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The Exit Problem in Close
Corporations in the US and
Sweden
- Today and Tomorrow

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Summary

The basis of this thesis is the exit problem in close corporations and the protections available to the minority.

The phase one of the problem is when oppression takes place, which includes actions when dividends are withheld and excessive bonuses are paid to the majority, leading to the unfair treatment of the minority. Phase two of the problem is the exit problem itself, the minority owner's difficulties to leave the corporation on fair terms since the securities in close corporations are not traded on a ready market. Hence there is no "fair" price set by the market.

The next section of this thesis will compare and contrast the protection afforded to minority shareholders under US and Swedish law. In particular a study of the Swedish limited liability company will highlight the differences regarding minority shareholder rights. One main difference is the US fiduciary duties which impose an obligation upon the controlling shareholders and directors to act in good faith. This is a good standard which affords a higher protection than the fair-play rules in Sweden.

The conclusion based on the analysis of the protections available is that the protections in Sweden are not satisfactory and that they need to be amended in order to enhance the protection. The best way to implement the changes is to amend the Companies Act; to put into place higher protection for the private company as well as to make it possible to opt out from certain onerous requirements.

Sammanfattning

Denna uppsats handlar om Exitproblemet i privata aktiebolag samt det skydd som finns för minoriteten.

Första fasen av problemet är när förtryck av minoriteten äger rum, vilket exempelvis innebär indragen aktieutdelning samt utbetalning av höga bonusar till majoriteten, vilket medför en orättvis behandling av minoriteten. Andra fasen av problemet är själva exitproblemet, vilket innebär svårigheter för minoriteten att lämna företaget på rimliga villkor, eftersom aktierna i ett privat aktiebolag inte handlas på börs vilket medför att det inte finns något rättvist pris fastställt av marknaden.

Nästkommmande del jämför skyddet för minoritetsaktieägare i amerikansk och svensk rätt. En huvudskillnad är de amerikanska sk. fiduciary duties, vilka påför en skyldighet för kontrollaktieägare och styrelsemedlemmar att agera rättvist. Detta är en bra standard vilken innebär ett högre skydd än de motsvarande fair-play reglerna enligt svensk rätt.

En sammantagen bedömning av minoritetens skydd visar att reglerna i Sverige inte är tillfredställande och att det är nödvändigt att införa ett högre skydd för minoriteten. Det bästa sättet att införa denna förändring är att ändra Aktiebolagslagen och införa ett högre skydd för de privata aktiebolagen såväl som avtalsfrihet för vissa betungande regler.

Preface

This master thesis has been carried out over the fall 2007 and the beginning of 2008. However, it started already during the spring 2007, when studying Corporations in Boston. Here I learned about the flexible protections afforded to minority shareholders in close corporations. With this in mind, I wanted to examine whether the protection in Sweden was sufficient or not.

I want to thank my supervisor Torsten Sandstöm for leading me in the right direction, professor Pizzano at Suffolk University for the inspiring lectures and finally all friends in Lund for making my time there a great pleasure.

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Abbreviations

Companies Act	The Swedish Companies Act (SFS 2005:551)
EU	European Union
Prop	Proposition (Swedish government bill)
SOU	Statens offentliga utredningar (The Swedish government official report)
US	United States
UK	United Kingdom

1 Introduction

1.1 Background

The word "corporation" often brings to mind an institution such as General Motors or IBM, a multinational organisation with thousands of widely spread investors who have pooled their money under the leading of grey-suited managers. The advantages of incorporation, the limited liability, however are just as attractive to smaller enterprises.

In Sweden there are approximately 315 000 corporations.¹ The majority of these are small enterprises with a few or only one owner. These small closely held or "close" corporations face different problems. The basis in the corporate structure is the majority control and a relatively limited role for shareholders in the management of the business. One significant problem specifically for the shareholders in these corporations is the exit problem. In contrast to a public corporation, dissatisfied shareholders can sell on a public traded market. In a close corporation, this option is unavailable since there is no ready market.

The thesis is a comparative study describing the different ways of solving the exit problem under US and Swedish laws. A comparative study is interesting because a lot of regulations in all countries are based upon traditions. When taking a comparative perspective, it is easier to be open minded and to take a critical approach when conducting the study.

The US is an interesting country to make a comparison with mainly because of two circumstances. First, it is a common law jurisdiction that dramatically differs from the civil law system in Sweden. Second, it is a power nation that has led the development on the economic arena for the last decades. Hence, the exit problem will be studied from common law and civil law perspectives and the rules in place will be analysed in order to make proposals for improvements of the Swedish rules.

1.2 Purpose

The thesis has two purposes and is therefore divided into two separate parts. The first purpose is to analyse the exit problem in close corporations in the US and in Sweden and explicitly the way this problem is addressed in the legislation in these countries. This part will try to answer the question:

What options are available for the minority shareholders today?

¹ Promemoria JU 2006/8869/L1, Justitiedepartementet, Behovet av en ny bolagsform, p. 1.

This comparative study will serve as a starting point for the second part of this thesis. That includes the second purpose which is to analyse the need of a new way of approaching the exit problem in Sweden. Further it will try to answer the question:

What options should be available for the minority shareholders in Sweden in the future?

1.3 Delimitations

The exit problem is only one problem that minority shareholders might face. The thesis will only analyse the exit problem. It will not discuss contractual limitations on transferability or control devices in the close corporation, such as supermajority requirements, shareholder agreements, vote-pooling agreements or voting trusts. It is nevertheless important to bear in mind that shareholder agreements are an important device in order to put limitations on the minority shareholder rights.

The entities covered in the thesis are only corporations, the limited liability corporation in the US and the limited liability company (*Sw. Aktiebolag*) in Sweden, regulated by the Companies Act. In Sweden the equivalent to the US close corporation would be the private company, since the securities in a private company not may be subject to trading. Nevertheless, private companies could consist of numerous shareholders, whereby in the thesis when discussing close corporations it refers to private companies with few owners.

In regard to the Swedish regulation, the Swedish Companies Act will be described and no other laws that may affect the situation will be taken into consideration.

1.4 Method and Material

A traditional legal method will be used to assess the laws and case laws concerning the exit problem and minority shareholder protections.

A descriptive study of the sources of law will be used when describing the regulations regarding the exit problem in the US and Sweden to attempt to establish the position *de lege lata* on the issue as well as a comparative perspective.

In the next phase a *de lege ferenda* perspective will be taken analysing the future in Sweden and suggesting implementation of new rules within the area. The *de lege ferenda* and proposed changes will be analysed from a law and economic perspective as well as from a comparative perspective obtaining inspiration from the US.

Since the hierarchy of sources of law differs in the US and in Sweden, the material used is based on the most important sources in the two jurisdictions. In the US the main source is case-law and doctrine. For the US section, therefore leading cases and law reviews will be used. Some of my reflections are based upon my notes from the lectures in Corporate law taken in Boston, US. Some reflections are based upon these, but mainly they have been used for inspiration and are therefore not mentioned as sources in the foot notes. In Sweden the main source is the 'law by the book', hence the Companies Act will be used as well as doctrine.

1.5 Outline

The thesis is divided into three parts.

Part I, chapters 2-5, are mainly descriptive where chapter 2 describes the features of the close corporations. Chapter 3 describes the problem itself, the exit problem. The problem is universal and could be found in close corporations in the US as well as in Sweden. Chapters 4-5 will present the approach taken to address the exit problem and the regulation in force in the US and Sweden.

Part II, chapters 6-7, contain an analysis of the protections described in part I. Chapter 6 contains an analysis of the adequacy of the protection and remedies in the US and chapter 7 in Sweden.

Finally Part III, chapters 8-9, will look into the future in Sweden. Chapter 8 will analyse the future in Sweden and discuss new rules regarding the private company and will give suggestions when drafting these rules inspired by the US regulations. The conclusion in chapter 9 attempts to bring the first and second parts together.

Part I – Today

2 The Close Corporation

2.1 In General

There are basic differences between a closely held and publicly held corporation. The basic differences are drawn up in the figure below:

Closely held corporation	Publicly held corporation
A small group of shareholders who often are affiliated (family members or former partners)	A large number of shareholders who have no relation with each other
No ready market for shareholders and sometimes contractual limitations on transferability	Public trading markets such as stock exchanges and no restrictions on transferability
Often active participation by the shareholders/owners in the management	Limited participation by shareholders through voting at meetings
The purpose behind the investment is often salary/means of livelihood, i.e. more important than dividends	The purpose behind the investment is more likely to be return on investment and dividend income

Table 2.1

Closely held corporations or hereafter close corporations generally have a small number of shareholders and no ready market for their shares, as shown in Table 2.1. Usually the corporations are formed by friends or by family members. The shareholders are often involved in the business and become employees which lead to the fact that they rely on salaries from the entity as well as return on their investment.² Therefore, the foremost feature important linked to the exit problem is the lack of a market for close corporation shares.³

In the following two sections of the thesis the definition of the close corporation in the US and in Sweden will be discussed. Since shareholders in close corporations in the US benefit from higher protection than in publicly held corporations it is important to be able to recognise the close corporation.

2.2 Definition in the US

In the US there is a definition based on the specific features of the close corporation. In the Donahue case, which will be discussed in section 4.3.2.1, the court defined what was meant by a close corporation. It concluded that

² Richard M. Blaiklock, *Fiduciary duties owed by frozen-out minority shareholders in close corporations*, 1997, p. 766.

³ Douglas K. Moll, *Shareholder Oppression in close corporations: The unanswered question of perspective*, 2000, p. 789-790.

there is no single, generally accepted definition.⁴ Some emphasise an integration of ownership and management in which the shareholders occupy most management positions. Others focus on the number of shareholders and the nature of the market of the shares. According to this view, close corporations have few shareholders and there is little market for shares. This latter view was adopted by the court in the *Galler v. Galler*⁵ where the court stated that “[f]or our purposes, a close corporation is one in which the stock is held in a few hands...and wherein it is not at all, or very rarely, dealt in by buying or selling.” In the *Donahue* case, the court accepted aspects of both definitions. It deemed that a close corporation is to be defined by:

- (1) a small number of shareholders;
- (2) no ready market for the corporate stock; and
- (3) substantial majority stockholder participation in the management, direction and operations of the corporation.⁶

Hence, the close corporation bears striking resemblance to a partnership. The close corporation is only little more than an incorporated partnership.⁷ Close corporations are like partnerships, but the participants have chosen to form a corporation in order to not be personally liable. Partnership is the easiest form of conducting business in the US where the owners are personally liable. On the other hand there are no formal requirements when establishing or ending a partnership in the US. Just as in partnerships, the relationship among the shareholders in close corporations must include trust, confidence and loyalty.⁸

2.3 Definition in Sweden

Despite the fact that there are different types of corporations; large ones, small ones, corporations with publicly traded shares etc, all these types are regulated by the same law in Sweden; The Swedish Companies Act.⁹

When Sweden entered the EU, they needed to distinguish rules regarding widely held corporation and those closely held corporations. In some other EU countries this had been solved by implementing new rules regarding the closely held corporation. In Sweden however, the problem was solved by implementing two categories of companies in the Companies Act; the private- and the public-company.¹⁰

There are specific rules relating to the two types of companies. In a private company the share capital shall amount to not less than SEK 100,000.¹¹ A

⁴ *Donahue v. Rodd Electrotype Co.* 328 N.E.2d 505 (Mass. 1975), p. 511.

⁵ *Galler v. Galler*, 32, Ill.2.d 16, 203 N.E.2d 577 (1965).

⁶ *Donahue v. Rodd Electrotype Co.* 328 N.E.2d 505 (Mass. 1975), p. 511.

⁷ *Ibid*, p. 512.

⁸ *Idem*.

⁹ Sandström, Torsten, *Svensk aktiebolagsrätt*, 2007, p. 55.

¹⁰ *Idem*.

¹¹ Companies Act, Chapter 1, section 5.

private company may not through advertising attempt to sell shares or subscription rights in the company.¹² Further, such securities may not be the subject of trading on a Swedish or foreign exchange or any other organised marketplace.¹³

The share capital in a public company shall amount to not less than SEK 500,000.¹⁴ Further, the securities may be subject to trading on an exchange.

Albeit the difference in share capital requirement and the fact that the shares in public corporations are allowed to be traded, there are only minor differences in the regulations between private and public companies in Sweden.¹⁵

Moreover, in Sweden, the equivalent to the US close corporation would be the private company, since the securities in a private company not may be subject to trading. Nevertheless, private companies could consist of numerous shareholders, whereby as mentioned earlier, close corporations are in this thesis defined as private companies with few owners.

¹² Companies Act, Chapter 1, section 7.

¹³ Companies Act, Chapter 1, section 8.

¹⁴ Companies Act, Chapter 1, section 14.

¹⁵ Examples of the differences could be found in chapter 2 section 28 (Information in the memorandum of association regarding the costs for the formation of the company), chapter 3 section 11 (Information regarding company category), chapter 7 sections 55 – 60 (provisions regarding General Meetings) chapter 8 sections 46 – 50 (provisions regarding Management of the Company), chapter 13 sections 39 – 42 (provisions regarding new issues of shares), chapter 19 sections 13- 37 (special provisions regarding acquisitions of own shares).

3 The Problem

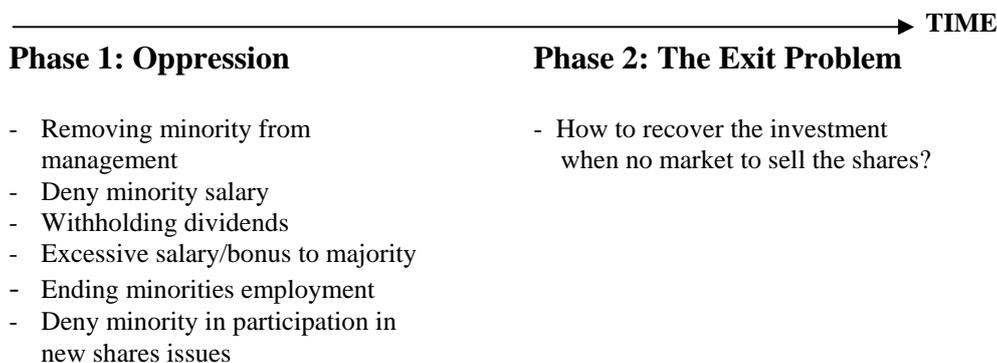
3.1 Phase One: Oppression

When knowing the basic differences between a closely held corporation and a publicly held, one could ask what kind of problems that typically arise in the close corporation due to the specific features. This will be discussed in this chapter. The following example illustrates the problems in close corporations:

Cousin A and B and uncle C decide to go into the estate agent-business, incorporating it as 'Family Homes' with 100 shares. Cousin A and B together have 80 shares and uncle C has 20. Suppose that cousin A and B get together and exclude the uncle from the board, cut off his salary and stop paying him dividends. What can uncle C do, are there any options?

The available options according to US and Swedish law will be discussed in the following two chapters. In this chapter the focus is to examine the problem itself.

The nature of the minority shareholder's lack of control over the corporation makes the minority vulnerable to the majority.¹⁶ Oppression could be called phase one of the problem, leading to the problem that the minority becomes dissatisfied and wants to leave the corporation.



¹⁶ Richard M. Blaiklock , Fiduciary duties owed by frozen-out minority shareholders in close corporations, 1997, p. 775.

Many different situations can be discussed were oppression of the minority takes place in close corporations. Hence, you can hear a lot of different terms in the context of oppression of the minority. Squeeze-out is a term often used for freeze-outs and force-outs which are two different ways of oppression by the majority. The term refers to a majority shareholders' use of their power to exclude minority shareholders.¹⁷

Freeze-outs include a situation when the controlling shareholders strive to force the minority into selling out at a low price, or buying at a high price from, the majority.¹⁸ Professor O'Neal set forth the generally accepted definition:¹⁹ the term "freeze-out" means the use of some of the owners or participants in a enterprise of strategic position, inside information, or powers of control, or the utilisation of some legal device or technique, to eliminate from the enterprise one or more of its owners or participants.²⁰ Common techniques include ending a minority shareholder's employment, removing minority shareholders from management, deny them participation in new share issues, withholding dividends or deny them salaries.²¹ Further, the squeezers could drain off the corporations earnings in the form of excessive salaries and bonuses to the majority shareholders-officers, their relatives, or in the form of high rent by the corporation for property leased from majority shareholders or they may cause the corporation to sell its assets at an inadequate price to the majority shareholders.

Force-outs are more decisive than freeze-outs, which means that they include the manipulation of the fundamental structure of the corporation. This results in the elimination of minority interests.²²

The list of oppressive or disadvantageous actions is long. Phase one is the oppressive act by the majority, which leads to phase two, the problem that the minority face difficulties to leave the corporation on fair conditions, i.e. sell to a fair price. This is what the exit problem is about, and will be discussed more in the next section.

¹⁷ Julian Javier Garza, Rethinking Corporate governance: the role of minority shareholders- a comparative study, 2000, p. 622.

¹⁸ Lewis D. Solomon and Alan R. Palmiter, A student's guide to understanding Corporations, p. 237.

¹⁹ Although there are other definitions of Freeze outs, Professor O'Neal is frequently referred to in cases.

²⁰ Hodge O'Neal and Robert B. Thomson, O'Neal's Oppression of minority shareholders (2d Ed. 1993 and Suppl. 1996) , supra note 10, §1.01.

²¹ Lewis D. Solomon and Alan R. Palmiter, A student's guide to understanding Corporations, p. 237.

²² Ibid, p. 238.

3.2 Phase Two: The Exit Problem

Recalling the example above, this is an example of a freeze out. The company in the example is a close corporation since the oppressed Uncle C could not sell his shares in order to recover some of his invested capital. By definition, this market is not available.

As mentioned above, there is no ready market in the close corporation; therefore this is not an available option. Without a trading market there are probably no potential buyers. A buyer will have to undertake a costly study before deciding how much the shares are worth, i.e. what price to pay. The only alternative is to sell to the other shareholders, probably to an unattractive price.²³ Due to the lack of a ready market, the exit problem is a specific problem to the close corporation. In public corporations, shareholders typically receive a return on their investment through capital gains upon the sale of their shares and through payment of dividends. Shareholders in close corporations typically receive a return on their investment primarily through salaries as opposed to dividends. Consequently, a shareholder in a close corporation who is not employed by the corporation has no way to earn a return on her investment.²⁴ The majority shareholders can take advantage of the situation by offering to purchase the minority's shares to an unfairly low price.²⁵ In the absence of legal remedies, the minority shareholder might have no choice but to accept the unfair offer.²⁶

The different options available for the oppressed minority according to US law will be discussed in chapter 4 and options according to Swedish law, in chapter 5.

²³ Julian Javier Garza, Rethinking Corporate governance: the role of minority shareholders- a comparative study, 2000, p. 622.

²⁴ Donahue v. Rodd Electrotpe Co. 328 N.E.2d 505 (Mass. 1975), p. 515.

²⁵ Idem.

²⁶ Idem.

4 Minority Shareholder's Options in the US

4.1 In General

It is important to bear in mind that the US consists of 52 different states, each with its own legal system. Therefore it is not possible to describe each jurisdiction and hence only the general rules that have been adapted by a majority of the states will be referred to. General codes have been adapted in many states in order to get the law more harmonised. The leading state in the US for corporate law is Delaware. This is the reason why many corporations are incorporated in this state just to benefit from the advantageous corporate rules.

Court rulings are based on a case-to case basis which makes the system in the US very flexible. A flexible system is advantageous for the business climate of the country.

Close Corporations are the most common form of business entity in the United States.²⁷

As discussed above, the core of the problem is that there is no ready market to enable the shareholder to get a fair price for the shares. Since there is no existing market, this option is not available. The option available to the minority shareholders when oppression occurs is to bring a court action resulting in an involuntary dissolution. Minority shareholders also hold special rights, which originate from fiduciary duties imposed on the majority and the corporation's management for the benefit of the minority shareholder. Corporate law in the US does not provide a special buy-out right for the minority. The legal system nevertheless is based on a case-to-case basis, hence the court may be willing in certain situations to intervene and order buy-out or otherwise one of the other available remedies; involuntary dissolution or find a breach of the fiduciary duties.

The available options are divided into 3 steps; the claim, the grounds and the remedies.

²⁷ Sandra K Miller, *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem"*, 1997, p. 383.

4.2 Step One - Claim

4.2.1 Derivative Suit

There are two different types of claims that could be made. The first one is the derivative suit which is an action made on behalf of a company. The second one is the individual suit against the corporation or the majority shareholders to enforce a personal right.²⁸

Since fiduciary duties are owed to the corporation rather than to particular shareholders, suit should be made by the corporation. However, since persons abusing their control are unlikely to use their control to sue themselves, this is rarely to take place. Instead the shareholders will bring a derivative suit on behalf of the corporation claiming breach of fiduciary duties.²⁹ Other examples of potential actions include violations of minority shareholder rights and oppressive actions against the minority.³⁰ This right is triggered when management takes action that may injure the company and indirectly the shareholders. Derivative suits are notable instruments of power for the minority. Even the mere threat of derivative actions is a powerful tool for the minority.

4.3 Step Two – Grounds

4.3.1 Fiduciary Duties

Among the protections afforded the minority in a corporation are the fiduciary duties flowing to them from the controlling shareholders and directors.³¹ Fiduciary duty refers to a duty to act mainly for someone else's benefit. In a corporation, partners, directors and officers are all fiduciaries. These duties impose an obligation upon the fiduciaries to act in good faith regarding the corporate matters.³²

The Fiduciary rules take two different themes into consideration: **management discretion** means that the management must have broad discretion in order to maintain the efficiency of central management.³³ **Management accountability** signifies the limitations on this discretion due to the risk of having a management made up by non owners and possibly

²⁸ F. Hodge O'Neal, *Oppression of minority shareholders: protecting minority rights*, p. 139-140.

²⁹ Lewis D. Solomon and Alan R. Palmiter, *A student's guide to understanding Corporations*, p. 294.

³⁰ Julian Javier Garza, *Rethinking Corporate governance: the role of minority shareholders- a comparative study*, 2000, p. 668.

³¹ *Ibid*, p. 625.

³² *Idem*.

³³ Lewis D. Solomon and Alan R. Palmiter, *A student's guide to understanding Corporations*, p. 294.

could have conflicting interest. Without the limits, the risk is higher that the management abuses its corporate control.³⁴

4.3.1.1 Case-law

The cases discussed below show the development of the fiduciary duties established by the courts. The Jones-case lines out the fiduciary duties owed to the minority. The following Donahue-case defines the heightened fiduciary duty in a close corporation. Finally, in the Wilkes-case the court took one step back from the broad equal opportunity rule established in the Donahue-case.

In the first case *Jones v. H.F. Ahmanson & Co*³⁵, the court stated that majority shareholders have a fiduciary responsibility to the minority and to the corporation to use their ability to control the corporation in a fair, just and equitable manner. Any use in which they use their power to control the corporation must benefit all shareholders proportionally and must not conflict with the proper conduct of the corporations business.³⁶ Further in this case, the court stated that “[t]he rule of corporation law and of equity invoked is well settled and has been often applied. The majority has the right to control; but when it does so, it occupies a fiduciary duty toward the minority; as much so as the corporation itself or its officers or directors.”³⁷

The *Donahue v. Rodd Electrottype*³⁸ is a landmark case that addresses minority shareholder rights. The case defines the heightened fiduciary duty in close corporations. Here, action was brought by minority shareholder against the directors, the former director, officer and controlling shareholder in a close corporation seeking to rescind corporation’s purchase of former controlling shareholders’ shares.³⁹ One of the directors, who was also part of the controlling group, had resigned and sold a portion of his shares to the company. The plaintiff claimed breach of fiduciary duties since she had not been given an opportunity to sell her shares back. The defendant argued that the share purchase was within the powers of the corporation and met the requirements of good faith and inherent fairness imposed on a fiduciary in his dealing with the corporation.⁴⁰ The Supreme Judicial Court agreed with the plaintiff. It held that the shareholders in close corporations owed one another the same fiduciary duty as that owed by one partner to another in a partnership. The action of controlling shareholders by authorising the purchase of former controlling shareholders’ shares without granting an

³⁴ Lewis D. Solomon and Alan R. Palmiter, A student’s guide to understanding Corporations, p. 294.

³⁵ *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93 (Cal. 1969)

³⁶ Julian Javier Garza, Rethinking Corporate governance: the role of minority shareholders- a comparative study, 2000, p. 626.

³⁷ *Ibid*, p. 627.

³⁸ *Donahue v. Rodd Electrottype Co.* 328 N.E.2d 505 (Mass. 1975).

³⁹ *Ibid*, p. 505.

⁴⁰ *Ibid*, p. 511.

equal opportunity to minority shareholders to sell shares for same price constituted a breach of fiduciary duty. The court offered the minority a choice of rescinding redemption or of participating on the same terms. However, the court limited the ruling to close corporations and also defined the standards for a close corporation in the ruling.⁴¹

To conclude this option, this case stands for a broad fiduciary duty, stating that shareholders in a close corporation have partnership-type duties of “utmost good faith and loyalty.” The duty implies that the minority must be given an equal opportunity to take part of corporate benefits.⁴²

Soon after the Donahue-case, the court took one step back from the broad equal opportunity rule laid out in this case. In *Wilkes v. Springside Nursing Home*⁴³ the court concluded that in certain matters such as employment matters, declaring dividends, mergers and dismissing directors, the majority should have discretion to manage the business even if at the expense of the minority. In this case a dispute arose between two of the shareholders; Quinn and Wilkes. There were only four shareholders in the corporation, and the other two sided with Quinn. As a consequence of the dispute, the directors terminated Wilkes salary and increased Quinn’s compensation. Later the directors also removed Wilkes as a director. The court established a balance test, where a balance has to be struck between the majority’s fiduciary obligations and majority rights.⁴⁴ The court stated that those in control of a corporation must have a large measure of discretion in establishing a corporation’s business policy, e.g. in declaring or withholding dividends, deciding whether to merge, deciding salaries, dismissing directors and hiring employees.⁴⁵ Further, the court created a test for the application of the Donahue doctrine. If a controlling shareholder proves that there is a legitimate business purpose, the conduct will not violate the Donahue fiduciary duties unless the minority shareholder can prove that there is a less harmful means of achieving that purpose.

Important to note is that not all jurisdictions extend special protection to the shareholders of close corporations. Delaware rejected the broad fiduciary duty doctrine in the case *Nixon v. Blackwell*.⁴⁶

4.3.1.2 Duty of Care and Duty of Loyalty

A discussion of the fiduciary duties owed to the minority shareholders implicates a review of the corresponding standard of care and the duties of loyalty. The fiduciary duties could be divided into two separate duties; the

⁴¹ See chapter 3.2 regarding the definition of Close Corporation.

⁴² Lewis D. Solomon and Alan R. Palmiter, A student’s guide to understanding Corporations, p. 241.

⁴³ *Wilkes v. Springside Nursing Home Inc.* 353 N.E.2d (Mass. 1976), p. 657.

⁴⁴ *Ibid*, p. 663.

⁴⁵ *Idem*.

⁴⁶ *Nixon v. Blackwell* 626 A.2d 1366 (Del. 1993)

duty of care and the duty of loyalty. The difference between them is that the duty of loyalty arises in situations with conflict of interests and duty of care is more of a standard used for judging the adequacy of corporate decisions.⁴⁷ One thing in common is that the implied duty is heightened for participants in close corporations.

The duty of care deal with the competence of managers in performing their decision making functions. Shareholders possess dual interests; their economic investment and their active participation. The duty of care strives to protect the minority's right to maintain their interests. The presumption is anyhow that directors do not breach their duty of care. For this reason directors have only been held liable for breaches in a narrow range of cases.⁴⁸ In regards to the close corporation the duty of care is heightened and therefore the range of cases where management is held liable is broader. Despite this reluctance, the threat to legal liability alone serves as a remedy by motivating directors to comply with their duties.⁴⁹

The duty of loyalty prohibits fiduciaries from serving their own interests at the expense of the corporation. Fiduciaries breach their duty of loyalty when they use assets, opportunities or information about the corporation for personal gain.⁵⁰ The duty of loyalty prevents self-dealing at the expense of shareholders. Self-dealing will not render the transaction void only due to the self-dealing itself. If the transaction is fair to the corporation, no violation of the duty of care arises, but could violate the duty of loyalty.⁵¹

4.3.1.3 Exception to the Fiduciary Duties: Business Judgement Rule

The business judgement rule works as an exception rule for the majority i.e. defendant. Therefore, it could be seen as an obstacle for the plaintiff to obtain the court relief. Further, the rule primarily addresses the care with which directors make decisions. The rule is attributable to the general acceptance by courts, due to the hesitancy of courts to substitute their judgement for that of directors.⁵² Even though a shareholder prove that dividends are being wrongfully withheld, the directors may argue the exception rule, the business judgement rule, presenting an analysis of the enterprise's financial and business condition, to support their business

⁴⁷ Lewis D. Solomon and Alan R. Palmiter, A student's guide to understanding Corporations, p. 294.

⁴⁸ Ibid, p. 296.

⁴⁹ Julian Javier Garza, Rethinking Corporate governance: the role of minority shareholders- a comparative study, 2000, p. 630-631.

⁵⁰ Lewis D. Solomon and Alan R. Palmiter, A student's guide to understanding Corporations, p. 296.

⁵¹ Julian Javier Garza, Rethinking Corporate governance: the role of minority shareholders- a comparative study, 2000, p. 631.

⁵² F. Hodge O'Neal, Oppression of minority shareholders: protecting minority rights, p. 126.

judgement in withholding dividends.⁵³ Nevertheless, there are limitations to directors' privilege to retain dividends. That especially applies to close corporations. A court may grant relief where the minority can prove that directors have abused their discretion by acting gross negligent, fraudulently, or in bad faith. Where fraud or bad faith is absent, but where the directors have unreasonably refused to declare dividends, the decisions are in conflict on whether the courts will interfere and compel with the payment of dividends.⁵⁴

The rule's interaction with the duty of care is illustrated in *Smith v. Van Gorkom*.⁵⁵ In this case the directors approved a merger agreement. They did however not inform the shareholders of all material facts. The court determined that the actions of the board were grossly negligent and it had breached its fiduciary duty. Although *Smith* involved the duty of care in a large corporation, the duty of care also applies to close corporations.⁵⁶

4.3.2 Oppression

Many US states allow a minority shareholder to seek dissolution of a corporation upon a showing of "oppression". There has been a variety of approaches in determining what constitutes "oppression" by courts.⁵⁷ In general it could be defined as a departure from fair dealing and fair play.⁵⁸

Oppression is a ground used in some states, but the meaning is almost the same as fiduciary duties, defined as act in good faith. Therefore, this concept will not be discussed any further.

4.3.3 Reasonable Expectations

The reasonable expectations test was laid out by the New York court⁵⁹ in *In re Kemp & Beatley, Inc.*⁶⁰ The test is used to determine whether a minority shareholder in a close corporation has been oppressed. In this case the minority shareholders had been employees since a long time. The court ordered involuntary dissolution due to the fact that the majority shareholder

⁵³ *Idem*.

⁵⁴ *Idem*.

⁵⁵ *Smith v. Van Gorkom or the Trans Union case*, 488 A.2d 858 (Del 1985).

⁵⁶ Julian Javier Garza, *Rethinking Corporate governance: the role of minority shareholders- a comparative study*, 2000, p. 629-630.

⁵⁷ Rogers Keith, *Protecting minority shareholders in Alaska close corporations*, p. 51.

⁵⁸ *Idem*.

⁵⁹ Besides New York, other states that have adopted the Reasonable Expectations test include Alaska, Arkansas, Montana, North Carolina, New Jersey, North Dakota, South Dakota, and West Virginia. Rogers Keith, *Protecting minority shareholders in Alaska close corporations*, p. 52.

⁶⁰ *In re Kemp & Beatley, Inc* 473 N.E.2d 1173 (N.Y.1984).

had decided to end their long running practice of distributing the profit as dividends.⁶¹

In *In re Kemp & Beatley*, the court stated: “[a] shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations and there exists no means of salvaging the investment.”⁶² Under this test, the minority’s disappointment is not always equivalent to oppression. Oppression will only be found when expectations that were central to the minority’s decision to invest in the close corporation are violated.⁶³

4.4 Step Three – Remedies

4.4.1 Involuntary Dissolution

The traditional remedy for shareholders has been to seek dissolution of the corporation. Dissolution means the formal extinguishment of the Corporation.⁶⁴ This involves two different steps. First the winding up of the affairs, selling all assets and paying off the debt. Second, distributing the remaining capital to shareholders. Dissolution is the most common form of relief granted to minority shareholders by state legislatures.⁶⁵ It is a drastic remedy, since it means the extinguishment of the corporation and it also presents a difficult road to go.⁶⁶ In a corporation the grounds for dissolution are more limited. This remedy is available only if any of the following conditions prevail: board deadlock, shareholders deadlock or illegality.

Board deadlock occurs when the management of a corporation is deadlocked, and where the corporation’s business is suffering as a result. In some states this is the only situation when dissolution is allowed. Keep in mind that there are different rules in all states and that in some states this is the exclusive ground for dissolution.⁶⁷

⁶¹ Lewis D. Solomon and Alan R. Palmiter, *A student’s guide to understanding Corporations*, p. 240.

⁶² *In re Kemp & Beatley, Inc* 473 N.E.2d (N.Y.1984). p.1179.

⁶³ Rogers Keith, *Protecting minority shareholders in Alaska close corporations*, p. 52.

⁶⁴ Lewis D. Solomon and Alan R. Palmiter, *A student’s guide to understanding Corporations*, p. 239.

⁶⁵ Charles W. Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares*, 1990.

⁶⁶ Lewis D. Solomon and Alan R. Palmiter, *A student’s guide to understanding Corporations*, p. 239.

⁶⁷ Lewis D. Solomon and Alan R. Palmiter, *A student’s guide to understanding Corporations*, p. 239.

Shareholder deadlock takes place when the shareholders have not been able to elect new directors.⁶⁸

Oppression or illegality is fulfilled when the majority has acted fraudulently or illegally.⁶⁹ This means that the minority must show that the majority or the board has behaved in a way that amounts to fiduciary breach.⁷⁰ This means that the minority must prove that fraud, oppression, illegality or waste of corporate assets has occurred.

However, both case law and legislation recognise that this is an extreme remedy within the discretion of courts. Though, in many states the standard for this remedy is lower regarding close corporations. Some courts have interpreted the “oppression” conditions to refer to the reasonable expectations of shareholders. This approach was taken by the court in the case *In re Kemp & Beatley, inc.*⁷¹, discussed above.

Corporate statutes generally provide that shareholder’s remedy for oppression is dissolution. However, several states explicitly allow remedies less severe than dissolution, like ordering a buyout.⁷² The court order of involuntary dissolution works as a pusher for the minority, because if the majority fails to offer a fair price, the corporation will instead be liquidated with the consequence that they lose much more, like “ongoing concern” value etc.⁷³ Therefore, it could be said, that an order of involuntary dissolution not necessarily has to mean the termination of the business, thus it can be an order pointing out to the majority to treat the minority in a more fair equitable way.

4.4.2 Involuntary Buy-out

The involuntary dissolution may seem drastic, the whole extinguishment of the entity, but courts have therefore often chosen a less drastic remedy. An alternative remedy recognised by the courts is the involuntary buy-out; the majority shareholders purchase the shares of the complaining shareholders. The price could either be a price established by the court or an offer from the majority which the minority accepts.⁷⁴ However, the price should be in favour of the minority.

⁶⁸ *Idem.*

⁶⁹ *Idem.*

⁷⁰ See further regarding fiduciary breach in section 3.3.2.

⁷¹ *Matter of Kemp & Beatley, inc* 473 N.E.2d 1173 (N.Y. 1984).

⁷² Rogers Keith, *Protecting minority shareholders in Alaska close corporations*, p. 53.

⁷³ Lewis D. Solomon and Alan R. Palmiter, *A student’s guide to understanding Corporations*, p. 240.

⁷⁴ Julian Javier Garza, *Rethinking Corporate governance: the role of minority shareholders- a comparative study*, 2000, p. 623.

4.4.3 Equal Opportunity Remedy

The equal opportunities remedy is the remedy laid out in the Donahue and Wilkes-cases. This remedy means that the minority must be given the same opportunity as the majority. See further the Donahue-case in section 4.3.1.1. This will not be discussed further since it is not a solution to the exit problem itself, rather a protection for the minority to not be treated unfairly.⁷⁵

⁷⁵ In Sweden we have a kind of equal opportunity protection for shareholders in the Companies Act chapter 4, section 1, chapter 7, section 47 and chapter 8, section 41.

5 Minority Shareholder's Options in Sweden

5.1 In General

In Sweden with its civil law system, legislation is seen as the primary source of law. Courts are bound by the written laws. They may, nevertheless reason extensively and draw analogies from statutory provisions to achieve coherence. The main difference is that common law draws abstract rules from specific cases, whereas civil law starts with abstract rules, which judges must then apply to the various cases before them.

The main source of law within this area is the Companies Act. Among the approximately 315 000 companies in Sweden only 1300 are public.⁷⁶ This means that 99 % of the companies regulated by the Companies Act are thus private companies. The rules in the Companies Act are created for the public companies and are mainly utilised by public companies with a large number of shareholders.⁷⁷ The close corporation is consequently governed by rules not suited for the close corporation.

Above all there are three reasons to choose the corporate form in Sweden: first in order to receive limited liability i.e. to avoid the personal responsibility, second it is a good way to collect capital by issuing shares and third it could involve organisational advantages.⁷⁸

5.2 Step One - Claim

Claims regarding damage to a company may be brought where a majority or a minority consisting of owners of not less than one-tenth of all shares in the company have, at a general meeting, supported a resolution to bring such a claim in damages or, with respect to a member of the board of directors or the managing director, have voted against a resolution regarding discharge from liability (*Sw. ansvarsfrihet*).⁷⁹ When the owners have voted against a resolution regarding discharge from liability, the owners of not less than one-tenth of all shares in the company may, in their own name, commence an action regarding damage to the company.⁸⁰

Proceedings on behalf of a company against a member of the board of directors or the managing director for damages as a consequence of

⁷⁶ Sandstöm, Torsten, *Svensk aktiebolagsrätt*, 2007, p. 57.

⁷⁷ *Ibid*, p. 56.

⁷⁸ SOU 1978:66, p. 117.

⁷⁹ Companies Act, Chapter 29, section 7.

⁸⁰ Companies Act, Chapter 29, section 9.

decisions or measures taken during a financial year shall be brought not later than one year from the date on which the annual report and the auditor's report for such financial year were presented at the general meeting.⁸¹

There is one exception to the time limit. An action may be brought where, in the annual report or the auditor's report or otherwise, materially correct and complete information regarding the resolution or the measure on which the proceedings are based was not provided to the general meeting.⁸²

According to Chapter 29 section 7 and 9, shareholders owning not less than one-tenth of the shares could bring a claim. There are however situations where a minority shareholder owning fewer shares could bring a claim.⁸³

One situation is when the majority buys company assets for a price under market value. This means that the minority's shares are worth less. Albeit, it could be hard to show that it exists causality between the low price and the decrease in value of the shares.⁸⁴ This was the scenario in the case *NJA 2000 s. 404*. The board members had transferred the business in the corporation SWAB to one of the majority owner's wholly owned subsidiary for SEK 0. The subsidiary continued to conduct the business, and the business in the first corporation SWAB ceased. The majority owner thereafter sold the business thereafter for SEK 2M. The court held that a minority owner, owning 8% of the shares in the corporation should be compensated by the board members.⁸⁵ This rule is not applicable when the loss, i.e. decrease in share value; does not affect all the shareholders to the same extent. Even though it could be shown that the loss in share value were due to the action, this is no ground for damages since the decrease in value have an effect on all shareholders to the same extent.

To conclude, claims can only be made when not less than one-tenth of the shareholders have voted against a resolution regarding discharge from liability. Further, the time limit for the claim is one year from the date on which the annual report and the auditor's report for such financial year were presented at the general meeting, except from when incorrect information was provided. The main rule in chapter 29 section 7 and 9 is that owners of not less than one-tenth could bring a claim, except from certain circumstances where only one shareholder could bring a claim.

5.3 Step Two – Grounds

Important differences between the minority shareholder's options are that the rules in sections 5.3.1 and 5.3.2 are only applicable in case of oppression

⁸¹ Companies Act, Chapter 29, section 10.

⁸² Companies Act, Chapter 29, section 11.

⁸³ Sandstöm, Torsten, *Svensk aktiebolagsrätt*, 2007, p. 392.

⁸⁴ *Idem*.

⁸⁵ *NJA 2000 s. 404*.

of the minority. In contrast, the rules in section 5.3.3 can be used when no abuse occurs.

5.3.1 Involuntary Liquidation and Buy-out due to Fraud on the Minority

The option of dissolution was discussed in chapter 4.⁸⁶ There is a significant difference between dissolution and liquidation when it comes to examining the differences between the remedies available in the US and in Sweden. In the US the term dissolution means the formal extinguishment of the corporation, while liquidation is the formal process of reducing the corporation's assets to cash, i.e. winding up of the business. The corporation remains only as a liquid shell.⁸⁷ In Sweden, the term involuntary liquidation is equivalent to the US term dissolution. The meaning according to the Companies Act of the term liquidation is however the formal extinguishment of the corporation.

In Sweden there are rules regarding involuntary liquidation. Chapter 25 section 21 states that when a shareholder, through abuse of his or her influence over the company intentionally has participated in violation of the Companies Act, applicable annual reports legislation or the company's articles of association, a court may order that the company go into liquidation. One-tenth of the holders of all shares must make a petition to the court in order to receive the remedy. The courts order thus provided that the following prerequisite occurs; special cause exists therefore as a consequence of the long duration of the abuse or some other reason.⁸⁸

Section 22 states that the court may in such cases as referred to in section 21, on petition of the company and in lieu of liquidation, order the company to buy-out the petitioner's shares within a prescribed period of time. When considering the company's petition, the court shall give special consideration to the interests of employees and creditors.⁸⁹ Where the company fails to buy-out the shares within the prescribed period, the court may on petition of the shareholder, order that the company go into liquidation.⁹⁰

⁸⁶ See section 4.2.3.1 regarding the involuntary dissolution remedy in the US.

⁸⁷ Lewis D. Solomon and Alan R. Palmiter, A student's guide to understanding Corporations, p. 239.

⁸⁸ Companies Act, Chapter 25, section 21.

⁸⁹ Companies Act, Chapter 25, section 22.

⁹⁰ Companies Act, Chapter 25, section 22.

5.3.2 Shareholders' Buy-out Obligation in the Event of Fraud on the Minority

A shareholder could be obliged to buy-out the shares of a shareholder suffering damage according to chapter 29, section 4 Companies Act. This could occur when a shareholder who causes damage to the company, a shareholder or another person as a consequence of participating, intentionally or through gross negligence, in any violation of the Companies Act, applicable annual reports legislation or the company's articles of association.⁹¹ The court also takes into consideration the risk of continued fraud on the minority and general circumstances. These pre-requisites could be difficult to prove. Further, the minority shareholder shows that potential abuse will take place in the future.⁹²

Chapter 29, section 4 also contains a rule explaining how to determine the price of the buy-out shares. It states that the purchase price shall be determined by an amount that is reasonable taking into consideration the company's financial position.⁹³

5.3.3 Buy-out of Minority Shareholders

As discussed, the rules in the two sections above are only applicable in the case of oppression of the minority. The provision in chapter 22 section 1 does not require abuse by the majority. The rule gives both a majority holding more than nine-tenths and a minority holding less than one-tenth the right to call for buy-out.⁹⁴ The legislator wants to give the right to a minority holding less than one-tenth because the minority lacks some of the important protections⁹⁵ that a minority holding more than one-tenth has.⁹⁶

5.3.4 Fair-play Rules

The fair-play rules described in this section are the equality principle, the general clauses and the duty of care and duty of loyalty.

The **equality principle** establishes that all shares carry equal rights in a company.⁹⁷ The articles of association, however may specify that there shall be shares of different classes.⁹⁸ There are other exceptions to the equality principle in Chapter 4, sections 2-5. The principle also establishes that two

⁹¹ Companies Act, Chapter 29, section 4.

⁹² Sandstöm, Torsten, Svensk aktiebolagsrätt, 2007, p. 203-204.

⁹³ Companies Act, Chapter 29, section 4.

⁹⁴ Sandstöm, Torsten, Svensk aktiebolagsrätt, 2007, p. 204.

⁹⁵ For example the protections in chapter 18 section 11, chapter 25 section 21 and chapter 29 section 7 Companies Act.

⁹⁶ Sandstöm, Torsten, Svensk aktiebolagsrätt, 2007, p. 204

⁹⁷ Companies Act, Chapter 4, section 1.

⁹⁸ Companies Act, Chapter 29, section 2.

shareholders holding the same number of shares should have the same rights, unless something else is agreed upon. If a transaction affects all shareholders, the equality principle is not used, for example a minority shareholder could not bring a suit claiming breach of the equality principle if a decision by the board affects all shareholders.

The minority shareholder may in such case instead claim **the general clauses** in chapter 7, section 47 and chapter 8, section 41, first sentence. These provisions contain general restrictions on the right of decision-making of general meetings and directors. The first one establishes that the general meeting may not adopt any resolution likely to provide an unfair advantage to a shareholder or another person to the disadvantage of the company or another shareholder. The second clause establishes the same duty for the directors or any other representative of the company. The general clauses prohibit decision making and other measures that are likely to provide an unfair advantage to a shareholder. Further, the general clauses cover acts that provide an unfair advantage to associated persons. The assessment could be made as a balance test between two different interests with the protection of the minority shareholders on one side and the economical interests of the corporation on the other.⁹⁹

The **duty of care** is not established by law. The Companies Act however contains the main responsibilities of a board of directors and managing directors. The lack of rules within this area is influenced from the US business judgement rule, i.e. the freedom of corporations to make decisions, not the legislator. The legislator should only act in cases of wrongdoing.¹⁰⁰

The purpose of business is to make profit and a transaction that is meant to be profitable is considered to be in accordance with the business purpose. Therefore it would be more difficult to claim. Directors have limited **duty of loyalty** to care about the shareholders' interests according to the rules in chapter 29.

5.4 Step Three – Remedies

A minority shareholder could claim damages from other shareholders as well as from founders, board members and managing directors. The rules regarding damages are found in chapter 29 the Companies Act. The purpose of the rules is to force the leaders of companies to act in the best interest of the company and its owners.¹⁰¹

The liability of damages of **founders, board members and managing director shareholders** is stated in chapter 29, section 1, Companies Act. A founder, member of the board of directors or managing director who, in the

⁹⁹ Sandstöm, Torsten, Svensk aktiebolagsrätt, 2007, p. 197.

¹⁰⁰ Ibid, p. 255.

¹⁰¹ Ibid, p. 382.

performance of his or her duties, intentionally or negligently, causes damage to the company shall compensate such damage. This also applies where damage is caused to a shareholder or to a person as a consequence of violation of the Companies Act, applicable annual reports legislation or articles of association.¹⁰²

The liability of damages by **shareholders** is stated in chapter 29, section 2 Companies Act. A majority owner who abuses his/her power and it lead to an involuntary liquidation according to chapter 25, section 21-23 or a buy-out obligation according to chapter 29, section 4 may be liable for damages since he/she has violated the Act. The liability only occurs if the following conditions are fulfilled; the shareholder shall compensate damage which he or she causes as a consequence of participating, intentionally or through gross negligence, in any violation of the Companies Act, applicable annual reports legislation or the company's articles of association.¹⁰³

A minority who refuse to sell his/her shares to a majority or a majority who refuse to buy the shares from a minority according to chapter 22, section 1 has breached the Companies Act. In this case, the same liability in damages rule in chapter 29, section 4 Companies Act applies.

¹⁰² Companies Act, Chapter 29, section 1.

¹⁰³ Companies Act, Chapter 29, section 3.

Part II - Analysis

6 Analysis of the US Rules

6.1 Adequacy of Protection

6.1.1 Fiduciary Duties

According to the Donahue-case, shareholders in a close corporation have partnership-type duties of “utmost good faith and loyalty.” The duty implies that a minority must be given equal opportunity to take part in corporate benefits.¹⁰⁴ Since close corporations are like partnerships but incorporated only in order to obtain the specific benefits given to corporations,¹⁰⁵ I think it is a good standard that addresses the specific features of close corporation. In order to ensure flexibility conducting business, the legislator should not interfere too much. It should however, work as a guideline without putting too much constraint on the power of initiative, risk taking and competition within the market.

Case-law further recognises that decisions and activities by management and majority shareholders should not focus on the benefits received by shareholders, but on fairness and the business motivation behind the corporate action.¹⁰⁶ One example of this is found in the *Wilkes*-case, discussed in section 4.3.1.1. In this case the minority shareholder remained unpaid and was not elected as a director. The court concluded that management has certain management rights. These rights will be considered in the case of a breach of fiduciary duty suit.¹⁰⁷ The court stated that “[t]he traditional view where shareholders have no fiduciary duty to each other, and transactions constituting freeze-outs or squeeze-outs generally cannot be attacked as a breach of duty of loyalty or good faith to each other, is outmoded.”¹⁰⁸ The conclusion is that when reviewing a breach of fiduciary duty in a corporate setting, the appropriate standard depends on whether the majority shareholders can show a legitimate business purpose or not.

6.1.2 Oppression

Since the term oppression has different definitions in different jurisdictions, it is difficult to analyse this approach further. Nevertheless, if it is defined to imply the presence of wrong doing, it is a good standard. In comparison

¹⁰⁴ Lewis D. Solomon and Alan R. Palmiter, A student’s guide to understanding Corporations, p. 241.

¹⁰⁵ The benefits are among other to receive limited liability; to collect capital by issuing shares and obtain organisational advantages

¹⁰⁶ Julian Javier Garza, Rethinking Corporate governance: the role of minority shareholders- a comparative study, 2000, p. 636.

¹⁰⁷ *Wilkes v. Springside Nursing Home Inc*, 353 N.E.2d (Mass.1976).

¹⁰⁸ *Idem*.

with the reasonable expectations test it seems a better approach to explicitly require the majority's wrongdoing in order to justify a remedy.

6.1.3 Reasonable Expectations

One problem with the Reasonable Expectations approach is that the extent to which wrongdoing by majority directors is required is unclear. A shareholder's reasonable expectations may be stepped over by the majority without any accompanying wrongdoing. For example directors decide to extend the business and invest in bigger premises rather than in the payment of dividends. This action may violate the shareholders expectations. It nevertheless seems unfair, and too harsh, to order a dissolution or even a buyout of the minority's shares.

Another problem with this test is that the determination of whether a violation has occurred or not depends on the subjective expectations of a particular minority shareholder. The expectations of the shareholders are subjective and only limited by the "reasonable" standard. This means that the majority needs to determine the expectations of each minority shareholder before deciding whether an action will be acceptable or not. This seems impossible, and even if possible, it would be costly to obtain such information.

6.2 Adequacy of Remedies

Remedies vary depending on in what state the business entity is formed. The major failure of remedies has been that courts have been unwilling to expel a majority shareholder. In increasing order of severity, the remedies are: the equal opportunity-remedy; a judicially ordered buyout and dissolution.

In most cases, an order requiring a corporation to equally share benefits will suffice to remedy a minority's injury. Under the balance test in the Wilkes-case, a shareholder must show unequal treatment whereupon the majority has an opportunity to show that there was a valid business purpose behind the action. The minority then has the opportunity to show that the majority could have achieved its purpose through a less restrictive alternative.¹⁰⁹

There are no clear guidelines for when the courts order buy-outs and when they order dissolution. Since a buy-out represents a less severe remedy than dissolution, it seems reasonable that a lower standard of wrongdoing should represent a buyout remedy than that required to justify a dissolution. Since dissolution is a harsh remedy, it should only be ordered in extreme situations, when a buyout remedy is regarded insufficient. This might be the case when a corporation does not have enough funds to purchase the minority's shares to a fair price. Such buyout may cause short term liquidity

¹⁰⁹ Wilkes v. Springside Nursing Home Inc, 353 N.E.2d (Mass.1976) p. 663.

problems to the company, which is not desirable from a larger economic view. The remedy of involuntary dissolution presents a difficult way to go for the minority. Although, this option is easier to receive for close corporations; courts have been reluctant to order this remedy. A court challenge on fiduciary ground is an easier way to go and more probable to succeed with. However I think it is negative from the standpoint of the rule of law to have these unclear standards regarding the prerequisites for different remedies.

Even though the remedies discussed above are available; costs of obtaining such remedies may be prohibitive. In order to bring action in the US a minority shareholder must incur the expense of filing a lawsuit and paying for an attorney. Although the minority shareholder eventually obtains the buyout of his or her share, the benefits gained are substantially reduced by the costs.

6.3 Summary

The US legal system furthers the efficient management of a corporation and provides for detailed mechanisms to enforce rights of shareholders and rules to apply fiduciary duties.¹¹⁰ The most significant benefit in US law is the flexibility to run a business. Contrary, it is negative that standards for the different remedies are unclear which is undesirable from the rule of law perspective.

¹¹⁰ Julian Javier Garza, Rethinking Corporate governance: the role of minority shareholders- a comparative study, 2000, p. 696.

7 Analysis of the Swedish rules

7.1 Adequacy of Protection

7.1.1 Involuntary Liquidation and Buy-out Rule

The liquidation of a corporation is a harsh and far-reaching remedy, since it means the ending of the entity. Therefore, the prerequisites to apply the rules are significant.¹¹¹ In the Trustor-case, the involuntary liquidation rules were applied by the court.¹¹² Since then, however, the rules have not been applied. One draw-back with the rules is that they require a court ruling, which means that it takes some time before the misbehaviour stops. Hence a good way to go is then to make a petition for a receiver.¹¹³ Chapter 25, section 23 states that a court may appoint a receiver where it exists a clear risk that continued abuse will significantly prejudice the petitioner's rights. The receiver will then be appointed to manage the company in lieu of the board of directors and the managing director until the court's liquidation order has become final.¹¹⁴

7.1.2 Shareholders' Buy-out Obligation in the Even of Fraud on the Minority

In order to apply the shareholders buy-out obligation, the first step for the minority shareholder is to prove that the pre-requisites in chapter 29, section 3 are fulfilled, e.g. the provision regarding damages. The majority owner must be liable in damages and this must be proven by the minority. As discussed in 5.4, this is not easy to prove. A shareholder could be obliged to buy-out the shares of a shareholder suffering damage according to chapter 29, section 4 Companies Act. As discussed, this remedy could be ordered when a shareholder who causes damage to the company, a shareholder or another person as a consequence of participating, intentionally or through gross negligence, in any violation of the Companies Act, applicable annual reports legislation or the company's articles of association.¹¹⁵ The court also takes into consideration the risk of continued fraud on the minority and general circumstances. The last pre-requisite could be difficult to prove since the minority shareholder must show that potential abuse will take place in the future, as well as the other prerequisites.¹¹⁶

¹¹¹ Sandstöm, Torsten, *Svensk aktiebolagsrätt*, 2007, p. 202.

¹¹² *Idem*.

¹¹³ Sandstöm, Torsten, *Svensk aktiebolagsrätt*, 2007, p. 202, foot note 9.

¹¹⁴ Companies Act, Chapter 25, section 23.

¹¹⁵ Companies Act, Chapter 29, section 4.

¹¹⁶ Sandstöm, Torsten, *Svensk aktiebolagsrätt*, 2007, p. 203-204.

7.1.3 Buy-out of Minority Shareholders

This rule does not require the abuse of a majority. It is advantageous since there are instances when the minority wants to leave even though no abuse occurs. Further, it is advantageous since it can be difficult to prove that the abuse occurs. The disadvantage, however is that it could only be used by a minority holding less than one-tenth of the shares in the corporation.

7.1.4 Fair Play Rules

The equality principle and general clauses provide the equivalent protection as the fiduciary duty, only in a more vague form. It is good to include these kinds of rules, establishing some sort of duty of loyalty.

The general clauses prohibit decision making and other measures that are likely to provide an undue advantage to a shareholder. The assessment will probably be made as a balance test between two different interests with the protection of the minority shareholders on one side and the economical interests of the corporation on the other.¹¹⁷ It would have been preferred to have an established standard of this balance test. A balance test is a good way; nevertheless there need to be some certainty regarding the interpretation of the rules. Therefore, my suggestion is a implementation of a balance test like the one established in the *Wilkes-case*.¹¹⁸

The lack of rules within the area of fair dealing and duty of care is influenced by the business judgement rule in the US.¹¹⁹ The duty of care in the US is a good standard and the business judgement rule seems to work well in the US in order to establish the flexibility for board members and managing directors to make business decisions. The question is whether by omitting these rules in Sweden, a civil law country used with well established rules, are as efficient as in the US. Further I think it would be advantageous to implement a higher standard of fiduciary duties/fair-play rules for the private companies.

7.2 Adequacy of Remedies

To be entitled damages according to chapter 29, the Companies Act, the following four conditions must be fulfilled: activity or inactivity to act intentionally or negligently must have occurred. The activity or inactivity must be shown to have caused the damage and the damage must represent economical lost.¹²⁰

¹¹⁷ Sandstöm, Torsten, *Svensk aktiebolagsrätt*, 2007, p. 197.

¹¹⁸ See further regarding the *Wilkes-case* in chapter 4.3.1.1 and 6.1.1.

¹¹⁹ Sandstöm, Torsten, *Svensk aktiebolagsrätt*, 2007, p. 255.

¹²⁰ *Ibid*, p. 385-387.

Even though the conditions may appear high, these kinds of claims are rare, but anyhow are the rules important in order to deter.

7.3 Summary

The first remedy discussed, the involuntary liquidation is almost never used. This is because the conditions are high and this provision will only be available under extreme circumstances.

The buy-out remedy of minority shareholder is only used when the minority holds less than one-tenth of the shares. Consequently, this does not provide protection in all instances.

The last remedy available is the shareholders buy-out obligation. The problem with this provision is the minority's burden of proof. As discussed above, the minority must be able to show that the fraud will continue in the future.

To conclude, in order to be entitled the remedy, the minority shareholder's has the burden of proof to show that the grounds are fulfilled in order to be entitled the remedy. The requirements are set high which means that in reality these remedies are not available to the minority. The provisions are difficult to apply and do not specifically address the exit problem in close corporations.

Further to the above analysis, the conclusion is that the available options are not satisfactory and a change in the Swedish system is necessary.

Part III - Tomorrow

8 Future in Sweden

8.1 The Need of Improvements

As discussed in the introduction, there are 315 000 corporations in Sweden. The majority of these are close corporations, and these stand for a great part of the business conducted in the country. Private corporations count for 99% of the companies regulated by the Companies Act. Yet the Act contains rules for the public corporations. It is important to establish a great protection for these close corporations in order to stimulate entrepreneurs and to maintain a good business climate.

In Sweden the options related to the exit problem are limited to the three remedies discussed in chapter 5. This section will debate whether we need a change in the Swedish law system is necessary, the adequacy of the rules addressing the exit problem in Sweden and propose improvements.

The reason why so many small companies are corporations is not because this is a suitable company form for their needs rather it's the only option available if you don't want to be personally liable. Partners enter into shareholder agreements, which show the need of increased regulating issues. This further demonstrates the need for enhanced flexibility.¹²¹ Most issues regarding decision making and dissolution of companies are regulated in the shareholder agreement.¹²²

The Swedish Companies Registration Office (*Sw.:Bolagsverket*) issues thousands of bans each year, which also shows the need of improvements of the existing rules.¹²³

The ownership structure in Swedish companies point out the need for greater flexibility in order to be able to adapt to specific organisational circumstances.¹²⁴ This is further a reason pointing in the direction for the need of a new corporate form in Sweden.

Due to rulings in the EG-court, the freedom of establishment is unlimited, which means that you may for example incorporate a private ltd in the UK, and then conduct the business through a branch in Sweden.¹²⁵

The conclusion of the survey of protection in Sweden and the statements in this chapter is that the exit rules are not satisfactory. The rules are difficult to use, not adjusted to the exit problem in close corporations and the right to

¹²¹ Lindskog, Stefan, Behöver vi en liten aktiebolagsform, p. 11.

¹²² Lindskog, Stefan, Behöver vi en liten aktiebolagsform, p. 11-12.

¹²³ Centros Ltd v Erhvervs- og Selskabbstyrelsen, Case C-212/97, p. 42.

¹²⁴ SOU 1978:66, p. 123.

¹²⁵ Skog, Rolf, Ny företagsform utan personligt ägaransvar, p. 24.

damages established in the Companies Act is ineffective. Consequently, the exit rules should be changed. The Swedish government has started to look into the question of implementing a new corporate form, with limited liability but simpler rules for companies with few owners.¹²⁶

Since there is a need for a change, the following question will be how this change would be accomplished in the best possible way. How and where the changes best could be implemented will be discussed in the next chapter.

8.2 How to Make Improvements

8.2.1 Desirable Protection

One way of improving the protection in Sweden could be to broaden the availability of buyouts, according to chapter 29, section 4, by removing some of the conditions; for example the requisite to show that potential abuse will take place in the future. It would be enough to show that abuse is currently taking place. It is good to keep the rules regarding how to determine the price and also to include that the price always should be determined in favour of the minority shareholder. Further, you could add rules regarding what to do if the majority does not afford to buy-out the shares, which ultimately would be followed by liquidation of the company.

In regards to the fiduciary duties, the existing fair-play rules should be further developed. The fair play duties should be higher for participants in private companies, just like in the US where the fiduciary duty is higher on the fiduciaries in close corporations. It makes sense to implement a higher protection in the cases where it is best needed.

Broadening the availability of buyouts and imposing higher fiduciary duties on shareholders, nevertheless implicates the need to develop judicial standards for those concepts. It is therefore suggested that a balance test like the one established in the *Wilkes-case* should be implemented.¹²⁷ The rule should be that once a minority shareholder shows that a disproportionate benefit has been conferred on the majority, the minority should be entitled to relief if there were no business purpose for the unequal treatment or there were no less restrictive alternative. This rule protects the minority without improperly burden the corporation as a whole.¹²⁸ The allocation of burden of proof should be that the majority has the burden to show that there was a valid business purpose for the unequal treatment, whereupon the minority has the burden to show that there were a less restrictive alternative available.

¹²⁶ Behovet av en ny bolagsform, Ju 2006/8869/L1, Promemoria, Justitiedepartementet.

¹²⁷ See further regarding the *Wilkes-case* in chapter 4.3.1.1 and 6.1.1.

¹²⁸ *Wilkes v. Springside Nursing Home Inc*, 353 N.E.2d (Mass.1976) p. 663.

8.2.2 Desirable Remedies

Although dissolution may be considered an option this remedy implies that the corporate entity ceases to exist. This is not efficient from an economic point of view. As Sweden wants to encourage business, it rather wants to enhance market economy and support competitive enterprises than support remedies that destroy business.

The buy-out remedy should only be amended by adding unambiguous rules regarding the calculation of the price of shares in order to make sure that the minority obtains a fair price for its shares.

Irrespective to what rules of protection of minority shareholders in close corporations that will be implemented, there are some general principles that should be followed. In determining the appropriate remedy for the plaintiff, courts should first allocate the fault between the parties. The more fault the majority is responsible for, the more willing should courts be to give the minority a severe remedy. Albeit, the protections should not be too generous so that minority shareholders could ruin profitable corporations.

8.2.3 Share-capital Issues

In other countries it is common that there exist other corporate forms parallel to the corporation. The requirement for share capital is normally lower for this corporate form and it is tailored to corporations with few shareholders, by simpler rules regarding the formation of the company and limitations on transfers of shares.¹²⁹ Lower requirement for share capital stimulates incorporation of new companies.¹³⁰

In Sweden today, protection of the creditors is solved by requirements of minimum required share capital.

In the US there is no requirement of a fixed minimum capital since 1969.¹³¹ The reason behind this change can be summarised as follows:

- the arbitrary nature of any fixed minimum capital;
- the changing value of the dollar; and
- increased reliance on credit reporting rather than the concept of corporate capital as the basis for the extension of credit.¹³²

¹²⁹ SOU 1978:66, p. 115.

¹³⁰ Idem.

¹³¹ Except from in the following five states: District of Columbia, Puerto Rico, South Dakota and Texas. Further it is allowed in Ohio to include minimum capital requirements in the article of association. Andersson, Jan, Rättsutvecklingen i Förenta Staterna – Vad kan vi lära i Norden? p. 46.

¹³² Andersson, Jan, Rättsutvecklingen i Förenta Staterna –Vad kan vi lära i Norden? p. 45.

When there is insufficient capital in the corporation, the court has decided that it is possible to pierce the corporate veil. This means to hold managers or officers personally liable for corporate debt. A guideline established by the courts how to establish the meaning of insufficient, is that it has to be a 2:1 ratio; the equity must be as twice the sum of the debt.

To omit the capital requirements all together could be a too drastic step, and if implemented, it would have to be possible to pierce the corporate veil. From a rule of law perspective, it is not advantageous to implement a possibility to pierce the corporate veil in Sweden, since it would mean that you first grant immunity from personal liability and then later on could change your mind and remove the immunity.

A good middle way to go is to allow incorporating the company without transferring the SEK100.000 and later on when profits are made it will be bound according to the company's article of association to transfer the required capital. The share capital could also be lower than SEK100.000. The change is needed because of the freedom of establishment within the EU. Since today it is possible to incorporate a private ltd in the UK were the founders decide the share capital, you need to harmonise the rules in order to keep up with the competition.¹³³ The reform work has already begun in several European countries. In some countries the minimum share capital had been lowered and in some completely removed.¹³⁴

8.3 Where to Make Improvements

8.3.1 New Rules within the Companies Act

The first option to make improvements is to amend the existing rules for private companies could be to enhance the protection for the existing private companies. It could be done in three ways:

- first higher protection for private companies could be implemented;
- second private companies could be allowed to opt out from some of the current rules; or
- third both of the above mentioned amendments could be implemented.

The third option would be preferred.

Whichever of the three alternatives that is chosen, this option would turn out as the same system in place today, with a division between private and public companies.

¹³³ Skog, Rolf, Ny företagsform utan personligt ägaransvar, p. 24.

¹³⁴ Idem.

Regarding the **higher protection**, it would be good to implement higher duties in private companies, common to those that apply for close corporations in the US. Since employees in these companies almost relate to each other as partners in a partnership, it makes sense. There are fair-play rules in Sweden, these however are not satisfactory. It is therefore suggested to impose a higher duty of loyalty and care on the fiduciaries in Swedish private companies.

Regarding the **opt-out right**, either the rules should be voluntary for private companies or you could allow total freedom of contract regarding issues as transferability of shares. A total freedom of contract is not the most efficient solution from an economic perspective. It would be better to include legal standard solutions that shareholders could opt out from using provisions in the articles of association. One possible solution could be to implement new rules into the Companies Act, whereby private companies have the opportunity to choose to be bound by the new less complicated rules. In this case, shareholders in close corporations may opt out from the rules in the Companies Act and instead put into practice simpler decision norms.¹³⁵ This would be a good way of dealing with the problem.

It is important nevertheless to keep a high protection for the minority even though you reduce the organisational rules, since a high minority protection is even more important in these smaller companies.

One drawback with implementing new rules within the Companies Act would be that the existing law would contain even more provisions. This would make the Act less lucid and logical. It would further be contradictory to the purpose of the 1975 years reform of the Companies Act which was to simplify the Act.¹³⁶ This is a significant reason why implementing the new corporate form should be in a new act. This would be discussed in the next section.

8.3.2 New Rules in a New Act

This option would be to create a new corporate form in a new act. At a first glance this could seem like an attractive way of implementing higher protection.

The structure and contents regarding the headings and numbering for the new law could follow the Companies Act. It would be possible to in a separate law for small companies address all specific problems in close corporations and the total effect of this reform would be advantageous for start ups in the country. It would be possible to make the regulation for the

¹³⁵ Sandström, Torsten, Svensk aktiebolagsrätt, 2007, p. 56.

¹³⁶ SOU 1978:66 p. 129.

smaller companies simple at the same time as the rules regarding private companies could easily be adapted to the development in Europe.¹³⁷

It would be easier to incorporate and manage a small company if all the rules, not applicable to the close corporation were omitted or made voluntary. It would also represent less cost for these corporations. This is a main reason to implement new rules specifically drafted for the close corporation which addresses the specific problems in close corporations.

For example, easier rules regarding the formation of the company would stimulate the incorporation of more corporations and increase the incentives for entrepreneurs to start their own businesses.

This would, however, be the most complicated reform. It could be that it is possible to ensure the same protection within the Companies Act for existing private companies. A problem that arise when implementing a new corporate form and which hence need to be solved is the relation between the new form and the existing private company in the Companies Act. Another question would be how this new company fit into the existing and future EU-regulations within the corporate area? It is important to bear in mind that the reform to implement the limited liability corporation (LLC) and the limited liability partnership (LLP) in the US was because of tax purposes and not to enhance the protection for minority shareholders.¹³⁸ Hence, US model, cannot be used as an argument for implementing a new corporate form in Sweden, when striving to enhance the protection for the minority.

A further question that must be addressed is whether the new corporation should include restrictions in order to limit the use only to small corporations. Restrictions could be implemented as a limit on maximum share capital or a maximum number of shareholders.¹³⁹ It seems disadvantageous to include these kinds of restrictions, since it also harm and restrict the growth of the company. Further, the problem of what to do when the company grows and becomes too big for these rules has to be addressed. One negative implication with the new company form would be that it could harm the growth of smaller companies. A transfer to the ordinary company form must be easy to conduct, in order not to counteract economic growth. In the UK the rules regarding change of company category is simple and could work as an inspiration when drafting the Swedish ones.

8.4 Summary

It is suggested to amend the existing rules for private companies, by implementing higher duties of loyalty and care on the fiduciaries specific in

¹³⁷ SOU 1978:66 p. 130.

¹³⁸ Skog, Rolf, Ny företagsform utan personligt ägaransvar, p. 25.

¹³⁹ SOU 1978:66 p. 132.

the private companies as well as allowing these companies to opt out from some of the rules in the Companies Act.

It is further proposed that simpler rules would stimulate and enhance the number of incorporated companies. Moreover, it would be good to harmonise the Swedish rules with the rest of Europe and to keep up with the competition. It will constrain that corporations incorporate in other EU countries with simpler rules and lower minimum capital and then act from a branch in Sweden.

The larger economic interests of society must be considered. By implementing the above protections both majority and minority in close corporations will know they would be treated fairly as long as they act carefully and in good faith.

9 Conclusion

Comparing the Swedish system with a foreign system provides useful information for efficiently improving minority shareholder involvement in a company. Ultimately, this comparison provided the foundation for future improvements of corporate provisions in Sweden benefiting both minority shareholders and corporations.

The increasing complexity of financial and business transactions may lead to the fact that traditional theories like fiduciary duties might be inadequate today. On the other hand, it probably be even more important to include duties to act fair and loyal in a world where people often seem to forget about moral and ethics. This is still a flexible way to handle this problem and that it is a good standard since it takes into consideration the duty to act fair and loyal.

In order to maintain and stimulate a good business climate it is important to establish great protection for close corporations. It is therefore suggested that the rules for the existing private company should be amended in order to create a modern Company law for a competitive economy.

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