley de Sociedades de Capital*, LSC; Arts. 227–231 LSC)[1]. The duty of due diligence is defined in a looser and more generic fashion: the directors are required to run the company in the manner of a "orderly business person" (*ordenado empresario*, Art. 225 LSC). This general obligation has to be interpreted on a case by case basis, in keeping with the "nature of the role and the specific functions" (*la naturaleza del cargo y las funciones atribuidas a cada uno de ellos*) assigned to each director. However, the law does launch certain particular obligations and prohibitions: for example, the directors have to issue financial statements, the management report and the proposed distribution of earnings within three months of the end of the financial year; they have to call the annual general meeting within the first six months of the financial year; there are prohibitions on operations involving the company's shares; the law also requires the directors to request the opening of insolvency proceedings if the company cannot meet its financial obligations. On the other hand, directors profit from a high degree of discretion in the running of the company, which is reflected in a special liability privilege referring to the compliance of this duty of diligent management (Art. 226 LSC).

The main focus of this paper is on the duty of diligence, and, specifically the discretion afforded to directors in managing the company. This allows company directors to avoid judicial scrutiny and is necessary to ensure a satisfactory equilibrium between autonomy and liability.

Traditionally this question has been analyzed from the perspective of its importance in large public companies. Far less attention has been given to the same question within the most common type of company: closed companies with a small number of shareholders.

II. General Considerations on the Duty of Diligence

It is widely accepted that directors should only be held liable for damages caused to the company as a result of exercising their decision-making discre-

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[1] *Real Decreto Legislativo 1/2010, de 2 de julio, por el que se aprueba el texto refundido de la Ley de Sociedades de Capital.*

tion in exceptional cases. However, this cannot result in their immunity when they have harmed the company as a result of a clear breach of their duty to manage the company diligently. It might be helpful to consider some of the fundaments of this rule.

1. It cannot be the objective of company law to guarantee a company's financial success, but rather to ensure that the directors manage the company diligently. This is, in effect, an obligation of manner and not results. Courts of law should not therefore judge business decisions on their financial results. The economic risks of the business activity of the company are met by the shareholders and not the directors. The directors cannot be held financially responsible for either the positive or the negative consequences of the business activity of the company nor for the economic consequences of their decisions, even if in retrospect they appear to have been the consequence of mistaken choices.

2. When making business decisions there is rarely only one option available and a large number of circumstances normally have to be taken into account. The principal motive for permitting directors so much leeway is to provide sufficient free reign to adapt to unforeseen and unforeseeable circumstances, since the response to the demands of the market implies that there is always a great degree of uncertainty involved. In fact, the ability to take business decisions freely is an irreducible pre-condition for the existence of a free market economy.[2]

3. The precise content of duty of diligence depends upon "the nature of the position and the role" assigned to each director, as well as the obligations inherent to these factors. It also depends on the real type of company in which the director operates, as each type of company places different requirements on the directors according to its specific needs. Even if the directors must always defend the interests of the shareholders, in large public companies it is not easy to identify a single common position for all these shareholders with respect to business risk. For this reason, directors are obliged to act free of outside influences and to exercise their discretion when managing the company (Art. 228 lit. d LSC).[3] Directors are, in this sense,

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[2] *U. Immenga*, Economic Order and Company Law, The Journal of Interdisciplinary Economics 22 (2010) 3 et seq.

[3] The relations between directors' leeway and the duty to act with independence (in front of third parties and even shareholders) in *G. Esteban Velasco*, Distribución de competencias entre Junta general y el Órgano de administración, en particular las facultades de la justa sobre activos esenciales, in: Roncero Sánchez (ed.), Junta general y consejo de administración en la sociedad cotizada, Vol. I (Cizur Menor 2016) 29; *A. Recalde Castells*,

neutral with respect to business risk and should act according to this neutrality. The purpose is to allow them to be free to develop new areas of the business, by taking even hazardous decisions. From the perspective of the shareholders the optimal option is to allow them to make investment decisions with an expected positive return, independently of the business risk associated with them. Risk adverse shareholders may reduce this risk by diversifying their portfolios and investing in various companies.[4]

However, this is not the case in closed companies, in which the shareholders have concentrated their investment and who are profoundly interested in determining how the company is run. Inevitably this leads to a situation in which the directors have far less scope to be able to make autonomous decisions.[5]

This approach is useful for determining the scope of freedom of action in the management of companies and whether this could lead to a framework of immunity against judicial review. It is also pertinent to the question of whether the discretion afforded to directors is a general principle of company law that is common to all companies, or if it has to be adapted for each type of company, and even whether it has to consider specific characteristics in individual cases.

III. The Aims and Purposes of the Business Judgement Rule and their Legal Tools

1. Directors are prohibited from promoting their personal interests, and may only exceptionally be held financially responsible for poor decisions, and clearly not in cases in which it was impossible to anticipate a negative outcome. However, there is a commonly accepted justification among legal policy makers concerning the freedom granted to directors to make managerial decisions. A reasonable mixture of rights and obligations in the rules governing management seeks to safeguard directors from an external revision of those acts.

Taking decisions that have unpredictable consequences is inherent to good management. In fact, directors should be encouraged to take innovative decisions whose consequences are essentially unpredictable. Company Law should

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Distribución de competencias en materia de gestión entre los órganos de las sociedades de capital, AAMN 59 (2019) 629 et seq.

[4] This argument is employed in *C. Jungmann*, Die Business Judgement Rule – ein Institut des allgemeinen Verbandsrechts?, in: Bitter/Lutter et al. (eds.), Festschrift für Karsten Schmidt (Cologne 2009) 831, 839 et seq.

[5] *H. Fleischer*, Das unternehmerische Ermessen des GmbH-Geschäftsführers und seine GmbH-spezifischen Grenzen, NZG 2011, 521, 524 et seq.; *G. Bachmann/H. Eidenmüller et al.*, Regulating the Closed Corporation (Berlin 2014) 60 et seq.

vary greatly from the role of mere supervisors to those that take executive decisions. This is particularly relevant when the company is governed by a board of directors, each of whom is given a different function. In listed public companies (*sociedades anónimas cotizadas*), the law distinguishes among internal (executive) directors and external directors, and in the case of external directors, it makes a further distinction between those that have been appointed due to their relation to main shareholders (proprietary directors) and those nominated as independent directors (Art. 529 duodecies LSC).

However, any objective method attempting to determine how a company ought to be managed and how the "will" of the company should be formed will also have to take into account the real type of company. Any formal procedure will depend on the subjective composition of the company (the number of shareholders and how the shares are divided among them), the size of the company, the activities it carries out and the complexity of its corporate structure (for example the extent to which it is institutionalized) or the contractual provisions contained in its deed of constitution.

Listed public companies may have thousands of shareholders, widely dispersed. The great majority of these shareholders are not able to play a part in the decision-making processes of the companies they have invested in. The clear separation between the ownership and the management of companies is compensated by the large degree of independence granted to directors. This freedom allows them to weigh up all the available choices and act in the best interests of the company and the different types of shareholders.

At the same time, abstract decision-making procedures objectivize the form in which the will of the company is shaped. Where there is a complex corporate structure, these procedures are possible, since large companies may absorb the costs of the bureaucracy entailed in such procedures.

On the other hand, closed companies are characterized by the close link between shareholders, and between shareholders and directors. The most common conflicts in closed companies are not agency conflicts between directors and shareholders, but those between the majority shareholders who control and manage the company, and the minority shareholders. The deed of constitution and the terms of the contract entered into upon investing in the company should establish a balance between different classes of shareholders and determine the extent to which they are able to become involved with the management of the company: as *Davies* has remarked "the best protection for minority shareholders […] is the careful negotiation of the terms on which the investment is made, as well as a close scrutiny of the decisions of the majority".[10]

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[10] *P. Davies*, Introduction to Company Law (Oxford 2002) 254; *Bachmann/Eidenmüller et al., supra* note 5, 41. In closed companies the majority is not submitted to capital market regulation or to the threat of a mandatory public takeover which would make it feasible for the minority to exit the company (*Bachmann/Eidenmüller et al., supra* note 5, 9).

c) The third issue relating to the business judgement rule is that of the legal effects that should be attributed to compliance with the established procedure for taking managerial decisions. There are two alternatives.[11] One option would see the fulfilment of the conditions or requirements that make up the business judgement rule summarize the required standard of conduct. The judicial review of managerial decisions would be limited, as there would be a legal presumption of compliance, which could be overturned if there were evidence to the contrary. The second alternative is that the procedure could be seen as establishing a standard for the review of the directors' actions. The directors need only comply with the conditions or requirements of the rule. Compliance with the requirements of the rule would signify that the duty of diligence had been fulfilled by the directors, and so they would be immune from any risk of becoming liable. If these conditions or requirements had been met, a safe harbor would be created, and a presumption *iuris et de iure* would then exclude directors from any liability for damages.[12]

The difference between these two interpretations lies in who bears the burden of proof and the type of evidence required.[13]

IV. Spanish Regulation of the Business Judgement Rule

1. It would be helpful to give some background information on the introduction of the business judgement rule into Spanish Law before entering into the details of the argument I wish to present in this paperarticle. The Royal Legislative Decree 1/2010, of the 2nd of July passed the consolidated text of the *Ley de Sociedades de Capital* into law. The consolidated text derogated previous legislation that had regulated separately the two principal types of limited liability company, the Public Limited Liability Company (*sociedad anónima*, S.A.) and the Private Limited Liability Company (*sociedad de responsabilidad limitada*, S.L.). The S.A. was previously regulated by the Spanish Stock Corporation Act of 1951 (*Ley de sociedades anónimas,* LSA)[14], which was modified a number of times, most significantly in 1989. The S.L. had been regulated by the Law on

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[11] *S. Bainbridge*, The Business Judgment Rule as Abstention Doctrine, Vand. L. Rev. 57 (2004) 83 (<https://papers.ssrn.com/sol3/papers.cfm?abstract_id=429260>).

[12] *Roncero, supra* note 7, 392; *C. Guerrero Trevijano*, El deber de diligencia de los administradores en el gobierno de las sociedades de capital (Madrid 2015) 225; *L. Hernando Cebría*, El deber de diligente administración en el marco de los deberes de los administradores sociales (Madrid 2009) 117 et seq.

[13] *A. Recalde Castells*, La prueba en la regla de la discrecionalidad empresarial ("the business judgement rule"), in: Juste Mencía/Espín Gutiérrez (eds.), Estudios sobre órganos de las sociedades de capital. Liber amicorum Fernando Rodríguez y Artigas Gaudencio Esteban Velasco (Cizur Menor 2017) 1050 et seq. and see *infra* V.

[14] *Ley de 17 de julio de 1951 sobre régimen jurídico de las sociedades anónimas*.

Private Limited Companies of 1995 (*Ley de Sociedades de Responsabilidad Limitada*).[15] The consolidated text of the LSC puts these two laws together in the same legal act but did not create a single regulation applicable to a unified type of company with capital by shares: S.L. and S.A. remain separate legal entities. However, the dispositions of the consolidated text were broadly uniform in their treatment of both types of companies.

Actually, the law shows a clear tendency to reduce the legal differences between the S.A., the form that is typically adopted by large corporations with a great number of shareholders (whether or not these are issued on the stock exchange), and the S.L., which, while being a multi-purpose legal format, is commonly used by closed companies with a small number of shareholders that are connected contractually. Most of the dispositions of the consolidated text of the LSC apply to both types of limited company, and the special typological features for each class of company have reduced.

The recent amendments also demonstrate a tendency on the part of the legislators to focus on specific questions that are the domain of large public corporations. The law took a sharp turn in this direction with the reform of the LSC in 2014, which focused on the corporate governance. These amendments reduced the provisions that envisaged the requirement of S.L.s, the typical legal form taken by family businesses.

This is clearly evident in the regulation of the duties of the directors, and specifically their duty to manage the company with diligence and in compliance with the so called *business judgement rule*. Art. 226 para. 1 LSC states that:

> "With regards to the strategic and business decisions subject to the business judgement rule, the standard of diligence from an orderly business person is understood to have been fulfilled when the director acts in good faith, without personal interest in the matter being decided, and with sufficient information and prior organisation to be able to take an appropriate decision."

This article applies to all classes of corporation, listed S.A.s and S.L.s. In both cases the effects of this provision only come into play if the conditions required by the law are met; but these conditions reflect a decision-making procedure which is particularly suited to the operations of large public companies with a complex structure.

2. The new regulation concerning the management of the business and the degree of discretion afforded to the directors, raises various questions. The first of these is whether it was really necessary to include the business

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[15] The Consolidated LSC also regulates other forms of capital companies, such as the "sociedad nueva empresa" a special type of S.L. (Título XII), the *Societas Europeae* located in Spain (Título XIII), and it also includes a special regulation exclusively to listed S.A.s (Título XIV).

judgement rule in a legal text. The second is whether the rule can be considered a general principle of company law or if it refers exclusively to issues that only certain types of company arise. The third is what the specific requisites and conditions to be met for an orderly business management are, while the fourth is what the effects resulting of compliance with these requisites would be.

a) Comparative Law does not provide a unanimous answer to the first question. Some European countries recognize the business judgement rule through case law (as in the cases of UK[16], Italy or France). This is consistent with how it was approached in its American roots.[17] Other countries use a statutory legal provision to provide the leeway required for business management and prevent the judicial revision of business decisions, upon the fulfilment of certain conditions. This is the case in German law, although it is limited to public companies.[18] This has also been the path followed by Spanish law.

If the sole aim of the business judgement rule were to hinder courts from enquiring into the merits of business decisions, it would probably not have been necessary to establish a statutory regulation. The reluctance to review management decisions other than in exceptional cases has a long tradition in Spanish law. Under the 1951 Spanish Stock Corporation Act (LSA), directors could only be held liable for damages caused to the company in cases of willful misconduct, abuse of powers or gross negligence. In 1989 this "privilege" of directors was derogated, since they should be held responsible for damages derived from acts executed without the diligence with which the position should be carried out (Art. 133 para. 1 LSA, this rule also applied to S.L.s).[19]

For a long time, Spanish courts have been reluctant to scrutinize management decisions taken by directors. The sole exceptions were resolutions condemning directors for damages due to conduct bordering on fraud or willful misconduct.[20] This indicates a strong acknowledgement of the directors' lee-

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[16] *R. Hollington*, Shareholder's Rights (London 2010) 91.

[17] Court of Chancery, 13 August 1742, 26 ER 642 (*Charitable Corp. v. Sutton*); Louisiana Supreme Court, 1 January 1829, 7 Mart. (n.s.) 352 (*Percy v. Millaudon*) and lately Delaware Supreme Court, 1 March 1984, 473 A.2d 805 (*Aronson v. Lewis*).

[18] In 2005 the Law on Corporate Integrity and the Modernization of the Right of Contestation (*Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts*, UMAG [BGBl. I S. 2802] approved § 93 para. 1 sent. 2 AktG. But it also occurred in other countries: in Portugal Art. 72 para. 2 Companies Act (Código das Sociedades Comerciais [Decreto-Lei n.º 262/86 – Diário da República n.º 201/1986, Série I de 1986-09-02]); in Greece Art. 22.a Law 2190/1920 (replaced by Law 4548/2018 on 1 January 2019).

[19] *E. Polo*, Los administradores y el consejo de administración de la sociedad anónima (Madrid 1992) 283.

[20] *J. Llebot Majo*, El deber general de diligencia (Art. 225.1 LSC), in: Roncero Sánchez (ed.), Junta general y consejo de administración en la sociedad cotizada, Vol. II (Cizur Menor 2016) 317, 329 et seq. mentions three Supreme Court decisions: TS, 13 February 1990; TS,

way or discretional powers in managerial matters. Condemnation of directors for infringing their duties of diligence was expressly rejected in an eminent judgement of the Provincial Court of Madrid, where the business judgement rule was acknowledged under a definition similar to the understanding of the rule common in other countries.[21] The assumption was that "The court is not a body to determine if business decisions are mistaken, nor is it a body that dictates what should be convenient for company at any given time"[22]. Later the Supreme Court would expressly recognize the business judgement rule in those same terms.[23]

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11 May 1991 (gross negligence and discrimination in payment debts of the company to creditors), and TS, 5 November 1997 (failure to wind up the company). There are also cases of fraud closer, therefore, to infringement of the duty of loyalty in TS, 4 February 1999 (misappropriation of funds) or very gross negligence in TS, 30 March 2001 and TS, 10 March 2003 (over-indebtedness of the company), TS 26 May 2003 or lack of impartiality TS, 14 October 2011 (remission of the company's debt so that the director acquired the shares for himself).

[21] AP Madrid, 13 September 2007: "no se observa negligencia ni deslealtad alguna en la actuación de los administradores demandados. Los mismos adoptaron el acuerdo reputado por la recurrente como determinante de su responsabilidad habiéndose informado adecuadamente, pues habían solicitado la elaboración de diversos informes y la realización de revisiones del plan de negocio inicialmente previsto a la vista de las nuevas circunstancias concurrentes (fundamentalmente, construcción de una nueva terminal en el aeropuerto de Barajas que restaría pasajeros a las otras terminales en cuyas inmediaciones se ubicaría el centro de servicios objeto de la concesión, y secundariamente, la disminución del tráfico aéreo consecuencia de los atentados del 11-S y la posibilidad, publicada en la prensa, del traslado del aeropuerto a otra ubicación distinta), sin hacer dejación alguna de sus obligaciones de gestión, hasta el punto de que el consejo de administración se reunió con frecuencia y se respetaron los cauces y modos de funcionamiento propios de las sociedades mercantiles, informando a los diversos componentes del consejo de administración y sometiendo las principales decisiones a la junta de accionistas, sin que se hubiera producido ocultación alguna a los consejeros y accionistas, concretamente a la actora. // Es evidente que la decisión empresarial adoptada es discutible, como toda decisión de esta naturaleza, puesto que la administración y dirección de empresas no es una ciencia exacta, y más aún cuando, pasado cierto tiempo, es posible ahora conocer las consecuencias de la decisión empresarial adoptada por el órgano de administración, mientras que en el momento en que los administradores adoptaron el acuerdo esto no era posible, teniendo además los administradores un margen de tiempo limitado para adoptar la decisión empresarial. Pero la prueba obrante en autos muestra que se trató de un acuerdo, […], adoptado tras el acopio y análisis de información rigurosa, a la vista de circunstancias que generaban serias dudas sobre la rentabilidad del negocio a acometer, con criterios de racionalidad y encaminado a la protección del interés social. La obligación de administrar que concierne a los administradores sociales es una obligación de medios, por lo que no puede determinarse su incumplimiento o cumplimiento defectuoso en función de los resultados" (see also AP Alicante, 15.7.2010; other courts resolutions in *Roncero, supra* note 7, 399).

[22] AP Madrid, 24 September 2009, JUR 2009, 470747.

[23] TS, 17 January 2012: "Corresponde a los empresarios la adopción de las decisiones empresariales, acertadas o no, sin que el examen del acierto intrínseco en sus aspectos

Despite this express aversion to reviewing any conduct which might cause damage to the company and shareholders, Spanish courts have quite often come to assess directors' liability for conduct that damaged third parties or that might lead to the insolvency of a company or aggravated this insolvency (Art. 164 para. 2 Insolvency Act [*Ley Concursal*, LC][24]). Actually, the situations (Art. 165 para. 1 LC) in which bankruptcy may be presumed to be negligent (if no proof to the contrary is alleged) and may lead to directors' liability are, once again, those resulting from a breach of the duties expected from an orderly business person, but limited to special serious cases. The test to be applied is whether willful misconduct or gross negligence occurred.

This restrictive perspective of judicial review has reappeared in the framework of the duty to act diligently in the vicinity of insolvency, thus, limited to cases of *deliberate or grossly negligent conduct*. And this is not only established in academic texts,[25] but also provided in European legislation. Art. 19 of Directive (EU) 2019/1023[26] imposes new obligations on directors, among which is the duty to "have due regard […] to […] (a) the interests of creditors, equity holders and other stakeholders [and (c)] to avoid *deliberate or grossly negligent* conduct that threatens the viability of the business".[27]

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económicos pueda ser fiscalizado por los Tribunales ya que, como señala la sentencia de 12 de julio de 1983 […], aquel "escapa por entero al control de la Jurisdicción".

[24] *Ley 22/2003, de 9 de julio, Concursal.*

[25] *G. Spindler*, Trading in the Vicinity of Insolvency, EBOR 7 (2006) 340, 348; *P. Davies*, Director's Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency, EBOR 7 (2006) 304, 311, 315, 320; in Spanish academic literature *F. Marín de la Bárcena*, Deberes y responsabilidad de los administradores ante la insolvencia de las sociedades de capital, RdS 24 (2005) 91, 118; *F. Marín de la Bárcena*, Responsabilidad concursal, *ADCo* 28 (2013) 104, 127; *E. Recamán Graña*, Los deberes y la responsabilidad de los administradores de sociedades de capital en crisis (Pamplona 2016) 119 et seq.; *P. Vizcaino Garrido*, El interés social como fin de la actividad gestora de los administradores de las sociedades en crisis (Pamplona 2015) 382 et seq. Creditors cannot expect any protection from directors, as soon as they do not benefit from the right of a risk neutral management; on the contrary, creditors rather may see directors as legitimately jeopardizing their claims, *Jungmann, supra* note 4, 839; *E. Recamán Graña*, La "business judgment rule" en la crisis. Una propuesta interpretativa, RdS 54 (2018) 1134.

[26] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).

[27] Preamble no. 71 Directive (EU) 2019/1023 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency), establishes: "Where the debtor is close to insolvency, it is also important to protect the legitimate interests of creditors from management decisions that may have an impact on the constitution of the

Nevertheless, this responsibility for infringing special duties in the vicinity of insolvency refers exclusively to damages caused by directors to creditors or third parties. It is therefore an issue that cannot be explained by the business judgement rule, since this rule establishes a liability privilege to be applicable only to damages that directors may cause to the company or to shareholders.

b) The second question to be addressed is whether the business judgement rule should be considered a general principle of company law, or if it is specific to some types of business or legal forms of companies.[28] The need to avoid the revision of directors' decisions when they run a business can be applied independently to big public companies, and to closed companies with a small number of shareholders with strong personal or family ties. However, even if the directors' power of discretion should be recognized in all cases, and the possibility of judicial scrutiny of the merits of business decisions must always be exceptional, diligence in the management of the company cannot be contemplated in the same manner for all types of companies.

The business judgement rule was created within a specific legal system (USA), and considered features particular to large public companies with a complex organization and structure. Transplanting this doctrine to other countries and to other types of companies must be executed with extreme care.

However, when Spanish law adopted the 2014 amendment to the rule on the discretional power of company directors, it did it adopting a single and unique formulation, and with a general scope of application. It extends to all capital companies without any specification that would permit the adaptation of the rule according to the specific class of company. The generalized scope of the rule gives rise to a number of issues that will be addressed *infra* VII.

c) The third issue (the requirements or conditions to be met for regular and orderly management) and the fourth (the consequences of the fulfilment of those requirements) are the object of some detailed considerations below.

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debtor's estate, in particular where those decisions could have the effect of further diminishing the value of the estate available for restructuring efforts or for distribution to creditors. It is therefore *necessary* to ensure that, in such circumstances, directors avoid any *deliberate or grossly negligent* actions that result in personal gain at the expense of stakeholders, and avoid agreeing to transactions at below market value, or taking actions leading to unfair preference being given to one or more stakeholders.", s. *E. Recamán Graña*, Hacia una determinación del comportamiento debido por los administradores en la reestructuración, RDCyP 32 (2020), 127 et. seq; *J. Alfaro*, Administradores frente a accionistas y acreedores: Deberes de lealtad para los accionistas y obligaciones pactadas o legales para los acreedores, *N. Bermejo Gutiérrez/A. Martínez Flórez/A. Recalde Castells*, Reestructuraciones de las sociedades de capital en crisis (Cizur Menor 2019), 69 et seq.

[28] *Jungmann, supra* note 4, 846 et seq.

V. Conditions to be Met as a Prerequisite for the Application the Business Judgement Rule

As stated above, the primary policy purpose of the business judgement rule is to protect directors from the risk of incurring liability when making business decisions. But the rule goes beyond this primary aim, when it establishes a presumption of diligence based upon the fulfilment of certain conditions that summarize a formal procedure considered to represent orderly management of a company.

The Spanish wording of the legal provision corresponds to the well-known and widely used concept of the rule established by American courts[29].

1. Not all directors' actions are covered by the business judgement rule. The rule does not shield them from the consequences of directors' behaviors that could give rise to individual actions by third parties and, in particular, by creditors. As mentioned previously, the rule only applies to the conduct of directors that damage the company or the shareholders.

Spanish law restricts the scope of the rule to the case of "strategic and business decisions". This wording has led to a widespread understanding that corporate decisions referring to how to organize the company, would not benefit from the rule. However, the boundaries between corporate decisions and business decisions are faint. Difficulties to identify these differences arise in many cases. E.g. the resolutions determining the retribution of company directors, involves a business decision; but it also affects internal relationships between the bodies of the company, and between shareholders and directors. That is why, in my opinion[30], the business judgement rule should also apply to the powers assigned to directors in this field (see Art. 217 para. 3 sent. 2 and 3 LSC).

It has been said that the *rule on the discretionary powers of the directors* does not apply if the law requires directors act in a specific way or establish a concrete prohibition.[31] But often the conduct required from directors by the

[29] Delaware Supreme Court, 1 March 1984, *supra* note 17 and Delaware Supreme Court, 29 January 1985, 488 A.2d 858 (*Smith v. Van Gorkom o Tran Union*) (*Guerrero Trevijano, supra* note 12).

[30] *Recalde Castells, supra* note 13, 1065; *C. Guerrero Trevijano*, La protección de la discrecionalidad empresarial en la Ley 31/2013 de 3 de diciembre, RDM 298 (2015) 167. *Roncero, supra* note 7, 413 refuses to apply the rule to resolutions of the board of directors referring to directors' payment, since these would *affect them personally* or to persons related to the directors, which is contrary to some of the Spanish legal conditions of the rule.

[31] *Paz-Ares, supra* note 7, 202, 223: "queda fuera de la zona de incertidumbre, [...] el cumplimiento de los deberes específicamente establecidos por la ley y por los estatutos (por ejemplo, convocar Junta, formular cuentas, informar a los reguladores, etc.) [...] no hay razón alguna para que la franquicia se extienda a estos ámbitos, puesto que en ellos la

law is not fully specified. If the obligation is established through an open definition, a margin for discretion remains. This happens in many situations. For example, when the law establishes the directors' duty to display an adequate level of dedication to the company and to adopt the measures necessary to establish good management and control of the company (Art. 225 para. 2 LSC);[32] or in the case of the legal duty to be sufficiently informed (Art. 225 para. 3 LSC); this lack of clarity also becomes apparent when considering a director's duty to act under the principle of personal responsibility with freedom of judgement and independence from foreign instructions (Art. 228 lit. d LSC); or regarding the power of the directors to refuse to provide the information required by the shareholder because of the damage that may be caused to the company (Arts. 196 para. 2 and 197 para. 3 LSC). There is also quite a wide scope for directors to decide what constitutes an orderly conduct in relation to the duty of confidentiality (Art. 228 lit. b LSC).

In all these cases (and in many others), even if the legal provision contains a mandate to behave in a certain way, directors can act with a broad range of discretion.[33] The freedom to make a choice and the indulgence inherent in the business judgement rule preventing judicial review need to be maintained. Hence the rule should, in my opinion, apply to all types of directors' decisions if there is any margin of uncertainty that requires them to weigh up the circumstances and choose between alternative actions.

2. The law states four conditions that must be met for the effectiveness of the rule. The first two requirements can be easily verified: they imply objective conduct (when *no conflict of interests* arises and if the director *acts in good faith*) and relate to directors, as much as to the resolutions taken by them.[34] The other two conditions imply a subjective judgement, since they require that the directors' decision was made with *sufficient information* and in the framework of an *appropriate procedure.* Hence, they must be checked case by case according to the role assigned to the director, the amount of information gathered by him/her, or the procedure adopted in making his/her decision.

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actividad de los administradores no está sujeta a riesgos de error y sobrecumplimiento relevantes, que son cabalmente los que justifican la indulgencia".

[32] In Italy, but with interesting references to Spanish law s. *C. de Benedetti*, L'ápplicabilità della business judgement rule alle decisioni organizzative degli amministratori, Riv. Società 64 (2019) 413 et seq.

[33] *J. Alfaro*, in: Juste Mencía (ed.), Comentario de la reforma del régimen de las sociedades de capital en materia de gobierno corporativo (Ley 31/2014) (Cizur Menor 2015) Art. 226, 330; *Guerrero Trevijano, supra* note 30, 165; *Recalde Castells, supra* note 13, 1058.

[34] *Roncero, supra* note 7, 414.

a) If directors want to benefit from the rule, they *cannot be subject to any conflict of interest*. This is usually seen as a prerequisite above any other considerations. Directors will not be allowed to engage in transactions when they have, or could have, a personal interest that conflicts with those of the company, in whose interests they are bound to act. A decision taken by a director with a personal interest is not protected by the rule. The need to act in a disinterested fashion includes indirect conflicts, meaning where the interest of the director is not personal, but of a third party related to him/her. Hence, the rule does not cover decisions or actions that affect other directors or persons related to them.

This means that according to Spanish law, unlike in the USA, the rule would not apply to the assessment of the fulfillment of fiduciary duties. The exclusion of the rule in any case of personal interest, leads to some controversial issues. The law provides the possibility to exclude regulation of fiduciary duties in cases of a conflict of interest. In fact, the prohibition imposed on directors to intervene in these situations may be waived, if the company authorizes directors, or a person related to them, to complete a particular transaction with the company, to use company assets, to take advantage of a specific business opportunity, or to obtain an advantage or remuneration from a third party.

In all these cases, the existence of the conflict of interest and of the circumstances allowing the waiver often requires a considerable amount of information and involves a formal procedure. The more complex the company's structure, the greater the need for information and advice. Directors also enjoy leeway when evaluating all these data. Therefore, the rule should apply to compliance with the procedure that leads to the exemption. Some authors reject this opinion and maintain that under Spanish law the mere existence of a conflict automatically excludes the application of the *rule of discretion*.[35]

b) Directors must act *in good faith*. There is a shared understanding, that the concept of good faith should be contemplated in a subjective manner.[36] Directors should be required to behave with the personal belief that they are defending the interests of the company. However, they are obliged to provide justification of the good faith of their decisions, to demonstrate they were entitled to believe they were acting in the interests of the company. This leads to exclude cases in which their conviction was absolutely unreasonable.[37] In short, directors would be liable for damages they may cause if they clearly

[35] But criticizing the position of Spanish law excluding the discretion in the field of fiduciary duties *Roncero, supra* note 7, 418.

[36] *Hernando Cebriá*, *supra* note 12, 143; *Paz-Ares*, Identidad y diferencia del consejero dominical, in: Juste Mencía/Espín Gutiérrez (eds.), Estudios sobre órganos de las sociedades de capital. Liber amicorum Fernando Rodríguez Artigas y Gaudencio Esteban Velasco (Cizur Menor 2017) 39, 61.

[37] *Roncero, supra* note 7, 418; *Paz-Ares, supra* note 36, 62 at note 53.

breach the standard of conduct that can be expected of an orderly business person in the management of the business, despite their subjective beliefs.

c) In order to be protected by the rule, *directors must act also with sufficient information*. Once again, it is not possible to establish *ex ante* how much information would be necessary. A question will always hang over how much is enough, as directors could always have gathered more.[38] This could however lead to absurdity. Therefore, determination of the quantity of information required falls within the scope of the directors' powers of discretion. Directors assume the task of assessing the costs of generating information, and the benefits they can derive from new data. Managing a firm often involves making decisions based on information later is considered to be imperfect or insufficient.[39]

The directors' duty to be informed is complemented by their duty to seek adequate advice on the relevant elements of the decision, on the consequences of the decision, and on the likelihood of the risk of damage resulting from the decision.

Independence of opinions and reports must always be guaranteed. The diligence presumed when external advice has been followed, could be undermined in the event of a "war of (contradictory) opinions" presented by different advisers, e.g. when those who bring the action against a decision present contradictory reports.[40] In this case the courts must review the adequacy of the opinion, and the impartiality or suitability of the author of the report.

A mass of reports and opinions ("paper mountains") may also be the object of revision. A widespread practice in big corporations involves routinely collecting opinions from lawyers, financial advisors, academics, or any other external consultants, which directors consult to cover themselves from the risk of liability. Courts can also evaluate these practices and the inherent

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[38] *H. Fleischer*, La 'business judgement rule' a la luz de la comparación jurídica y de la economía del derecho, RDM 246 (2002) 1727, 1743.

[39] *J. Cox/T. Hazen*, On Corporations (2nd ed., New Yok 2003) 185. The German doctrine criticized a resolution of the Supreme Court (BGH, 16 June 2008, VIII ZR 282/07, NJW 2008, 3361), issued shortly after the UMAG was approved, which obliged the administrators, in order to invoke their discretion, to show that they exhausted "all" possible or conceivable sources of legal or other relevant information, *G. Spindler*, in: Goette/Habersack/Kalss (eds.), Münchener Kommentar zum Aktiengesetz (3rd ed., Munich 2008) § 93 marg. no. 75. Subsequent resolutions refrained from requiring the availability of exhaustive and complete information and rejected the fact that the information was not enough, *G. Bachmann*, Reformbedarf der Business Judgement Rule, ZHR 177 (2013) 2 et seq.; *Hernando Cebriá*, *supra* note 12, 148.

[40] AP Madrid, 18 November 2016 rejected a request to compare the reports on which the directors based their decisions and the reports issued years later, in which the demand had been sustained. In this case even the former would be ineffective, if the decision taken proved to be unreasonable.

costs, by assessing the benefits gained from them. In fact, the accumulation of a great number of reports can reflect a negligent practice if it leads to a bureaucratic style of management, which quashes spontaneity and reduces the freedom and independence of the directors' judgement. This conduct could be considered contrary to fiduciary duties, since its aim is mainly to protect directors from eventual risks, rather than the good of the company.[41]

In any case, there is no guaranteed certainty as to the effectiveness of amassing opinions and reports (no matter how "pleasing" they might have been to the potential addressees of the petition) and their capacity to exclude liability. The advice of experts does not provide a safe harbor, particularly if it simply offers directors the arguments they were seeking. The mere existence of opinions in favor of one decision does not provide directors a safe harbor nor exempt them from liability for a lack of diligence. Likewise, negative reports against an eventual decision are also not binding, although they could result in directors having to face a complex process of proving diligence.

d) Directors must make decisions or perform *in accordance with an appropriate procedure.* Actually, following this appropriate procedure embraces all the other prerequisites that define how directors should manage the company.[42] Decision-making must be the consequence of a defined process of forming the proposal, calculating the risk involved, ultimately taking the decision, and then monitoring *ex post* the execution of the process.

This intricate process is often standardized when management is organized in the form of a board of directors, especially in public companies. The final decision must be taken after a reasonable number of meetings, with the participation of those directors who are responsible for adopting it, and with the assistance of others, if they should be consulted. A board of directors may also delegate faculties to professionals with special skills, and internally distribute tasks and functions. If the decision refers to non-delegable powers, it must be taken by the entire board. The formalization is a result of the difficulty of managing a company by a collegiate body that often represents a channel through which the interests of distinct groups of shareholders compete for representation.

The appropriate procedure also presupposes compliance with the regulation and duties provided in the law and the articles of the company (*cumplir los deberes impuestos por las leyes y los estatutos*, Art. 225 para. 1 LSC). The precise content of the formal and objectivized procedure to be adopted depends on the activity, the size of the company, the subjective composition,

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[41] *Paz-Ares, supra* note 7, 208.
[42] *Recalde Castells, supra* note 7, 264.

and the complexity of the organization.[43] In listed company, systems that allow for the supervision of compliance and risk detection, and other types control are expressly required (Art. 529 ter para. 1 lit. b LSC); similar norms exist for companies engaged in activities of special regulatory significance (e.g. for credit institutions).

c) Some preliminary conclusions can be drawn from what has been stated so far. Courts should not judge whether a decision of the companies' directors was correct, as this falls within the realm of business risk. The exemption from judicial review should extend to mistake or erroneous decisions. That being said, the understanding of the rule as a tool to exclude liability does not cover cases of willful misconduct, nor will it shield the directors from liability for any decisions adopted with gross negligence.

However, the real scope of the business judgement rule goes further than this. The rule is established by setting procedural conditions and limits with which action must conform.[44] It is usually considered a tool focused on specifying what is required to shape the will of the company and to establish formal processes for the management of companies. Even while there is no possibility of determining *ex ante* whether a given decision is correct, it must have been taken within a framework that would allow the directors to foresee its probable consequences. Based on this understanding, it creates an assumption that the action taken by the directors was diligent if the decisions were adopted in accordance with a procedure that meets certain standards.

The conditions for the application of the business judgement rule are well suited to the functioning of the board of directors in large public companies, since they represent complex structures, with formal procedures for making decisions that contain multiple checking mechanisms. The proper organization of a corporation above a certain size requires systems be established to allow for the monitoring of compliance and risk detection, and other sophisticated control structures. The regulation of listed companies expressly calls for them (Art. 529 para. 1 lit. b LSC). However, Spanish company law has extended the scope of these requirements to all types of company, including S.L. It is not clear whether these conditions may be met in the same manner in closed companies with a family structure or with strong ties among the stakeholders, nor whether the application of the business judgement rule should be conditioned on their concurrence.

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[43] *J. Salelles Climent*, La incidencia de la crisis financiera sobre el buen gobierno de las sociedades, in: Arenas García/Górriz López/Miquel Rodríguez (eds.), Autonomía de la voluntad y exigencias imperativas en el derecho internacional de sociedades y otras personas jurídicas (Barcelona 2014) 15, 37 et seq.

[44] *Roncero, supra* note 7, 418.

VI. The Legal Consequences of the Business Judgement Rule

It is usually said that the business judgment rule works as a presumption of diligence. But what exactly should be presumed? Should it also be presumed that the conditions of the rule were complied with and, therefore, that management acted diligently? Does this presumption admit proof to the contrary, or is it configured as a non-rebuttable presumption of diligence given prior evidence of the fulfilment of the legal conditions?

According to its most common understanding in American jurisprudence, the business judgment rule provides criteria to assess the conduct expected of the directors. It is a standard of diligence leading to the presumption that directors acted in an informed manner, in good faith and with the subjective belief they were acting in the interest of company. However, it would be possible to prove that the conditions assumed to have been met were not in fact met, or that the decision taken was completely unreasonable or negligent.[45] The rule does not completely exclude any judicial review of the decisions taken. It simply facilitates the process of proving diligent action, in keeping with the degree of discretion that directors enjoy. The presumption of diligence establishes the standard of conduct expected from the companies' directors; but this presumption can be rebutted. Without the need to determine if the conditions of the rule (the decision-making process) were complied with, it could be demonstrated that the decision taken was manifestly unreasonable and contrary to the standard of conduct required in the management of the business. Nevertheless, the use of proof against the presumption of diligence could contradict the policy of exempting directors from judicial supervision, hence it should apply in limited cases. The possibility of demonstrating that a decision did not accord with the required levels of due diligence, does not diminish directors' freedom. But it does allow, as does any test of diligence, for the questioning of conduct that has caused damages, even though the directors allege that the reasonable assumptions for their decisions were met.

Another possible take on the rule is that it contains the standard of required diligence. Consequently, it would prevent any subsequent scrutiny of directors' activity. The "adequate" process of making business decisions specifies the way diligent directors should act. Compliance with the rule would there-

[45] In the *Model Business Corporation Act* or in Delaware Courts' understanding of the rule, this is considered a presumption of directors' diligent behavior; "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company" (Delaware Supreme Court, 1 March 1984, *supra* note 17). However, it is still possible to prove that directors did not act diligently either by proving that the conditions were not really met, or that the decision was nonsensical.

fore satisfy the standard of diligence, and directors would benefit from an irrefutable presumption of diligence.

The differences between these two understandings of the rule are confined mainly to the evidence that must be provided in each case. The main issues are: firstly, who should bear the burden of proof: directors or claimants; and, secondly, what is it that must be proved: is it the directors' alleged lack of diligence, or should the proof be limited to demonstrating that the conditions of the rule were not met?

a) The majority of Spanish legal authors maintains that there should be no scrutiny of the decision if the legal conditions of the rule were met. The literal wording of the law matches with the idea that fulfilment of the conditions of the business judgement rule represents the standard of diligence expected from directors. Compliance with the conditions constitutes sufficient proof of diligent behavior. A case of immunity would be sustained on the mere fulfillment of the legal conditions, since they provide an exhaustive definition of diligent management, meaning the rule would create a non-rebuttable presumption of diligence. Accordingly, directors would remain *immune* from any claim for damages made against the company, ruling out any possibility that claimants could directly prove the negligence of the directors.

If the rule was understood in the above sense, e.g. as providing a *safe harbor,* the only possible way to successfully claim for damages caused to the company would be to prove that the conditions of the rule were not met. Obviously, claimants are always entitled to demonstrate a breach in the procedure. This happens when the conditions of the rule were not met; e.g. the directors had a personal interest, they did not act in good faith, they acted without enough information, the opinions and reports required were not unbiased, or the procedure was not adequate.

b) However, defenders of this strict understanding of the rule admit it cannot not be used to create a shield offering directors total impunity and that claims for liability should operate in the event of "obvious breaches of their obligations",[46] which effectively serve as proof of the lack of rationale for the decision taken.

It has been said that if a decision lacks a rational basis or deviates from acceptable decision-making criteria, it must be concluded that there was no

[46] *Fleischer, supra* note 38, 1741; *Paz-Ares, supra* note 7, 47 proposes "relajar el tratamiento de la responsabilidad de los administradores por infracción de los deberes de diligencia declarando un espacio de inmunidad para las decisiones empresariales y, en general, moderando el alcance de la responsabilidad"; but he admits, p. 33, that "La inmunidad de las decisiones empresariales frente a la acción de responsabilidad no puede conducir, sin embargo, a la impunidad generalizada de los administradores en el vasto territorio de la negligencia. El alcance de la inmunidad ha de quedar debidamente acotado".

compliance with the legal conditions for the application of the rule.[47] But simply proving a decision was irrational would preclude the effects of the rule; it is sufficient for claimants to demonstrate obvious breaches of due diligence obligations in order to claim liability from the directors, without it being necessary to prove that the conditions of the rule were not met. Behavior deviating from any rational standard is of itself "evidence" of non-compliance with diligence requirements, without having to prove that the legal rule's assumptions were not met.

On the other hand, if shareholders acting as claimants could only seek redress with proof that the directors did not comply with the established procedure, or that the other conditions of the rule were not met, then that proof might be unavailable or very difficult to obtain. In fact, accessing data that demonstrates the absence of the conditions of the protocol could be a very challenging task. A claim for directors' liability would depend on proving that the procedure for making the decision was incorrect, that the information gathered was insufficient, or that the recommendations of third-party advisors was either partial or professionally inadequate. It would lead *de facto* to a situation of virtual impunity. The claim would become almost impossible to defend if it depended entirely on a negative proof: i.e., that there had not been an acceptable decision-making process or that the directors had not made efforts to obtain sufficient information. While it might be relatively easy to show that the protocol was inadequate it would be much tougher to prove that the information gathered by the directors was insufficient.

c) With regard to the question of who bears the *onus probandi*, it is often stated that, in order to be able to invoke the business judgement rule, directors bear the burden of proof that the conditions of the rule were met.[48] However, this is not a clear conclusion to draw from Spanish civil procedural law, which requires that any claimant must prove the premises of his claim. Ac-

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[47] *Roncero, supra* note 7, 418 et seq.; *Paz-Ares, supra* note 36, 61 at note 49 sustains that the rule does not cover cases of absolute irrationality: irrationality shows the lack of any of the conditions of the rule, even if this proof by indicators have not been provided; *Alfaro, supra* note 33, Art. 226, 332: "el administrador de una sociedad no podrá ampararse en la business judgment rule si, aunque afirme que creyó que la decisión era 'buena' para la sociedad, ésta resulta disparatada o claramente inadecuada para preservar o aumentar el valor de la compañía o, si la conducta del administrador contradecía de tal modo su creencia subjetiva que ésta última no puede considerarse sincera […] Las decisiones disparatadas no pueden considerarse adoptadas 'de buena fe'", also in p. 340).

[48] *Alfaro, supra* note 33, Art. 226, 327 et seq. Under German law, if the conditions on which the business judgement rule is based were met, the duty of diligence is presumed to be satisfied and responsibility is avoided, but it is the directors who bear the burden of proof (*Spindler, supra* note 39, § 93 marg. no. 36; *W. Paefgen*, Organhaftung: Bestandsaufnahme und Zukunftsperspektiven, AG 2014, 555 et seq.).

cording to this standard, the claimant for damages caused to the company in the case of negligence will have the burden of proving that the conditions of the business judgement rule were not met. This would also apply to claims brought against the directors of a company for liability (Art. 236 LSC). On the other hand, civil procedural law adjusts the burden of proof according to the availability of evidence and the ease with which each of the parties in a dispute can prove the facts (Art. 217 para. 7 Civil Procedure Act [*Ley de Enjuiciamiento Civil*, LEC][49]).

Based on these assumptions, we have advocated for an opportunity to prove a lack of diligence if the decision taken by the directors is shown to be deprived of any rationality. This would mean that the claim could simply be supported by showing that the decision deviated clearly (*deutlich*, as *P. Ulmer* has argued in his projected amendment of the AktG in Germany) from ordinary standards. Denying the effects linked to the rule does not require establishing that the legal conditions of the rule had not been met. The claim could be sustained, and the presumption of diligence rejected, if the court were convinced that directors' decision was nonsensical and irrational.[50] On the other hand, it does not seem plausible that Spanish judges would require plaintiffs to prove that the conditions of the rule were not satisfied, if they had found that decisions which had proved to be harmful to the company were irrational.

VII. Applying the Business Judgement Rule to Closed Companies

1. The ideas developed previously have guided us to the issue on which I wished to focus. Should the regulation of the business judgement rule apply to all types of capital companies, including big listed public companies, public non-listed companies, and closed companies with limited liability? Or should the rule, as it is today configured in case law and in statutory provisions, not extend its scope to closed companies, whose shareholders are connected by intimate family or personal relations?

As said above, the rule can be understood as a tool to prevent judicial review of business decisions, and to protect directors when making those decisions, so that they need not fear being brought to court by shareholders if it is discovered *ex post* that the decisions caused damage to the company. This exclusion from liability or, at least, this substantial reduction of the risk that directors will face liability in the wake of bad decisions, is the price that shareholders must pay for the benefits they can reap from directors' successes.[51]

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[49] *Ley 1/2000, de 7 de enero, de Enjuiciamiento Civil.*
[50] *Recalde Castells, supra* note 13, 1076 et seq.
[51] *Jungmann, supra* note 4, 843.

But the business judgement rule was developed from case law in the United States, and it was developed further in other countries, with the purpose of determining an *ex ante* procedure for forming the will of the company. The aim was to establish a path for taking business decisions and carrying them out, facilitating or guaranteeing directors accomplish their duty of diligence.

I shall first examine it as a general policy issue, distinguishing between public and closed companies (*infra* 2.), and then I will consider it from the perspective of the provisions of Spanish company law (*infra* 3.).

2. If the objective of the business judgement rule is to reduce the risk of courts scrutinizing the merits of business decisions, or the risk of condemning directors for cases of simple failure, application of the rule to all forms and types of companies would be justified. Directors must always be able to carry out the management of a company in a framework of freedom, and not fear to be held liable for decisions that only time have revealed to be were mistaken. As previously noted, the directors' duty of diligence is of manner and not outcome. This notwithstanding, an adequate balance between the various interests involved in the company must be provided. The presumption of diligence does not exclude directors from bearing the responsibility and the consequences of their actions in all cases. Specifically, exclusion from liability should not be admissible if the damage caused was due to willful or grossly negligent behavior, even if those are not breach of fiduciary duties.

The conclusion is much more complex if the rule is seen as a protocol for taking business decisions. From this perspective, when the conditions inherent to an objectivized protocol were met, directors could reasonably expect to avoid the risk of becoming liable for the consequences of their conduct.

Two reasons justify this concept of the *rule* in large public companies. One of them is related to the features of the conditions on which the rule is based. The management of these firms relies on standardized protocols of decision-making. The requisites to which the business judgement rule is subject (specifically a formal procedure for shaping the companies will, a structure which allows for risk prevention and for monitoring the performance of the directors) presupposes a complex organization, which would only be attainable in large public companies. The process and the execution of companies' decisions is well suited to hierarchical organizations acting with total independence in order to adequately consider multifaceted interests within the company. Compliance with the conditions to which the rule is submitted, is itself a demonstration of an adequate organization. Directors' reliance on a defense of having acted diligently relies on their capacity to execute this protocol to which any decision-making is submitted.

The greater the degree of proceduralism, the lower the risk of abuses or deviations from an abstract idea of the interest of the company as determined by the procedural rules. The specific provision of a decision-making process can

only be expected in big corporations, where predetermining the conditions for managerial performance is workable, where mechanisms for risk prevention and reaction to new circumstances are common, and which provide models for the internal review of the consequences of the decisions taken.

In any case, the requirements underlying the conditions to be met in order to apply the business judgement rule are also typical of a management body structured as a board of directors. Within the board of directors, members of the board may delegate the preparation and execution of certain functions to internal committees or even to executives who are not members of the board. However, as expressed previously (*supra* note 9), in Spain statistics show significant differences between S.A. and S.L., in terms of the use of the different management structures in each class of company. While boards of directors are habitually used in S.A.s, in S.L.s a board is more of an exception.

The management of closed companies requires a specific approach, different to that of public companies. The exclusion of liability for wrong management cannot be conditioned to complex decision-making procedures. The creation of a pre-determined, formal and abstract procedure that defines how the management of the firm should be carried out may lead to extreme rigidity. Submitting management to compliance with a procedural protocol cannot be the condition for the presumption of diligence, and for avoiding the judicial review of business decisions. It would be out of step with the day-to-day running of companies based on contractual provisions. It would even be counterproductive from the perspective of orderly management, since it would lead to greater expense, bureaucracy and inefficiency, all of which are incompatible with the needs of a closed company. The existence of slow and costly organizational structures, or the need to operate through formal and complex organizational protocols, would lead also to unaffordable costs and curtail flexibility.

Diligence can still be presumed if the decision was taken with enough information and in good faith, i.e., with the director's subjective perception that he acted in the interests of the company. But this presumption should only operate *iuris tantum*, and in any case it cannot be exhausted by the fulfillment of certain conditions defined in the abstract. Courts must be entitled to scrutinize the content of management's decisions, and to take into account the diligence shown by directors.

The other explanation for the significance of the rule is more substantial and refers to the position of managers in public companies. Currently, the model on which the business judgement rule is based relies on a corporate governance model which is specific to public companies. As a result of the separation between ownership and management, the rule entitles directors with the power to manage the company to independence and discretion in the exercise of their judgement. This allows shareholders to diversify their investments, and to be in a neutral position with regard to business risk. They may even be interested

in encouraging directors to take on risk. Even though the objective of management is always to maximize the economic value of shareholders' investments, directors in public companies are assigned the task of modulating and balancing the competing interests. Actually, the features of the different classes of shareholders are as diverse (short-term investors, long-term investors, institutional investors, hedge funds) as the economic interests sought by them. That is why directors are charged with the task of integrating these different interests, along with those interests of stakeholders.[52]

This leads to the establishment of a legal framework, in which directors are assigned with the function of reconciling all kind of interests.[53] Directors must act with freedom of judgement and total independence from external instructions. Specifically, they should not be influenced by a unique and undefined company "interest". Therefore, they need to be able to make decisions with full discretion, which is the main condition upon which the business judgement rule is grounded.

The situation is completely different in the case of companies in which there are close personal or family ties between shareholders. Shareholders usually contribute a large proportion of their assets to the company.[54] When the same people manage the firm and bear the risk, there is no benefit to specialization. They have not diversified their investments by putting their money in different projects. A small number of shareholders both manage and bear the cost of their managerial decisions, what is good for them is also good for the firm and for other stakeholders,[55] since their interests are more likely to be homogeneous. Therefore, shareholders' instructions or strict controls on the management of the firm imposed by them lead to a significant reduction in directors' discretionary powers. Therefore, the arguments justifying the discretionary powers of the directors in public companies are no more transferable to closed companies.

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[52] *Spindler, supra* note 39, § 76 marg. no. 21 et seq. The ability to act with full independence implies the possibility of a dual interpretation of the interests that directors should or, at least, can defend; *M. Kort*, Vorstandshandeln im Spannungsverhältnis zwischen Unternehmensinteresse und Aktionärsinteressen, AG 2012, 605 et seq.; a critical vision towards any pluralist conception of company interests in *P. Mülbert*, Soziale Verantwortung von Unternehmen im Gesellschaftsrecht, AG 2009, 766 et seq.

[53] The exercise of this role requires freedom of judgement and independence, without any dependence on shareholders' instructions, *G. Esteban Velasco*, Buen gobierno, fin/interés social y responsabilidad social corporativa. Hacia un modelo de gobierno socialmente responsable, in: Roncero Sánchez (ed.), Sociedades cotizadas y transparencia en los mercados (Pamplona 2019) 969, 1008; *Paz-Ares, supra* note 36, 99.

[54] *H. Fleischer*, in: Fleischer/Goette (eds.), Münchener Kommentar zum GmbH-Gesetz (3rd ed., Munich 2018) § 43 marg. no. 68; *Jungmann, supra* note 4, 850 et seq.

[55] *F. Easterbrook/D. Fischel*, The Economic Structure of Corporate Law (Cambridge, Mass. 1991) 229.

Even when the shareholders have not expressed this determination to the directors, they must align their actions with the presumed will of the shareholders, whose aims are generally easily traceable and homogeneous.[56] Directors must even consider whether the shareholders are risk adverse or more risk-taking and manage the company accordingly. They must also consider that their decisions can have long-term effects on stakeholders, such when deciding to dismiss an employee who is also a stakeholder in the company.[57] In fact, the dismissal of an employee is a classic example of the exercise of the directors' powers of discretion subject to the business judgement rule in a public company. However, in a closed company, the termination of the contract of an employee may disguise an attempt to appropriate the firm's earnings to the detriment of the minority stakeholders.[58]

As mentioned previously, in closed companies, there is no real separation between ownership and control. Directors depend on the confidence of shareholders. If necessary, they can even seize the authority to manage the company for themselves by passing an agreement in the general meeting, expressing their will and aims. The conflict is moved to the sphere of the relations between shareholders and must be solved through their duty to act in good faith (duties of fidelity) when exercising their right to vote.

Shareholders run the firm directly or retain for themselves the power of monitoring the management. Directors are consequently obliged to carry out the shareholders will. In managing the firm, they should be neither independent, nor neutral with respect to risk or to shareholders' interests. Currently, they are the "masters of the company" and decide or at least have an influence on, all issues concerning the company, including its management. They are not only entitled to limit the entrepreneurial activities of directors by establishing prohibitions, but can also require them to take certain measures by means of binding instructions. These powers are usually established in the contract (in the deed of constitution, the articles or by-laws of the company), but company law also grants sovereign powers to the stakeholders.

However, if directors must ensure the alignment of entrepreneurial decisions with the interests of the shareholders, there can be very little leeway afforded to them in the management of the company. The involvement of shareholders in the organization and management of the company reduces the discretionary powers of the directors, or even effectively abolishes it. Even though guaranteeing the discretion of the directors to make business decisions freely was recognized as being the main purpose of the business judgement rule, and therefore justified the relative immunity from liability, the trans-

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[56] *Fleischer, supra* note 54, § 43 marg. no. 74.

[57] *Bachmann/Eidenmüller et al., supra* note 5, 61.

[58] *Easterbrook/Fischel, supra* note 55, 245.

plant of the rule to closed companies should only be submitted to narrow and specific restrictions.

This opinion is commonly supported in comparative law.[59] If the rule is founded on the fact that directors have the discretion to decide, this does not play any role in closed companies, where shareholders are directly involved in management. But, in this case there is no further reason to "privilege" the liability of management, in the sense of insulating them from any judicial review, since directors' decisions would not be attributable to them but to the shareholders themselves.

3. However Spanish company law does not pay attention to the needs of companies characterized by personal or family ties. Actually, the boundaries between S.A.s and S.L.s have been steadily blurred. This happened first in 2011 when the LSC consolidated the acts regulating S.A.s and S.L.s, and established a regulation which tended to be uniform for all forms and types of companies, whose capital is distributed in shares. The issue was further exacerbated with the amendment of 2014.

Many provisions of this reform referred to issues typical of large public companies. Spanish company law imposed upon directors the duty to manage the company as an orderly business person (Art. 225 LSC), and they must do it under the principle of personal responsibility with freedom of judgement and independence from third parties (Art. 228 lit. d LSC). This provision is consistent with the assumption that a director has discretion and leeway in running the firm, embodied in the business judgement rule (Art. 226 LSC). Those principles are necessary in order to balance interests of a very diverse nature. In public companies, it is not possible to identify a common and unique objective of the shareholders, because there is no common cause among them. At the same time, directors cannot exclude liability for carrying out any instructions, including those given to them by a resolution passed in the shareholders meeting (Art. 236 para. 2 LSC). This model is quite coherent for public companies.

However, in contrast with it, the law also provided an opposite rule allowing the general meeting to pass a resolution giving directors instructions on certain management matters, or requiring their decisions be submitted to the general meeting for authorization (Art. 161 LSC). This provision was origi-

[59] In Germany *Fleischer, supra* note 54, § 43 marg. no. 70, 71; also in the USA well-known authors advocate restricting the application of the business judgement rule over close companies, *F. Easterbrook/D. Fischel*, Close Corporations and Agency Costs, Stan. L. Rev. 38 (1986) 271; *Easterbrook/Fischel, supra* note 55, 244 et seq.; *F. O'Neal/R. Thompson*, O'Neal and Thompson's Oppression of Minority Shareholders and LLC Members (2nd ed., 2009 Eagan) § 10.4, 10-13 et seq. But it should be noted that this opinion excludes the rule for some cases that, under the general view arising from Spanish law, it would not be applicable since they refer to cases of fiduciary duties and where the interest of the director could be affected (salary, employment of directors).

nally exclusive to S.L.s. And it is perfectly understandable in the context of a type of corporation intended for closed companies in which the shareholders reserve a strong control over the management or even the power to decide on the most important matters.

However, the scope of this provision, allowing the shareholders meeting to give instructions on management matters was extended in 2014 to include S.A.s, and even listed companies. As a consequence, some authors have stated that Spanish company law reflects a "model of corporation" featuring a "clear submission of the board to the meeting", where "the administrative body is entirely subordinated to the shareholders meeting"[60].

Things are not probably so easy. If the law enables the general meeting of any company to pass a resolution giving instructions to management, directors must necessarily comply with these instructions. When a director loses the freedom to decide on his own and at his own discretion, he cannot be assigned with the consequences of fulfilling the instructions given to him.[61] If the directors must execute these binding instructions, they should then be exempt from liability for damages arising from their execution.[62]. But this is not the case (Art. 236 para. 2 LSC).

Considering the contradictions between both provisions, a restrictive interpretation of the rule allowing shareholders to give managerial instructions to directors has been developed (Art. 161 LSC).[63] This takes into account that the directors are submitted to the contradictory duty to decide and manage the

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[60] *M. Sáez Lacave*, Activismo accionarial, Hedge Funds y el artículo 161 de la LSC, InDret 4 (2018) 55; *J. Alfaro*, ¿Por qué algunos Derechos prohíben a los accionistas dar instrucciones a los administradores de sociedades anónimas?, Almacén de Derecho, 9 September 2019 (<https://derechomercantilespana.blogspot.com/2019/09/por-que-algunos-derechos-prohiben-los.html>).

[61] *Recalde Castells, supra* note 3. Before the 2014 LSC amendment, *Esteban Velasco* held that the provision should be extended by analogy to S.A.s but it should be excluded for public listed companies or companies with a significant free floating percentage, *G. Esteban Velasco*, Acuerdos de la junta general de socios de sociedad limitada en asuntos de gestión y la responsabilidad de los administradores, RdS 18 (2002) 221, 227; and *G. Esteban Velasco*, in: Rojo/Beltrán (eds.), Comentario de la Ley de sociedades de capital (Madrid 2011) Art. 161, 1217. This is why he criticizes the extension of the rule after the reform to any type of company (*Esteban Velasco, supra* note 3, 29, 75).

[62] In German law related to GmbH *Fleischer, supra* note 54, § 43 marg. no. 275.

[63] *A. García Vidal*, Las instrucciones de la junta general a los administradores (Pamplona 2006) 120 et seq.; *E. Gandía Perez*, La renuncia a la acción social de responsabilidad (Madrid 2017) 219 et seq.; *A. Recalde Castells*, in: Juste Mencía (ed.), Comentario de la reforma del régimen de las sociedades de capital en materia de gobierno corporativo (Ley 31/2014) (Cizur Menor 2015) Art. 161, 57, 62; *J. Juste Mencía*, Algunas reflexiones sobre las instrucciones de la junta en materia de gestión y la responsabilidad de los administradores, in: Juste Mencía/Espín Gutiérrez (eds.), Estudios sobre órganos de las sociedades de capital. Liber amicorum Fernando Rodríguez Artigas y Gaudencio Esteban Velasco (Cizur Menor 2017) 395, 403; *Paz-Ares, supra* note 36, 54.

company with freedom of judgement and independence, and the fact that liability cannot be excluded for carrying out these instructions. According to this interpretation, even if instructions from shareholders are "binding", directors should act as a "filter" or a gatekeeper. Therefore, they (i) can never be exempted from the duty of informing the shareholders of the harmful consequences to the company that may result from executing a resolution of the general meeting; (ii) cannot be exempted from liability for damages arisen from the execution of these instructions if they retained some leeway in it, and if the damages were caused in the exercise of this discretionary power; (iii) they will not be released from their duties of diligence or liability for infringing this duty, if new facts arise that the shareholders were not able to take into account when they passed their resolution; finally (iv), the instructions contained in the resolution passed at the general meeting are not-binding if their object is illegal,[64] in particular, in the case of instructions that were contrary to imperative rules, such as those resolutions that damage third parties, or represent an illegal oppression of minority shareholders.[65] In the face of illicit damages caused to third parties or abusive acts damaging minority shareholders, directors cannot allege that the instructions coming from shareholders were binding.[66] Hence the execution of the instructions given to them would not relieve them from any liability that arose from their acts (Art. 236 para. 2 LSC). Beyond these limits, shareholders have the power to determine (expressly or implicitly) how the company should be run.

VIII. Conclusion

The different origins of Spanish provisions regulating the relationship between a companies' bodies reflect a confusing system, particularly when the

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[64] TS, 20 July 2010, RJ 2010/4621: Directors could not invoke the authorization of the shareholders meeting to provide financial assistance to a shareholder for acquiring shares of the company, as this authorization infringed the prohibition of receiving such assistance (*Juste Mencía, supra* note 63, 407).

[65] But if the instructions only may cause damages to the company, directors must execute them, and hence they should be exempted from liability (*Gandía Perez, supra* note 63, 219 et seq.; a partly dissenting opinion in *Juste Mencía, supra* note 63, 410 et seq.).

[66] This limits the effect of the business judgement rule in the paradigmatic case of groups of companies. Directors' duty to act as gatekeepers is the lever that the legislation provides to safeguard the interests of the external shareholders, *Paz-Ares*, ¿Derecho común o derecho especial de grupos? Esa es la cuestión (Pamplona 2019) and *C. Paz-Ares*, ¿Derecho común o derecho especial de grupos? Esa es la cuestión, in: González Fernández/Cohen Benchetrit (eds.), Derecho de sociedades. Cuestiones sobre órganos sociales (Valencia 2019) 1561.

provisions have a common or general scope, and apply to all classes and types of companies.

From the point of view of the purposes of the law, Art. 226 LSC is also controversial. It is coherent with other provisions, that guarantee directors independence and discretion when managing the company. This suits the needs of public companies. But it does not work as well when applied to closed companies, and specifically to family companies. These companies require a model in which the power of decision belongs to shareholders, who should be entitled to give binding instructions to directors. This possibility is a direct and significant limit on directors' leeway. When no discretion remains, no place is left for the business judgement rule. This has consequences for director liability, with the exceptional case where the illegitimacy or abusive character of the instructions was evident and recognizable.[67]

[67] As the main defender of the merely indicative nature of the instructions coming from the parent company, recognizes, *Paz-Ares*, in: González Fernández/Cohen Benchetrit (eds.), *supra* note 66, 1570, 1573.

Business Judgment Rule in Closed and Family Companies

Gerald Spindler/Andreas Seidel

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I. Introduction

Closed companies, in particular family companies, are an essential element of the German economy. Most of the "Mittelstand" (middle class), which is one of the main drivers of German economy, is organized in such companies, whether as limited liability companies or stock corporations. Given the closed structure of these companies, the traditional principal-agency-problems between shareholders and directors do usually not apply, as shareholders have a much closer view on how their company is being managed. Closing this distance still further, shareholders are frequently also directors of their company or at least representatives from the same family as the directors.

To assess the impact of the business judgment rule on closed/family companies, we must be aware of the different types of companies in German corporate law, in particular stock corporations and limited liability corporations. Regarding stock corporations, the German Stock Corporation Act (*Aktiengesetz*, AktG)[1] provides only a limited set of provisions aimed at corporations not listed on a stock exchange. Thus, provisions concerning director's salaries for listed companies are enshrined in § 87 para. 1 sent. 2 AktG. In listed companies, director's salaries must be oriented towards a sustainable

[1] *Aktiengesetz vom 6. September 1965 (BGBl. I S. 1089), das zuletzt durch Artikel 1 des Gesetzes vom 12. Dezember 2019 (BGBl. I S. 2637) geändert worden ist.*

corporate development[2], whereas there is no comparable legal regulation for non-listed corporations.[3] Notwithstanding the lack of specific mention, the supervisory board must consider sustainable corporate development also in non-listed corporations, because the legislator wishes this to be taken into account.[4] However, adherence to that rule is not nearly as strict as for a listed company.[5] Moreover, there are, for example, special rules concerning the convocation of the shareholder meeting. A non-listed company, for example, has no duty to send the convocation to media which would probably spread the information across the whole European Union (§ 121 para. 4a AktG) nor it is required to publish the main information about the shareholder meeting on its website (§ 124a AktG).[6] The most important provision for closed corporations, formal statute stringency, remains unchanged: the charter/statutes cannot deviate from the German Stock Corporation Act unless a provision explicitly allows modification. In terms of directors' obligations and liability, the AktG does not know any kind of opening clause for the statutes so that these provisions – including the business judgment rule – are mandatory.[7]

The same is true for the European Stock Corporation (SE), as Art. 9 SE-regulation declares they are subject to national corporate law, hence, for issues of liability and the business judgment rule, the provisions of §§ 76, 93 AktG apply.[8]

In contrast, the limited liability company (*Gesellschaft mit beschränkter Haftung*, GmbH) is characterized by a freedom of charter: shareholders may structure their inner relations, be it voting rights, instruction rights, or representation on the board of directors as they see fit. Only a few provisions are mandatory, such as information and inspection rights (§ 51a *Gesetz betreffend die Gesellschaften mit beschränkter Haftung*, GmbHG)[9] or the minority right to call a meeting of the shareholder assembly (§ 50 GmbHG). However, the

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[2] *G. Spindler*, in: Goette/Habersack (eds.), Münchener Kommentar zum Aktiengesetz (5th ed., Munich 2019) § 87 marg. no. 78.

[3] *Spindler, supra* note 2, § 87 marg. no. 98.

[4] *Spindler, supra* note 2, § 87 marg. no. 78; *H. Fleischer*, in: Spindler/Stilz (eds.), Kommentar zum Aktiengesetz (4th ed., Munich 2019) § 87 marg. no. 30.

[5] *Spindler, supra* note 2, § 87 marg. no. 98; *Fleischer, supra* note 4, § 87 marg. no. 30.

[6] For an overview of the deviations see *I. Drescher*, in: Spindler/Stilz (eds.), Kommentar zum Aktiengesetz (4th ed., Munich 2019) § 3 marg. no. 3.

[7] *Fleischer, supra* note 4, § 93 marg. no. 3; *J. Koch*, in: Hüffer/Koch (eds.), Kommentar zum Aktiengesetz (14th ed., Munich 2020) § 93 marg. no. 2.

[8] *P. Hommelhoff/C. Teichmann*, in: Lutter/Hommelhoff/Teichmann (eds.), Kommentar zum SE-Recht (2nd ed., Cologne 2015) Art. 9 SE-reg. marg. no. 54; *J. Schürnbrand*, in: Habersack/Drinhausen (eds.), Kommentar zum SE-Recht (2nd ed., Munich 2016) Art. 9 SE-reg. marg. no. 24.

[9] *Gesetz betreffend die Gesellschaften mit beschränkter Haftung in der im Bundesgesetzblatt Teil III, Gliederungsnummer 4123-1, veröffentlichten bereinigten Fassung, das zuletzt durch Artikel 10 des Gesetzes vom 17. Juli 2017 (BGBl. I S. 2446) geändert worden ist.*

main disadvantage of the GmbH lies in its inability to be listed on a stock exchange, and severe creditor protection problems which gave rise to different instruments created by courts to render shareholders liable.

II. Business Judgment Rule

1. Development

In order to assess the role of the business judgment rule in closed corporations we must briefly review the development of the business judgment rule. This rule, as stipulated by the American Law Institute as "a director or officer who makes a business judgment in good faith fulfills [the duty of care] if the director or officer (1) is not interested in the subject of the business judgment; (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and (3) rationally believes that the business judgment is in the best interests of the corporation"[10] has its roots in US company law apparently.[11] If these essentially formal preconditions are satisfied, judges will not apply the duty-of-care-standard to this decision. Thus, the business judgment rule creates a "safe harbor" for board-decisions:[12] As long as the board meets the preconditions of the business judgment rule, it need not fear examination with regards to the content of the decision.

This rule is foremost motivated by the need for such a "safe harbor" for entrepreneurial decisions in a free-market economy, to accommodate the dynamic of the market – a fact that is now accepted worldwide.[13] Entrepreneurial decisions are subject to uncertainty and, to a great extent, prognostic elements. Therefore, the hazard of hindsight bias is high and carries the danger of a faulty judicial review on an *ex post* basis. In consequence, the risk of personal liability arising from wrong entrepreneurial decisions subsequently determined to be incorrect would lead to risk-averse behavior in management. However, successful corporate leadership requires innovation and, to a cer-

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[10] *American Law Institute*, Corporate Governance Principles (Philadelphia 1994) § 4.01(c).

[11] In detail *D. Block/N. Barton/S. Radin*, The Business Judgment Rule, Vol. I and II (5th ed., New York 1998) passim; *H. Merkt*, US-amerikanisches Gesellschaftsrecht (3rd ed., Frankfort-on-the-Main 2013) marg. nos. 922 et seq.; *H. Merkt*, Rechtliche Grundlagen der Business Judgment Rule im internationalen Vergleich zwischen Divergenz und Konvergenz, ZGR 46 (2017) 129, 130 et seq.

[12] *American Law Institute, supra* note 9, Comment to § 4.01(c), 173; *Merkt, supra* note 11 (US-amerik. GesellschaftsR), marg. no. 922.

[13] For an international comparison cf. *Merkt, supra* note 11 (Rechtl. Grundlagen der Business Judgment Rule), 130 et seq.

tain extent, the willingness to take (necessary) risks. Shareholders therefore expect this kind of risk tolerance to a certain point. Furthermore, risk-averse behavior is not conducive to commercial success. So management must be able to make potentially risky decisions without any fear of the risky decision itself leading to personal liability.[14] The business judgment rule was thus formulated to encourage risk tolerance on the board and thereby to promote entrepreneurial success.[15]

Thus, in 1997, the German Federal Court of Justice (*Bundesgerichtshof*, BGH) decided to adopt a business judgment rule based on the US-American role model for the famous ARAG/Garmenbeck-Judgment.[16] That the board of directors should have a broad freedom of action to lead the company is a key condition for entrepreneurial activity.[17] Subsequently, in 2005, the German legislator decided to regulate the business judgment rule for the board of directors in the German stock corporation in § 93 para. 1 sent. 2 AktG.[18] This norm also applies to entrepreneurial decisions of the supervisory board, as per § 116 sent. 1 AktG in conjunction with § 93 para. 1 sent. 2 AktG. Furthermore, according to the will of the German legislator, the business judgment rule applies not just to stock corporation law but also to "all forms of entrepreneurial activity".[19]

In an international comparison, the business judgment rule is broadly accepted in company law.[20] In fact, in addition to Germany, this rule has also been codified in other countries such as Portugal, Rumania, Croatia, Greece, Austria and Australia.[21] In many other countries inside and outside the European Union, the business judgment rule applies through precedent, like in UK, Ireland, Belgium, Denmark, Italy, Lithuania, the Netherlands, Spain, Hungary, Switzerland, Serbia, Norway and Japan.[22]

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[14] BGH, 21 April 1997, II ZR 175/95, BGHZ 135, 244, 253 (*ARAG/Garmenbeck*); *Spindler, supra* note 2, § 93 marg. no. 43.

[15] For a detailed economic view on the business judgment rule cf. *B. Scholl*, Vorstandshaftung und Vorstandsermessen (Baden-Baden 2015) 230 et seq.

[16] BGH, 21 April 1997, *supra* note 14, 253 et seq.

[17] BGH, 21 April 1997, *supra* note 14, 253.

[18] Law on Corporate Integrity and the Modernization of the Right of Contestation (*Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts*, UMAG, BGBl. I S. 2802).

[19] Begründung zum Regierungsentwurf, BT-Drs. 15/5092, 12 (justification for government draft on the Act for Corporate Integrity and Modernization of the Law of Avoidance).

[20] Cf. *Merkt, supra* note 11 (Rechtl. Grundlagen der Business Judgment Rule), 133 et seq.

[21] *C. Gerner-Beuerle/E.-P. Schuster*, The Evolving Structure of Directors' Duties in Europe, EBOR 15 (2014) 191, 204 et seq.

[22] *Merkt, supra* note 11 (Rechtl. Grundlagen der Business Judgment Rule), 133; *C. Gerner-Beuerle/E.-P. Schuster, supra* note 21, 191, 205 with footnote no. 80.

2. *Key Elements of the Business Judgment Rule*

As mentioned above, the American Law Institute defines the business judgment rule for applicable/the duty of care as met, if a director or officer, who makes a business judgment in good faith (1) is not interested in the subject of the business judgment; (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and (3) rationally believes that the business judgment is in the best interest of the corporation.[23] The German Stock Corporation Act prescribes, in the case of entrepreneurial decisions, a breach of duty does not exist if a member of the board of directors or the supervisory board could reasonably assume, based on appropriate information, that he/she was acting in the best interest of the company (§ 93 para. 1 sent. 2 AktG).

a) *Entrepreneurial decision*

Hence, the decision in question firstly has to be an entrepreneurial one, in contrast to those which are required by law. This term is hard to define.[24] Entrepreneurial decisions are usually, but not necessarily, characterized by some elements of prognosis,[25] in other words: decisions made under conditions of uncertainty or with a certain risk. Leaning on the insight of business economics, an entrepreneurial decision is a conscious choice for or against an entrepreneurial possibility with particular economic consequences, whereby the economic consequences can arise out of the scope, the risk or the significant influence on the future development of the enterprise.[26]

However, while this distinction seems clear, in practice the separation from legally required decisions is often blurred, for instance concerning options in accounting law. Accounting options have little in the way of prognostic elements, but at least the question of the financial presentation has (to some extent) an impact on creditors, the capital market, tax authorities etc., so that even these decisions have an entrepreneurial nature.[27] The same applies to (past related) bonus payments that could have an incentive effect on future

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[23] *American Law Institute, supra* note 10, § 4.01(c).

[24] Most recently *B. Pfertner*, Unternehmerische Entscheidungen des Vorstands (Tübingen 2017).

[25] Begründung zum Regierungsentwurf, BT-Drs. 15/5092 *supra* note 19, 11; *H. C. Grigoleit/L. Tomasic*, in: Grigoleit (ed.), Kommentar zum Aktiengesetz (2nd ed., Munich 2020), § 93 marg. no. 42; *W. Hölters*, in: Hölters (ed.), Kommentar zum Aktiengesetz (3rd ed., Munich 2017) § 93 marg. no. 30; *G. Spindler*, Prognosen im Gesellschaftsrecht, AG 2008, 677, 680.

[26] *S. Mutter*, Unternehmerische Entscheidungen und Haftung des Aufsichtsrats der Aktiengesellschaft (Cologne 1994) 23; *Spindler, supra* note 2, § 93 marg. no. 48.

[27] See *H. Merkt*, Bilanzierungsentscheidungen und unternehmerisches Ermessen, Der Konzern 2017, 353, 356 et seq.

board members.[28] These complex decisions with past, present, and future related parts show the insufficiency of the prognosis-based distinction.[29]

Thus, the criterion of demarcation should not be the element of prognosis but rather through contrast to decisions determined by law.[30] The duty to follow legally binding rules (duty of legality), including the duty of loyalty[31], is outside the scope of the business judgment rule.[32] Similarly, the breach of legal obligations or those arising from the charter, the implementation of general assembly resolutions, or from the employment contract are also not covered.[33] The idea of an "efficient" breach of the duty of legality, which is permitted under company law, is – at least under German law[34] – not common.[35] However, a different type of blurring results from decisions which, although they have a legally determined core, have a scope of discretion about the manner of execution or vice versa. For instance, organization and planning obligations are determined by law. Hence, the decision to observe the duty to organize the enterprise is not an entrepreneurial one. However, the decision of nature and manner of the organization has (at least to some extent) discretion.[36] Even concerning M&A-transactions, border lines are blurred. The transaction itself might be entrepreneurial in nature but the com-

[28] See BGH, 21 December 2005, 3 StR 470/04, NJW 2006, 522, 523 et seq. (*Mannesmann AG*).

[29] *N. Ott*, Anwendungsbereich der Business Judgment Rule aus Sicht der Praxis, ZGR 46 (2017) 149, 152 et seq.

[30] Begründung zum Regierungsentwurf, BT-Drs. 15/5092, *supra* note 19, 11; *G. Bachmann*, Reformbedarf bei der Business Judgement Rule, ZHR 177 (2013) 1, 8; *D. Weber-Rey/J. Buckel*, Best Practice Empfehlungen des Deutschen Corporate Governance Kodex und die Business Judgement Rule, AG 2011, 845, 849; *Spindler, supra* note 2, § 93 marg. no. 49.

[31] *Fleischer, supra* note 4, § 93 marg. no. 113; *B. Dauner-Lieb*, in: Henssler/Strohn (eds.), Gesellschaftsrecht (4th ed., Munich 2019) Aktiengesetz § 93 marg. no. 8.

[32] Begründung zum Regierungsentwurf, BT-Drs. 15/5092, *supra* note 19, 11; *H. Fleischer*, Die „Business Judgment Rule": Vom Richterrecht zur Kodifizierung, ZIP 2004, 685, 690; *S. H. Schneider*, Unternehmerische Entscheidungen als Anwendungsvoraussetzung für die Business Judgement Rule, DB 2005, 707, 708; *G. Spindler*, Rechtsfolgen einer unangemessenen Vorstandsvergütung, AG 2011, 725, 726.

[33] *H. J. Mertens/A. Cahn*, in: Zöllner/Noack (eds.), Kölner Kommentar zum Aktienrecht, Vol. II/1 (3rd ed., Cologne 2009) § 93 marg. no. 17.

[34] For the benefits of an "efficient breach of legal binding duties", see *S. M. Bainbridge*, Corporation Law and Economics (New York 2002) 272–274.

[35] *M. Habersack*, Die Legalitätspflicht des Vorstands der AG, in: Burgard/Hadding et al. (eds.), Festschrift für Uwe H. Schneider zum 70. Geburtstag (Cologne 2011) 429, 439 et seq.; *Mertens/Cahn, supra* note 33, § 93 marg. no. 71; *K. J. Hopt/M. Roth*, in: Hirte/Mülbert/Roth (eds.), Großkommentar Aktiengesetz, Vol. IV/2 (5th ed., Berlin 2015) § 93 marg. no. 134; *Fleischer, supra* note 4, § 93 marg. nos. 36 et seq.; *Spindler, supra* note 2, § 93 marg. nos. 52, 106.

[36] *Fleischer, supra* note 4, § 93 marg. no. 69; *Spindler, supra* note 2, § 93 marg. no. 115.

position, for example the duty to conduct a due diligence report could include legal grounds, if it is a purchase of great scope.[37]

Beyond that, an entrepreneurial decision may constitute not only as an action, but also as an omission of a business opportunity, e.g. if the board of directors considers the risks of a business opportunity too high.[38] In contrast, the board of directors is not allowed to sit idly twiddling its thumbs rather than actively searching for and taking entrepreneurial chances.[39] Moreover, as the term "decision" implies, the business judgment rule applies only to intentional actions or omissions.[40] Therefore, pure unconscious and negligent failure to act on a business opportunity or a limitation period is not an entrepreneurial decision, in contrast to the conscious decision to not take up an opportunity with high risks, as mentioned above.[41]

b) *Adequate information basis*

Secondly, the entrepreneurial decision has to be taken on the basis of adequate information. Of course, the notion of adequate information provides something of a backdoor for judicial control, and is to some extent tautological as the adequacy of information depends on the costs of collection and processing of such information which in turn, is also an entrepreneurial decision.[42] Thus, the adequacy of information depends on certain circumstances, such as the urgency of the decision, the impact on the corporation, the availability of information resources etc.[43]

The benchmark for adequacy of information is the duty of care of an ordinary board member.[44] So in general, the deciding board is obliged to use all available sources of information but has to weigh the costs and benefits of any additional sources of information.[45] In fact, it is virtually impossible to consider

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[37] *Spindler, supra* note 2, § 93 marg. no. 80.

[38] *Schneider, supra* note 32, 707, 712.

[39] *M. Kock/R. Dinkel*, Die Zivilrechtliche Haftung von Vorständen für unternehmerische Entscheidungen, NZG 2004, 441, 443.

[40] *Spindler, supra* note 2, § 93 marg. no. 51.

[41] *Fleischer, supra* note 4, § 93 marg. no. 73.

[42] *G. Bachmann*, Reformbedarf bei der Business Judgement Rule, ZHR 177 (2013), 1, 10; *Koch, supra* note 7, § 93 marg. no. 21; *Spindler, supra* note 2, § 93 marg. no. 55.

[43] *Hölters, supra* note 25, § 93 marg. no. 34; *Fleischer, supra* note 32, 685, 691; *T. Bunz*, Ist nur vollständige Information „angemessen"? Anforderungen an den Grad der Informiertheit bei unternehmerischen Entscheidungen, Der Konzern 2012, 444, 446.

[44] *Kock/Dinkel, supra* note 39, 441, 444; *J. N. Druey*, Standardisierung der Sorgfaltspflicht? Fragen zur Business Judgment Rule, in: Habersack/Hommelhoff (eds.), Festschrift für Wulf Goette zum 65. Geburtstag (Munich 2011) 57, 64; *Weber-Rey/Buckel, supra* note 30, 845, 851.

[45] BGH, 12 October 2016, 5 StR 134/15, NJW 2017, 578 marg. no. 34 (*HSH Nordbank*).

all (potentially) available information: there will always be one opinion or article not read or an expert not heard.[46] There is neither a need to consider all possible sources of information[47] nor for an optimal information base[48], but rather a duty to properly prepare the decision considering economic benchmarks.[49] Generally, the more important the decision is for the existence and the success of the company, the broader the information base needs to be.[50] Furthermore, the urgency of a decision plays a significant role in determining the adequacy: the board can limit itself to a summary review, if necessary.[51]

In accordance with the general dogma of civil law, board members with specific skills or knowledge are subject to higher expectations than members of the board who are not familiar with the specialized area in question. In the absence of personal expertise, the board member may need to have the information explained in order to arrive at an individual assessment.[52] On the other hand, it is not necessary to routinely request expert opinions,[53] but rather the basic idea of the business judgment rule also applies here with regard to the assessment of what information is reasonably necessary for a specific decision.[54] External evaluations can be helpful and must also be obtained where risky investment decisions are concerned.[55] However, such sources of information are not an absolute basis on which the board can solely rely.[56] Rather, it is up to the man-

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[46] *M. Peltzer*, Mehr Ausgewogenheit bei der Vorstandshaftung, in: Krieger/Lutter/Schmidt (eds.), Festschrift für Michael Hoffmann-Becking zum 70. Geburtstag (Munich 2013) 861, 866; *Spindler, supra* note 2, § 93 marg. no. 55.

[47] Begründung zum Regierungsentwurf, BT-Drs. 15/5092, *supra* note 19, 11: there is nothing like all-embracing information.

[48] *Mertens/Cahn, supra* note 33, § 93 marg. no. 33.

[49] *Fleischer, supra* note 4, § 93 marg. no. 70.

[50] *Bunz, supra* note 42, 444, 448; *J. Grundei/A. v. Werder*, Die Angemessenheit der Informationsgrundlage als Anwendungsvoraussetzung der Business Judgment Rule, AG 2005, 825, 826 et seq.; *Fleischer, supra* note 4, § 93 marg. no. 70.

[51] *M. Roth*, Unternehmerisches Ermessen und Haftung des Vorstands (Munich 2001) 81 et seq.; *Kock / Dinkel, supra* note 39, 441, 444.

[52] *Spindler, supra* note 2, § 93 marg. no 58.

[53] *B. Dauner-Lieb*, Unternehmerische Tätigkeit zwischen Kontrolle und Kreativität, in: Crezelius/Hirte/Vieweg (eds.), Festschrift für Volker Röhricht (Cologne 2005) 83, 96; *H. Fleischer*, Der Zusammenschluss von Unternehmen im Aktienrecht, ZHR 172 (2008) 538, 553; *U. H. Schneider*, Anwaltlicher Rat zu unternehmerischen Entscheidungen bei Rechtsunsicherheit, DB 2011, 99, 101; *K. Peters*, Angemessene Informationsbasis als Voraussetzung pflichtgemäßen Vorstandshandelns, AG 2010, 811, 813.

[54] In detail Begründung zum Regierungsentwurf, BT-Drs. 15/5092, *supra* note 19, 11 et seq.; *J. Gehb/M. Heckelmann*, Haftungsfreistellung von Vorständen, ZRP 2005, 145, 146; *C. Schäfer*, Die Binnenhaftung von Vorstand und Aufsichtsrat nach der Renovierung durch das UMAG, ZIP 2005, 1253, 1258; *J. Koch*, Das Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG), ZGR 2006, 769, 789.

[55] *Spindler, supra* note 2, § 93 marg. no. 60.

agement board to critically assess the results of the evaluations.[57] The same applies to the question of whether the involvement of third parties is necessary and whether the executive board can rely on their information.

As mentioned above, this criterion is a potential avenue for judicial review of an entrepreneurial decision. Due to that, the judicial ruling should consider the effect of hindsight biases in particular. There is a particularly strong need for *ex ante* consideration, notably in terms of what the board could reasonably assume in the sense of an ordinary manager.[58]

Finally, the procedures for forecasting are also part of legal control: even if the legal system must take into account the subjectivity of risk attitudes and probability assessments in order not to put the judge in the place of the market, it must also ensure the methods applied are not completely absurd or outdated.[59] Therefore, it goes without saying, that directors have to use rational methods in order to take their decisions.[60] However, this principle has recently been attacked by experienced practicing lawyers, stressing entrepreneurial instinct, which cannot be checked or analyzed, is one of the most important factors of business success.[61] In fact, decisions remain decisions, even when made intuitively (see above II.2.a)); however, these will often not be "reasonably" made, and in particular, not objectively comprehensible, although decisions that are obviously intuitive from the perspective of behavioral economics need not necessarily be "worse" than decisions that have been rationally prepared over a longer term.[62] Business decisions in particular are often likely to present themselves as such intuitive decisions beyond all maximizing business models, but do not fall under the business judgment rule for lack of comprehensibility.[63]

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[56] OLG Düsseldorf, 9 December 2009, I-6 W 45/09, ZIP 2010, 28, 32 (*IKB*); *M. Lutter*, Bankenkrise und Organhaftung, ZIP 2009, 197, 199; *H. Fleischer*, Verantwortlichkeit von Bankgeschäftsleitern und Finanzmarktkrise, NJW 2010, 1504, 1505.

[57] *Lutter, supra* note 56, 197, 199; *G. Spindler*, Sonderprüfung und Pflichten eines Bankvorstands in der Finanzmarktkrise, NZG 2010, 281, 284.

[58] BGH, 12 October 2016, *supra* note 45, 578 marg. no. 34.

[59] *Roth, supra* note 51, 42; cf. for the recognised economic assessment of the adequate information *Grundei/v. Werder, supra* note 50, 825, 829 et seq.; *C. H. Seibt/B. Wollenschläger*, Haftungsrisiken für Manager wegen fehlgeschlagener Post Merger Integration, DB 2009, 1579, 1580.

[60] *Spindler, supra* note 2, § 93 marg. no. 69.

[61] *E. Vetter*, Intuition und Business Judgement, in: Dreher/Drescher et al. (eds.), Festschrift für Alfred Bergmann zum 65. Geburtstag am 13. Juli 2018 (Berlin 2018) 827, 828 et seq.

[62] *Spindler, supra* note 2, § 93 marg. no. 51.

[63] *H. Hamann*, Reflektierte Optimierung oder bloße Intuition?, ZGR 41 (2012) 817, 825 et seq. with significant evidence from behavioural economics research; see also *Spindler, supra* note 2, § 93 marg. no. 51.

c) Decision consistent with company interests – no extraneous considerations

Thirdly, the decision has to be taken in the interest of the corporation; there must be no conflict of interest for directors. Drawing the line may sometimes be difficult, particularly in cases of a personal union between dominant shareholder and director.

Furthermore, the criterion of company interests is at some point tautological. The question arises as to what the interests of the company are. § 93 para. 1 sent. 2 AktG stipulates a decision for the benefit of the company, which, for the German legislator means a long-term strengthening of earnings and competitiveness.[64] These terms are themselves indefinite legal terms, although the board of directors (respectively the supervisory board) has some discretion in their definition. Thereby, the term "company interests" is very complex, with a whole network of interests, and goes beyond a strict shareholder value orientation. The board of directors is directly bound to the company, not to the shareholder, or a certain group of shareholders.[65]

Thus, the criterion of a decision that complies with company interests is quite vague, but at least it prevents the application of the business judgment rule to decisions made out of selfishness or with conflicting interests.[66] But even if the decision has to be made in the interest of the company and not out of self-interest, it is harmless if personal interest and those of the company coincide, as is the case, for example, with the partial compensation of board members with stock options, which links the board's own interest to that of the company.[67] Furthermore, not every conflict of interest should lead to an exclusion of the business judgment rule, but only those with a correspondingly significant potential to influence business decisions. Consequently, insignificant coincidence of decision outcomes with self-interest are harmless.[68]

Conflicts of interest must be disclosed as a result of the duty of disclosure (as part of the duty of loyalty) to the board.[69] If a conflict of interest is disclosed, the business judgment rule still applies to all other (not conflicted)

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[64] Begründung zum Regierungsentwurf, BT-Drs. 15/5092, *supra* note 19, 11; cf. *N. Horn*, Unternehmerisches Ermessen und Vorstandshaftung nach § 93 AktG, in: Aderhold/Grunewald et al. (eds.), Festschrift für Harm Peter Westermann zum 70. Geburtstag (Cologne 2008) 1053, 1058.

[65] OLG Frankfurt, 17 August 2011, 13 U 100/10, ZIP 2011, 2008, 2010.

[66] *Schneider, supra* note 53, 99, 101; *J. Koch*, Die Anwendung der Business Judgment Rule bei Interessenkonflikten innerhalb des Vorstands, in: Joost/Oetker/Paschke (eds.), Festschrift für Franz Jürgen Säcker zum 70. Geburtstag (Munich 2011) 403, 411; *Spindler, supra* note 2, § 93 marg. no. 54.

[67] *Fleischer, supra* note 32, 685, 691; *Mertens/Cahn, supra* note 33, § 93 marg. no. 26.

[68] *W. Paefgen*, Unternehmerische Entscheidung und Rechtsbindung der Organe in der AG (Cologne 2002) 215; *K. Schlimm*, Das Geschäftsleiterermessen des Vorstands einer Aktiengesellschaft (Baden-Baden 2009) 296.

members of the board, on the proviso that the board member in question does not participate in the preparation of the decision or in its adoption, as in this case, influence cannot be assumed.[70] If the conflicted board member does not comply with his duty of disclosure (hidden conflict of interest), this results in not only in the exclusion of that board member from the protection of the business judgment rule, but of all members of the board, i.e. the conflict of interest of one board member "infects" the entire body.[71] However, extending the individual violation to the other members of the board fails to acknowledge that the assessment of the breach of duty and also the application of the business judgment rule is carried out for each member of the board.[72] While the privilege of the individual board member is excluded in the case of conflicts of interest, the other board members can very well benefit from the business judgment rule.[73] The business judgment rule relates to the individual duties of each board member and must therefore be applied individually. Such "collectivization" of the conflict of interest of one member of the board to deny the business judgment rule to other members of the board would result in an undue imputation of a conflict of interest and would thus overly restrict the application of the business judgment rule.[74]

Potential conflicts of interest must also be disclosed for it is not the potentially involved party but the other, non-involved board members who are best placed to decide on the degree of involvement.[75] The person affected by the conflict of interest must be excluded not only from the actual decision, but also from the preceding consultations and discussions.[76] This is the only way to

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[69] *Koch, supra* note 66, 403, 404; *M. Habersack*, Managerhaftung, in: Lorenz (ed.), Karlsruher Forum 2009: Managerhaftung (Karlsruhe 2010) 5, 22; *Fleischer, supra* note 4, § 93 marg. nos. 72a, 130a; *Spindler, supra* note 2, § 93 marg. nos. 71, 125.

[70] *M. Lutter*, Interessenkonflikte und Business Judgment Rule, in: Heldrich/Prölss/Koller (eds.), Festschrift für Claus-Wilhelm Canaris zum 70. Geburtstag, Vol. I (Munich 2007) 245, 250; *Habersack, supra* note 69, 5, 22; *Fleischer, supra* note 4, § 93 marg. no. 72a.

[71] *Lutter, supra* note 70, 245, 248 et seq.; *Habersack, supra* note 69, 5, 22 et seq.; *S. Blaschke*, Die Anwendung der Business Judgement Rule bei Kollegialentscheidungen und Vorliegen eines Interessenkonflikts bei einem der Vorstandsmitglieder, AG 2010, 692, 695 et seq.

[72] *Koch, supra* note 66, 403, 413; *Hopt/Roth, supra* note 35, § 93 marg. no. 96.

[73] *Koch, supra* note 66, 403, 409; *Hopt/Roth, supra* note 35, § 93 marg. no. 96.

[74] *Mertens/Cahn, supra* note 33, § 93 marg. no. 29; as a result also *Hölters, supra* note 25, § 93 marg. no. 38.

[75] *Spindler, supra* note 2, § 93 marg. no. 73; cf. with regard to the duty of loyalty *Mertens/Cahn, supra* note 33, § 93 marg. no. 110.

[76] *Lutter, supra* note 70, 245, 248; *T. Bunz*, Die Business Judgment Rule bei Interessenkonflikten im Kollegialorgan, NZG 2011, 1294, 1296; *Weber-Rey/Buckel, supra* note 30, 845, 850; *H. Diekmann/D. Fleischmann*, Umgang mit Interessenkonflikten in Aufsichtsrat und Vorstand der Aktiengesellschaft, AG 2013, 141, 149 which, however, grant the affected member of the board a right to express an opinion.

ensure the decision is not influenced overall. At the deliberation and discussion stage, considerations of practicability due to otherwise unused expertise do not justify involvement: the exclusion of the affected member of the board is based precisely on the potential for subjective influence over that expertise.[77] The danger of influencing other members is not eliminated if the member concerned is the only member with the relevant specialist knowledge.

If the entire board is unable to make an independent decision because of conflicting interests, it still has to make a decision, but must nevertheless disclose the conflict of interests.[78] But the disclosure of the conflict of interest of the entire board does not mean that the board can secure the benefits of the business judgment rule in this way.[79]

d) Entrepreneurial discretion – justifiable decision

Personal independence in the performance of entrepreneurial tasks and goals necessarily includes a scope for one's own entrepreneurial discretion. When assessing whether a member of the board has breached his or her duties culpably, it must be remembered that the board is granted a wide scope of discretion in managing the company's business, without which entrepreneurial activity would not be possible, since taking risks is the very nature of entrepreneurial decisions that cannot (and should not) be justiciable.[80] Nevertheless, even in this context, the board must adhere to certain principles, apart from the creation of a sufficient factual basis, most importantly, the assessment of individual aspects and their weighting against involved risks.[81] On the one hand, it may not blindly focus on high returns if these have not been weighed against the corresponding risks, for example, in the case of currency hedging transactions. On the other hand, the board must also be able, under certain circumstances, to carry out risk-related transactions without the mere conduct of such transactions constituting a breach of duty or negligence by the company.[82]

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[77] Considering that *Koch, supra* note 66, 403, 416.

[78] *J. Semler*, Entscheidungen und Ermessen im Aktienrecht, in: Habersack/Hommelhoff et al. (eds.), Festschrift für Peter Ulmer zum 70. Geburtstag am 2. Januar 2003 (Berlin 2003) 627, 638; *Spindler, supra* note 2, § 93 marg. no. 75; also as a result *Koch, supra* note 66, 403, 418.

[79] *Semler, supra* note 78, 627, 638; *Spindler, supra* note 2, § 93 marg. no. 75.

[80] BGH, 21 April 1997, *supra* note 14, 253; BGH, 23 June 1997, II ZR 132/93, BGHZ 136, 133, 140 (*Siemens/Nold*); *B. Grunewald/H. F. Müller*, Die Entwicklung des Gesellschaftsrechts 1997/1998, JZ 1999, 442, 445 et seq.; *N. Horn*, Die Haftung des Vorstands der AG nach § 93 AktG und die Pflichten des Aufsichtsrats, ZIP 1997, 1129, 1129 et seq.; *Semler, supra* note 78, 627, 627 et seq.

[81] No overstretched willingness to take risks: BGH, 21 April 1997, *supra* note 14, 253.

[82] BGH, 21 April 1997, *supra* note 14, 253; cf. also *Hopt/Roth, supra* note 35, § 93 marg. nos. 88, 113.

Particularly with regard to the management board, it ought not to be ignored that while it acts autonomously and independently of instructions (§ 76 AktG), unlike a sole trader, it is nevertheless a quasi-trustee of the funds transferred by the shareholders, a fact which has also been clearly underlined by criminal law in § 266 of the German Criminal Code (*Strafgesetzbuch*, StGB)[83].[84] For this reason, the business judgment rule cannot protect extreme risk-taking behavior ("gambler's nature"), as shareholders have no opportunity to react in a timely manner; nor should the tendency of managers and shareholders to take excessive risks, which can easily contradict creditor protection be underestimated, particularly in times of crisis and in the vicinity of insolvency.[85]

A breach of the duty of care is to be affirmed if there is an action by the board that is absolutely unjustifiable.[86] Therefore, there must first be a management error that is so obvious even to an external party that the existence of an error becomes evident.[87] There is no general list of circumstances under which such proven faulty management is to be assumed; notwithstanding numerous attempts to differentiate between irresponsibility, unjustifiability, or "waste" in the sense of the US-American case law,[88] as the intensity of the control varies in each individual case. Rather, it depends on the market situation of the company, its structure, existing business opportunities, risks, etc.[89] Similarly, there are no equally valid organizational specifications and guide-

[83] *Strafgesetzbuch in der Fassung der Bekanntmachung vom 13. November 1998 (BGBl. I S. 3322), das zuletzt durch Artikel 5 des Gesetzes vom 10. Juli 2020 (BGBl. I S. 1648) geändert worden ist.*

[84] BGH, 21 December 2005, *supra* note 28, 522, 523 et seq.

[85] Cf. *G. Spindler*, Der Gläubigerschutz zwischen Gesellschafts- und Insolvenzrecht, JZ 2006, 839, 842; *G. Spindler*, Trading in the Vicinity of Insolvency, EBOR 2006, 339, 340; *P. Davies*, Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency, EBOR 2006, 301, 303 et seq.; on"gambling for resurrection" *F. Kebekus / W. Zenker*, Business Judgment Rule und Geschäfsleiterermessen – auch in Krise und Insolvenz?, in: Grunewald/ Westermann (eds.), Festschrift für Georg Maier-Reimer zum 70. Geburtstag (Munich 2010) 319, 332 et seq.

[86] BGH, 12 October 2016, *supra* note 45, 578 marg. no. 31; OLG Düsseldorf, 28 November 1996, 6 U 11/95, AG 1997, 231, 234; *Ott, supra* note 29, 149, 171 on organizational decisions; *W. Bayer*, Vorstandshaftung in der AG de lege lata und de lege ferenda, NJW 2014, 2546, 2547; *M. Nietsch*, Geschäftsleiterermessen und Unternehmensorganisation bei der AG, ZGR 2015, 631, 661 et seq.

[87] BGH, 12 October 2016, *supra* note 45, 578 marg. no. 31.

[88] *Roth, supra* note 51, 97 et seq.; *Hopt/Roth, supra* note 35, § 93 marg. nos. 113 et seq.; similar also *W. Paefgen*, Dogmatische Grundlagen, Anwendungsbereich und Formulierung einer Business Judgment Rule im künftigen UMAG, AG 2004, 245, 255.

[89] On individual attempts to substantiate the concept of entrepreneurial discretion, see the overview at *T. E. Abeltshauser*, Leitungshaftung im Kapitalgesellschaftsrecht, (Cologne 1998) 57 et seq.; *Paefgen, supra* note 68, 134 et seq.; *Roth, supra* note 51, 57 et seq.

lines that apply across all companies.[90] The decision alternatives, considerations, and knowledge possibilities at the time the measure is taken are crucial.

3. *Scope of Application*

These principles have mainly been developed for stock corporations, listed on a stock exchange. However, they are deemed to be general principles which can also be applied to the limited liability company[91] or closed corporations not listed at a stock exchange, particularly given § 93 para. 1 AktG does not distinguish between stock listed and non-listed corporations.

This transfer of the business judgment rule to other types of entrepreneurial activity is particularly necessary in the context of a teleological approach. The starting point must be the above-mentioned[92] observation that business decisions regularly contain prognostic elements, whose retrospective review bears the risk of so-called hindsight bias. It is to be assumed that a complete judicial review would increase the risk of personal liability of the decision-makers, thus forcing the adoption of risk-averse behavior in the context of business decisions. In contrast, successful management requires a willingness to take (necessary) risks. This willingness is both expected by shareholders and is economically reasonable.[93] Thus, the German legislator stipulated that the business judgment rule, given in § 93 para. 1 sent. 2 AktG, also applies to "all forms of entrepreneurial activity".[94]

This teleological view renders it necessary to apply the business judgment rule not only to the actions of members of the management board but also to the actions of members of the supervisory board.[95] The same conclusion can be drawn from the reference in § 116 sent. 1 AktG to § 93 para. 1 sent. 2 AktG. The management board is not alone in having a potential entrepreneurial quality of their actions, actions of the supervisory board may also fall under this

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[90] Cf. *G. Spindler*, Unternehmensorganisationspflichten (2nd ed., Göttingen 2011) *passim*; see also *H. Fleischer*, Vorstandsverantwortlichkeit und Fehlverhalten von Unternehmensangehörigen – Von der Einzelüberwachung zur Errichtung einer Compliance-Organisation, AG 2003, 291, 299.

[91] *H. Ziemons*, in: Michalski/Heidinger et al. (eds.), Kommentar zum GmbH-Gesetz (3rd ed., Munich 2017) § 43 marg. no. 134; *Y. Schnorbus*, in: Rowedder/Schmidt-Leithoff (eds.), Kommentar zum GmbH-Gesetz (6th ed., Munich 2017) § 43 marg. no. 16; regarding the application for limited liability companies see BGH, 18 June 2013, II ZR 86/11, NJW 2013, 3636, 3638.

[92] See above, II.1.

[93] Cf. BGH, 21 April 1997, *supra* note 14, 253; *Spindler, supra* note 2, § 93 marg. no. 43.

[94] Begründung zum Regierungsentwurf, BT-Drs. 15/5092, *supra* note 19, 12.

[95] See in detail *Spindler, supra* note 4, § 116 marg. nos. 43 et seq.; comparative on the application of the business judgment rule to supervisory bodies *Merkt, supra* note 11 (Rechtl. Grundlagen der Business Judgment Rule), 140 et seq.

category.[96] In this respect, it is essential to distinguish entrepreneurial decisions.[97] This is particularly true in the context of reservations of approval,[98] the selection of suitable management board candidates[99] (as well as their dismissal), the determination of management board salaries,[100] and the approval of contracts in accordance with §§ 89, 114, and 115 AktG[101]. Uncertainties about future developments or the need for a forecast are particularly evident here.

4. No Change

As already mentioned, the business judgment rule was principally developed for stock listed public corporations, which are characterized by the typical information asymmetry between shareholders (principals) and agents (directors). On the one hand, shareholders cannot monitor the director's behavior directly. On the other hand, too strict judicial control would result in the corporation coming to a standstill. However, for closed companies, these arguments are not valid, or at least only to some extent, as shareholders usually have a much tighter control over directors than in stock listed corporations.

However, to start with, we should identify the parts of the business judgment rule where there are no apparent differences between public and closed corporations:

a) No change in the need for adequate information

Firstly, the duty to take decisions based on adequate information should not change for closed corporations (both closed stock corporations and limited

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[96] *M. Lutter/G. Krieger/D. A. Verse*, Rechte und Pflichten des Aufsichtsrats (7th ed., Cologne 2020) marg. no. 989; a commercial characterization of the behavior is not necessary: *Ott, supra* note 29, 149, 156.

[97] Cf. *Schneider, supra* note 32, 707, 707 et seq.; *Fleischer, supra* note 32, 685, 690; *Schäfer, supra* note 54, 1253, 1255 et seq.; *Gehb/Heckelmann, supra* note 54, 145, 146.

[98] *K. J. Hopt/M. Roth*, in: Hirte/Mülbert/Roth (eds.), Großkommentar Aktiengesetz, Vol. V (5th ed., Berlin 2019) § 116 marg. no. 67; *W. Paefgen*, Organhaftung: Bestandsaufnahme und Zukunftsperspektiven, AG 2014, 554, 561; *W. Goette*, Zum Zusammenwirken von Vorstand und Aufsichtsrat im Spannungsfeld von Informationsordnung und Zustimmungsvorbehalt, in: Siekmann/Cahn et al. (eds.), Festschrift für Theodor Baums zum siebzigsten Geburtstag, Vol. I (Tübingen 2017) 475, 481 et seq.

[99] OLG Munich, 24 November 2016, 23 U 3582/16, AG 2017, 750, 753; *H.-J. Mertens/A. Cahn*, in: Zöllner/Noack (eds.), Kölner Kommentar zum Aktienrecht, Vol. II/2 (3rd ed., Cologne 2012) § 116 marg. no. 68; *Hopt/Roth, supra* note 98, § 116 marg. no. 66.

[100] *Spindler, supra* note 32, 725, 726; *Hopt/Roth, supra* note 98, § 116 marg. no. 66; *Mertens/Cahn, supra* note 99, § 116 marg. no. 68.

[101] *Mertens/Cahn, supra* note 99, § 116 marg. no. 68; *M. Habersack*, in: Münchener Kommentar zum Aktiengesetz (5th ed., Munich 2019) § 116 marg. no. 43; *N. Rahlmeyer/C. Gömöry*, Der unternehmerische Ermessensspielraum (§ 93 I 2 AktG) bei Beratungsverträgen mit Aufsichtsratsmitgliedern, NZG 2014, 616, 619.

liability companies), as it seems to be a general principle that a director should not randomly gamble on solutions or new business models.[102] In both forms of corporation, entrepreneurial decisions have to be made rationally – bearing the impact of business instinct in mind. This duty to make decisions on informed basis ultimately results from the duty of care that applies both to the corporate bodies of a stock corporation and to those of a limited liability company, as it is a general duty of all company bodies:

The members of the board of directors of a stock corporation must apply the standard of care of a prudent and conscientious manager in their management of the company (§ 93 para. 1 sent. 1 AktG).[103] The standard of care of a prudent and conscientious manager is understood as the care that a manager of a company of a specific type and size must apply. A more comprehensive duty of care is generally placed on a member of the board of directors to whom the management of a stock corporation is entrusted than that of an ordinary businessman.[104] For this reason – and also due to the principle of external board memberships within corporations – the board member of a stock corporation has an increased duty of care as a trustee of external financial interests.[105] The requirements of the duty of care are not measured according to a uniform fixed standard, but are determined by the type and size of the company, the number of employees, the economic situation, the time conditions, and the special tasks of the individual member.[106] It is a normative standard, thus negligence which is customary in an industry cannot exonerate the board of directors.[107]

Likewise, the supervisory board of a stock corporation is also subject to the duty of care of corporate bodies. They have to perform their duties with the diligence of a prudent and conscientious supervisor and advisor (§ 116 sent. 1 AktG).[108] In this regard, in the context of determining the content of the duty of care of the supervisory board, the ordinary managing director is replaced by an

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[102] *F. J. Säcker*, Gesellschaftsrechtliche Grenzen spekulativer Finanztermingeschäfte, NJW 2008, 3313, 3315 et seq.; *Spindler, supra* note 2, § 93 marg. no. 25.

[103] In detail *Spindler, supra* note 2, § 93 marg. nos. 25 et seq.

[104] *H.-J. Grolling*, Sorgfaltspflicht und Verantwortlichkeit der Vorstandsmitglieder für ihre Geschäftsführung innerhalb der nicht konzerngebundenen Aktiengesellschaft (Bad Schwartau 1969) 29 et seq.; cf. also OLG Koblenz, 10 June 1991, 6 U 1650/89, ZIP 1991, 870, 870 et seq.; *L. Böttcher*, Bankvorstandshaftung im Rahmen der Sub-Prime Krise, NZG 2009, 1047, 1050.

[105] OLG Koblenz, 10 June 1991, *supra* note 104, 870, 871; *Böttcher, supra* note 104, 1047, 1049; *N. Krause*, Managerhaftung und Strategien zur Haftungsvermeidung, BB 2009, 1370, 1371; *Mertens/Cahn, supra* note 33, § 93 marg. no. 10.

[106] *Böttcher, supra* note 104, 1047, 1050; *Hopt/Roth, supra* note 35, § 93 marg. no. 58; *Spindler, supra* note 2, § 93 marg. no. 25; *Fleischer, supra* note 4, § 93 marg. no. 41.

[107] *Böttcher, supra* note 104, 1047, 1050; *S. Blaschke*, Auswirkungen von Verstößen gegen das KWG sowie von Abweichungen von den MaRisk auf die zivilrechtliche Haftung des Bankvorstands, WM 2011, 343, 347.

[108] In detail *Spindler, supra* note 95, § 116 marg. nos. 37 et seq.

ordinary supervisory board member, and the supervisory function comes to the fore.[109] Not only can duties of care be violated by specific supervisory failure in individual cases, a violation of duty is also conceivable already in the context of the preceding duties of care in the case of self-organization.[110]

The director of a limited liability company is also liable if he or she violates his or her obligation under § 43 para. 1 GmbHG, to apply the duty of care of a prudent businessman in the affairs of the company.[111] In this respect, he or she is subject to the same duty of care as the executive board of a stock corporation.

b) No change in the indisputability of legal duties

Secondly, legal duties apply equally to the public corporation as well as to the closed corporation. In this respect, the principle of legality is a general principle of company law which all parts of both closed corporations and public corporations are obliged to obey.[112] Of course, each individual member of a corporate body has to observe and fulfil the duties laid down by law for that particular organ, especially with regard to the authority of the respective organs including the limits set by the statutes and the rules of procedure. In addition, corporations and thus also their organ members must comply with the obligations and requirements of the legal system.[113] This also includes compliance with supervisory law, which may be more stringent in individual cases.[114] As legal entities, the stock corporation and the limited liability company are subject to the same duties as other legal entities; however, since they can only comply with these legal duties through their organ members, these individuals must fulfil the duties on behalf of the legal entity.

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[109] *Koch, supra* note 7, § 116 marg. no. 2.

[110] *Habersack, supra* note 101, § 116 marg. nos. 17 et seq.

[111] In detail, *H. Fleischer*, in: Fleischer/Goette (eds.), Münchener Kommentar zum GmbH-Gesetz, Vol. II (3rd ed., Munich 2019) § 43 marg. nos. 48 et seq.

[112] In detail *C. Thole*, Managerhaftung für Gesetzesverstöße – Die Legalitätspflicht des Vorstands gegenüber seiner Aktiengesellschaft, ZHR 173 (2009) 504 et seq.; *Habersack, supra* note 35, 429 et seq.; *Spindler, supra* note 2, § 93 marg. nos. 86 et seq.

[113] *Paefgen, supra* note 68, 24 et seq.; *Abeltshauser, supra* note 89, 213 et seq.; *Habersack, supra* note 35, 429, 431 et seq.; *Thole, supra* note 112, 504, 509; see also *H. Fleischer*, Aktienrechtliche Legalitätspflicht und „nützliche" Pflichtverletzungen von Vorstandsmitgliedern, ZIP 2005, 141, 142 et seq., 144; *M. Dreher*, Die kartellrechtliche Bußgeldverantwortlichkeit von Vorstandsmitgliedern, in: Dauner-Lieb/Hommelhoff et al. (eds.), Festschrift für Horst Konzen zum siebzigsten Geburtstag (Tübingen 2006) 85, 92; *H. Merkt*, Managerhaftung im Finanzsektor: Status Quo und Reformbedarf, in: Erle/Goette et al. (eds.), Festschrift für Peter Hommelhoff zum 70. Geburtstag (Cologne 2012) 711, 713; *H.-C. Ihrig*, Reformbedarf beim Haftungstatbestand des § 93 AktG, WM 2004, 2098, 2103; *Paefgen, supra* note 88, 245, 251 et seq.

[114] *Thole, supra* note 112, 504, 512; *Merkt, supra* note 113, 711, 718; *Blaschke, supra* note 107, 343, 346 et seq.

This does not mean there are no special legal obligations, specifically for public corporations, so that the duty of legality of their organs has a different scope than in closed corporations. Nevertheless, the duty to observe legal requirements applies equally to both types of corporations – although the scope of the duty may differ.

Hence, there is no reason why the principle that legally bound decisions are not covered by the business judgment rule, should not apply for both types of corporations.

c) Conflicts of interests in closed corporations

However, other elements of the business judgment rule cannot be simply transferred directly to directors of closed corporations, at least not without modification. One of the main problems refers to the conflict of interests: on the one hand, as shareholders of a closed corporation are frequently also directors of their corporation, it seems that they are faced with a constant conflict of interest as the probability that they pursue their own interests cannot be discarded. On the other hand, shareholders are presumed to follow the corporation's interest unless there is evidence that they are pursuing personal interests. The interest of the corporation is, however, the leading principle for assessing conflicts of interest.[115] According to prevailing opinion, even if there is only one shareholder who is at the same time the only director of the company, the interest of the corporation remains the leading principle.[116]

The problem is, closed corporations thus refer to the definition of the interest of the corporation – which is not identical with the interest of the major shareholder. If not, the major shareholder would be free to define the corporate interest at his discretion, leaving minority shareholders without any protection. Hence, even if it is difficult to determine in individual cases, the courts must define the interests of the corporation independently in order to have a benchmark for both minority protection and conflicts of interest on the board of directors. However, the distinction between the interests of the corporation and the "interest of the enterprise" (*Unternehmensinteresse*) are often confused in the discussion.[117] Moreover, the interests of the corporation serve as the reference point for the duty of loyalty.[118] Only in cases of 100% owned corporations it

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[115] *Hölters, supra* note 25, § 93 marg. no. 37; *Spindler, supra* note 2, § 93 marg. no. 54.

[116] *Hopt/Roth, supra* note 35, § 93 marg. no. 366; *N. Horn*, Aktien- und konzernrechtlicher Vermögensschutz der Aktiengesellschaft und der Gang an die Börse, ZIP 1987, 1225, 1229; for the GmbH BGH, 29 May 1987, 3 StR 242/86, ZIP 1988, 306.

[117] For an overview about the determination of the interest of corporation see *Fleischer, supra* note 111, § 43 marg. nos. 13 et seq.

[118] *R. Wilhelmi*, in: Ziemons/Jaeger (eds.), Beck'scher Online-Kommentar zum GmbHG (39th ed., Munich 1 Feb 2020) § 13 marg. no 185; *L. Fastrich*, in: Baumbach/Hueck (eds.), Kommentar zum GmbH-Gesetz (22nd ed., Munich 2019) § 13 marg. no. 23,

would be hard to deviate from the interest of the only shareholder; even then, in extreme cases the element of conflict of interest may indirectly serve to protect creditors. However, case law has developed far more powerful tools in order to protect creditors against misuse of power by a shareholder-director, such as "Existenzgefährdung" etc.[119] For example, liability for existence-destroying acts on company assets was established as a group of cases of liability for intentional damage contrary to public policy (§ 826 BGB).[120] The focus here is particularly on case constellations featuring a company without assets, in which the causes for financial failure are not (or no longer) comprehensible because either the bookkeeping is inadequate or capital maintenance regulations have been breached.[121] This liability starts with individual (provable) actions of the shareholders, through which deep intervention in the asset structure of the company has been made and which have therefore contributed to the failure of the company, at least to a considerable extent.

III. Charters

As already mentioned, the statutes of a stock corporation cannot deviate from § 93 para. 1 AktG. It cannot even define specific areas of entrepreneurial decisions or which kind of information or method have to be used. Hence, there is no leeway for closed stock corporations to specify the business judg-

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26; *D. Verse*, in: Henssler/Strohn (eds.), Kommentar zum Gesellschaftsrecht (4th ed., Munich 2019) § 14 GmbHG marg. no 104 et seq.

[119] *J. Lieder*, in: Michalski/Heidinger et al. (eds.), Kommentar zum GmbH-Gesetz (3rd ed., Munich 2017) § 13 marg. nos. 420 et seq.; *Liebscher*, in: Fleischer/Goette (eds.), Münchener Kommentar zum GmbH-Gesetz, Vol. I (3rd ed., Munich 2018) Anhang zu § 13 marg. nos. 518 et seq.; *L. Fastrich, supra* note 118, § 13 marg. nos. 43 et seq.

[120] BGH, 16 July 2007, II ZR 3/04, BGHZ 173, 246, marg. nos. 17, 23 et seq. (*Trihotel*); BGH, 28 April 2008, II ZR 264/06, BGHZ 176, 204, marg. nos. 10, 13 (*Gamma*); in detail *J. Kroh*, Der existenzvernichtende Eingriff (Tübingen 2013) 13 et seq.; *S. H. Schneider*, (Mit-) Haftung des Geschäftsführers eines wegen Existenzvernichtung haftenden Gesellschafters, in: Burgard/Hadding et al. (eds.), Festschrift für Uwe H. Schneider zum 70. Geburtstag (Cologne 2011) 1177 et seq.; on the classification of liability for "existence-destroying" acts as an act of tort *G. Wagner*, Existenzvernichtung als Deliktstatbestand, in: Heldrich/Prölss/Koller (eds.), Festschrift für Claus-Wilhelm Canaris zum 70. Geburtstag, Vol. II (Munich 2007) 473 et seq.; on the principles for calculation enforcement in the qualified de facto company group, which are therefore no longer applicable *U. Hüffer*, Qualifiziert faktisch konzernierte Aktiengesellschaften nach dem Übergang zur Existenzvernichtungshaftung bei der GmbH?, in: Habersack/Hommelhoff (eds.), Festschrift für Wulf Goette zum 65. Geburtstag (Munich 2011) 191, 202.

[121] *J. Oechsler*, in: Kunz/Dobler et al. (eds.), J. von Staudingers Kommentar zum BGB, Unerlaubte Handlungen 2 (revised ed., Berlin 2018), § 826 marg. nos. 324 et seq.

ment rule. This is true even for the opposite, a derogation of the business judgment rule in order to enhance director liability.[122]

The situation changes significantly for limited liability companies, given the freedom for statutes to deviate or specify internal corporate governance structures. As liability and the business judgment rule address the relationship between directors and shareholders, statutes are more or less free to modify liability rules, either extending the business judgment rule (for example liability only for gross negligence), reducing it, or specifying areas where the business judgment rule should apply.[123] An example of a modification would be that the director does not have to make an adequately informed decision, but may simply follow instinct, and the business judgment rule would still apply.[124] Although it is not possible to abolish the business judgment rule, as this would lead to a strict director's liability.[125] However, the indirect role of directors' liability in protecting third party creditors is still not clarified. One may argue that a strict liability, thus giving rise to claims by the corporation, would also protect third parties.[126] As pointed out, case law has developed far better tools to cope with misuse of a limited liability company.

IV. Conclusion

In sum, the business judgment rule applies in both public corporations and closed corporations. Differences arise mainly in the definition of corporate interest as a benchmark for conflicts of interest for shareholder-directors. However, many traditional principal-agent issues referred to by the business judgment rule are alleviated in the closed corporation. Hence, it is no surprise that scarcely any cases are reported concerning the business judgment rule in closed corporations which, however, can also be due to arbitration clauses that block state courts from dealing with claims.

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[122] *Spindler, supra* note 2, § 93 marg. nos. 27 et seq.; *Grigoleit/Tomasic, supra* note 25, § 93 marg. no. 123.

[123] *C.-T. Taube*, Die Anwendung der Business Judgement Rule auf die GmbH Geschäftsführer (Berlin 2018) 298.

[124] *Taube, supra* note 123, 301.

[125] *Taube, supra* note 123, 311 et seq.

[126] *Hopt/Roth, supra* note 35, § 93 marg. no. 29; *Fleischer, supra* note 4, § 93 marg. no. 2; *M. Beurskens*, in: Baumbach/Hueck (eds.), Kommentar zum GmbH-Gesetz (22nd ed., Munich 2019) § 43 marg. no. 1.

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