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Regulating the Closed Corporation
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Preface

Small and medium-sized enterprises* (SMEs) are the backbone of Europe's economies. More than 99% of all European companies classify as SMEs. These companies employ more than 65 million workers, and they account for more than 60% of the European Union's (EU) gross domestic product. The preferred company law form for an SME is the *closed corporation*. It offers the shareholders limited liability and thereby protects them from grave entrepreneurial risks. The number of shareholders is limited, and the shareholder composition usually remains relatively stable over time. Not less relevant is the role of the closed corporation for other uses such as private equity firms, joint ventures, or as a building block of corporate groups. This relates to the legal structuring of cross-border business activity in particular and is important for large businesses and SMEs alike.

The legal rules governing the closed corporation are relevant to how well this company law form can achieve its manifold objectives. Both the EU and its Member States have recognized this. In the last years, many Member States have modernized their closed corporation statutes, and on the EU level it is intensively discussed whether and under which circumstances a European closed corporation form (*Societas Privata Europaea*, SPE) should be introduced.

Against this background, in this book we attempt to develop a framework for *regulating the closed corporation:* We seek to answer the question of what the legal rules governing the closed corporation should ideally look like, how – in other words – the 'Volkswagen' of the law of closed corporations should be construed. There is a clear research gap here: legal research worldwide has devoted its main attention so far primarily to public corporations.

With this book, we would like to contribute to modernizing the legal rules for closed corporations in Europe and support both the national and European lawmakers in their reform endeavors. The specifics of a genuinely *European* closed corporation statute will be examined in a chapter of the book. However, these specifics are not our only or primary concern. We are as much interested in the closed corporation statutes of the Member States.

The starting point for our analysis is the structure of a closed corporation and the conflicts (of interest) that characterize it: conflicts between the shareholders, between the shareholders and board members, and between the corpo-

* According to a definition of the EU Commission, SMEs include firms with less than 250 employees, a turnover of ≤ 50 million Euro p.a. or a balance sheet total of ≤ 43 million Euro. Start-ups are usually SMEs within this definition.

ration and its creditors. Hence, after an introduction to the aims of our project and the problem it seeks to address (§ 1) and a presentation of our analytical and methodological approach (§ 2), we examine shareholder conflicts in closed corporations (§ 3), the role of the board (§ 4) and creditor protection in a closed corporation (§ 5). Following this analysis, we discuss rules on formation of a closed corporation, management and share transfer (§ 6). In a final chapter, we examine regulatory specifics of a European closed corporation statute (§ 7).

Our analysis is based on a functional-economic perspective that attaches significant weight to the economic consequences of legal rules. Important regulatory approaches of European Member States as well as those in the US are taken into account comparatively. We also take account of the historical experiences that different jurisdictions have had with certain regulatory approaches. Each chapter in this book concludes with a set of main findings. These might guide lawmakers that seek to construe an 'ideal' closed corporation statute.

A draft for each chapter of this volume has been prepared by one of the authors. All chapters have thereafter been discussed extensively within our group. The book we present now is a work of all of us as co-authors – in all parts.

The project that finally led to this book goes back to an initiative of Horst Eidenmüller in 2008. This initiative was made possible by a grant of a research professorship by Ludwig-Maximilians-University Munich as part of the 'excellence scheme' of the German Research Foundation (DFG). For this grant Horst Eidenmüller is very grateful to the DFG and Ludwig-Maximilians-University Munich. In the course of this project, various research assistants at the chair of Horst Eidenmüller have provided research support and helped with the production process of this volume. We are very grateful to all of them. Feedback and criticism are, of course, most welcome.

Berlin, Hamburg, Mannheim and Munich, October 2013

Gregor Bachmann
Horst Eidenmüller
Andreas Engert
Holger Fleischer
Wolfgang Schön

Overview

Abbreviations

AcP	Archiv für die civilistische Praxis
Am. Bus. L. J.	American Business Law Journal
Am. Econ. Rev.	American Economic Review
BB	Betriebs-Berater (Zeitschrift für Recht, Steuern und Wirtschaft)
BGBl.	Bundesgesetzblatt
BGHZ	Entscheidungen des Bundesgerichtshofs in Zivilsachen
BOE	Boletin Oficial del Estado
Bus. Law.	The Business Lawyer
C.com.	Code de commerce (France)
Colum. L. Rev.	Columbia Law Review
DB	Der Betrieb
Del. Gen. Corp. L.	Delaware General Corporation Law
DJT	Deutscher Juristentag
DK	Der Konzern
DStR	Deutsches Steuerrecht
DZWiR	Deutsche Zeitschrift für Wirtschafts- und Insolvenzrecht
EEIG	European Economic Interest Grouping
ECJ	European Court of Justice
EBOR	European Business Organization Law Review
ECFR	European Company and Financial Law Review
Eur. Acct. Rev.	European Accounting Review
Eur. Bus. L. Rev.	European Business Law Review
Eur. Bus. Org. L. Rev.	European Business Organization Law Review
Eur. Co. & Fin. L. Rev.	European Company and Financial Law Review
EuZW	Europäische Zeitschrift für Wirtschaftsrecht
EWS	Europäisches Wirtschafts- und Steuerrecht
FS	Festschrift
Games & Econ. Behav.	Games and Economic Behavior
German L. J.	German Law Journal
GmbHG	Gesetz betreffend die Gesellschaften mit beschränkter Haftung (Germany and Austria)
GmbHR	GmbH-Rundschau
Harv. L. Rew.	Harvard Law Review
HGB	Handelsgesetzbuch
J. Acct. Res	Journal of Accounting Research
J. Bus. & Tech. L	Journal of Business & Technology Law
J. Corp. Fin.	Journal of Corporate Finance
J. Corp. L. Stud.	Journal of Corporate Law Studies
J. Fin. Econ.	The Journal of Financial Economics
J. Inst. Theor. Econ.	Journal of Institutional and Theoretical Economics
J. Legal Stud.	The Journal of Legal Studies
J. L. & Econ.	Journal of Law and Economics
J. Pol. Econ.	Journal of Political Economy
JZ	Juristenzeitung

Komm. z. GmbHG	Kommentar zum GmbHG
LLC	Limited Liability Company
LLP	Limited Liability Partnership
MittBayNot	Mitteilungen des Bayerischen Notarvereins, der Notarkasse und der Landesnotarkammer Bayern
Münchener Komm. z. GmbHG	Münchener Kommentar zum GmbHG
Münchener Komm. z. HGB	Münchener Kommentar zum HGB
NJW	Neue Juristische Wochenschrift
NZG	Neue Zeitschrift für Gesellschaftsrecht
PLC	Public Limited Company
Q. J. Econ.	Quarterly Journal of Economics
RabelsZ	Rabels Zeitschrift für ausländisches und internationales Privatrecht
RIW	Recht der Internationalen Wirtschaft
SE	Societas Europaea
Small Bus. Econ.	Small Business Economics
SPE	Societas Privata Europaea
Stan. L. Rev.	Stanford Law Review
U. Pa. L. Rev.	University of Pennsylvania Law Review
Va. L. & Bus. Rev.	Virginia Law & Business Review
Va. L. Rev.	Virginia Law Review
VGR	Gesellschaftsrechtliche Vereinigung
VVDStRL	Veröffentlichungen der Vereinigung der Deutschen Staatsrechtslehrer
W. L. R.	Wisconsin Law Review
WM	Zeitschrift für Wirtschafts- und Bankrecht (Wertpapier-Mitteilungen)
Yale L. J.	Yale Law Journal
ZBB	Zeitschrift für Bankrecht und Bankwirtschaft
ZEuP	Zeitschrift für Europäisches Privatrecht
ZGR	Zeitschrift für Unternehmens- und Gesellschaftsrecht
ZHR	Zeitschrift für das gesamte Handels- und Wirtschaftsrecht
ZIP	Zeitschrift für Wirtschaftsrecht
ZRP	Zeitschrift für Rechtspolitik
ZVglRWiss	Zeitschrift für Vergleichende Rechtswissenschaft

Chapter 1 Introduction and Objectives*

This book attempts to develop and discuss legal regulations for the closed corporation without taking into consideration existing statutory law or legislative projects.[1] What would the "small" corporation form ideally look like? This is the core issue we attempt to answer. "Closed corporations" are those characterised by a limited group of shareholders, whose shares are not traded on public capital markets.[2] These corporations characteristically display organisational and regulatory structures distinct from those of public corporations.[3]

We pursue a conceptual approach that leaves aside a comprehensive comparative treatment of existing regulatory systems. However, the experience of and solutions deriving from individual legal systems are selectively taken into consideration and included in our analysis. The concept of a "regulation" indicates that our discussion extends – as far as possible – beyond the identification of significant problem fields, such as shareholders' and directors' liability, share transfer or flexibility of organisation, regulatory structures and approaches to solutions, and at least in certain cases proceeds to make specific proposals for the regulation of particular issues. Where this seems impossible, we at least discuss various regulatory options and their respective merits. We do not intend to

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* The text is based on a draft by *Eidenmüller.*

1 For a "meta-theory" of the evolution of corporate law in different jurisdictions, see by contrast, for example, *McCahery*/*Vermeulen*/*Hisatake*/*Saito* The New Company Law: What Matters in an Innovative Economy, in: McCahery/Timmerman/Vermeulen, Private Company Law Reform: International and European Perspectives, 2010, p. 71 et seq. For a discussion of the development trends in various corporate law systems, see *Gordon*/*Roe* Convergence and Persistence in Corporate Governance, 2004.

2 In more recent legal and policy discussions, an emerging trend is to replace the distinction between open and closed or private and public corporate forms with the distinction between listed and non-listed corporate forms. See, for example, Report of the Reflection Group on the Future of EU Company Law, Brussels, 5 April 2011, p. 8 et seq. Such distinctions must always be viewed and justified on the basis of a specific heuristic or scientific purpose. Our interest focuses on the conflicts involved in closed corporations and legal regulations to resolve these conflicts. See Chapter 2 A and B below.

3 This characteristic distinguishes this project from the European Model Company Law Project, which aims at the development of model regulations for public corporations. See *Baums*/*Krüger Andersen* The European Model Company Law Act Project, in: Tison/de Wulf/van der Elst/Steennot, Perspectives in Company Law and Financial Regulation: Essays in Honour of Eddy Wymeersch, 2009, p. 5, 14.

produce a complete set of "model rules", such as those promulgated by the American Bar Association in 1984 for the U.S. closed corporation.[4]

The practical implementation of regulations for the closed corporation in a country presupposes that the applicable regulatory environment must always be taken into account. A meaningful regulation capable of being implemented in one jurisdiction in a certain environment may not be in another. At critical points in our investigation, we make explicit reference to such difficulties of implementation and/or adaptation. In any case, we presuppose that a corporate form capable of stock exchange listing is available as an alternative legal form alongside the closed corporation still to be conceived.

To a certain extent, our investigation focuses on the structure of closed corporations in Europe. Several years ago, the European Commission presented a proposal for the Statute of a "European private company" (*Societas Privata Europæa*, SPE).[5] The proposal aimed to create a European (supranational) legal form for closed corporations. With this, the Commission intended to provide a system of rules alongside the "European stock corporation" (*Societas Europæa*, SE) to be used particularly by small and medium-sized firms operating on a cross-border basis.[6]

Shortly after submission of the Commission's proposal, an intensive legal, policy and juridical discussion ensued – especially in Germany – about the merits and demerits of creating a "European private company" generally and the Commission's proposal in particular.[7] Following various proposed compromises, the draft failed before the Council on 30/31 May 2011 due to a lack of unanimity.[8]

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4 American Bar Association, Model Business Corporation Act Annotated: Professional Corporation Supplement: Close Corporation Supplement, 1984.

5 Proposal for a Council Regulation on the Statute for a European Private Company, COM(2008) 396 final of 25 June 2008.

6 COM(2008) 396 final of 25 June 2008, p. 2.

7 See *Drury* EBOR 9 (2008), 125; *Davies* FS Hopt, 2010, p. 479; *Neville* FS Hommelhoff, 2012, p. 835. For the discussion in Germany, see, for example, the opinion of the "Arbeitskreis Europäisches Unternehmensrecht", NZG 2008, 897; *Teichmann* Gesellschaftsrechtliche Vereinigung (VGR) 14 (2008), 55; *Hommelhoff* ZHR 173 (2009), 255; *Siems/Rosenhäger/Herzog* DK 2008, 393; *Hadding/Kießling* WM 2009, 145; *Wicke* GmbHR 2011, 566; *Jung* in: Jung, Supranationale Rechtsformen im Typenwettbewerb, 2011, p. 49 et seq.

8 See Council of the European Union, press release PRES/11/146: 3094th Council meeting on Competitiveness (Internal Market, Industry, Research and Space) Brussels, 30 and 31 May 2011, available at http://europa.eu/rapid/press-release_PRES-11–146_en.htm. Currently, it is quite uncertain whether a new regulatory attempt will be made. The Reflection Group on the Future of EU Company Law appears to favor another model, within which Member States would be obliged by a Directive to make available a single-member corporate form in their respective national laws with an extremely simple structure. This structure could be used as a group

Academic and political discussion of the SPE will nevertheless continue. It compels us to focus on European legislative tasks in the area of corporate law and to contribute to improving the quality of the SPE "product" – if it ever reaches the "market".[9] At the same time, the discussion's focus on the SPE project also involves disadvantages: it narrows the perspective to *one single* specific set of regulations, its advantages and weaknesses, and opportunities for improvement. This makes us lose sight of two elements: firstly, what an SPE might and should look like if it is conceived from scratch; secondly – and more importantly –, which regulations apply, or at least should apply generally, to the closed corporation in Europe. Reform is necessary not only for the creation of a new European corporate form, but also in relation to relevant systems of regulations of the Member States. Recent endeavours in the United Kingdom, France, Spain and Germany to make the respective legal systems more amenable to closed corporations under the influence of regulatory competition in corporate law[10] make this very clear.[11] In some respects, the very liberal law governing the U.S. limited liability company (LLC) serves as a source of inspiration and an engine for reform.[12]

Chapter 2 establishes the analytical framework for our subsequent investigation. We identify typical conflicts (of interest) and regulatory requirements aris-

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subsidiary or by start-ups. See Report of the Reflection Group on the Future of EU Company Law, supra (note 2), p. 30, 57 et seq., 66 et seq. In its "Action Plan: European company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies", the European Commission does not take up this suggestion explicitly. Instead, it simply states that it "... will continue to work on the follow-up to the SPE proposal with a view to enhancing cross-border opportunities for SMEs", COM (2012) 740 final of 12 December 2012, p. 14. See also Ch. 7, note 31.

9 On vertical regulatory competition between the European Member States and the EU see *Eidenmüller* Regulatory Competition in Contract Law and Dispute Resolution, in: Eidenmüller, Regulatory Competition in Contract Law and Dispute Resolution, 2013, p. 1, 4 et seq.

10 Empirical studies have shown both for Europe and the United States that the incorporation decisions of closed corporations – and not only those of public corporations – are also strategically based on a cost-benefit calculation by the founders. See *Becht*/*Mayer*/*Wagner* 14 J. Corp. Fin. 241 (2008); *Dammann*/*Schündeln* 27 J.L. Econ. & Org. 79 (2011).

11 UK Companies Act 2006; Loi n° 2003–721 du 1 août 2003 pour l'initiative économique, JORF n°179 du 5 août 2003, p. 13449; 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, BOE Núm. 184, 2 de agosto de 2011, Sec. I, Pág. 8746; Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG), Bundesgesetzblatt (BGBl.) I/2008, p. 2026.

12 On the development of the LLC in the United States, see *Ribstein* The Rise of the Uncorporation, 2010, p. 119 et seq.

ing in closed corporations. We also discuss different regulatory goals, contents and forms. Chapters 3 to 5 then address regulations governing the relationships between shareholders, between shareholders and directors and between the corporation or its shareholders and third parties. Each section predominantly focuses on the issue that directs our research, namely the reducing or avoiding costs involved with the diverse conflicts (of interest). By contrast, Chapter 6 deals with the formation of a closed corporation, the transfer of shares, the costs involved and how those costs may be reduced. Finally, Chapter 7 is devoted to the special regulatory features of a European closed corporation.

Chapter 2 Analytical Framework*

Table of Contents

A Closed Corporations

The development of the "right" rules – or perhaps the most "convincing" rules – for closed corporations first requires a clear description of the object of investigation: closed corporations. For the *corporation*, the comparative-functional legal analysis agrees that it represents a type of company with the decisive characteristics of legal personality, limited liability (of the shareholders), transferability of shares, the possibility of delegated management and ownership of the capital providers where management and property rights are linked to the role of capital provider.[1] The first two characteristics, in particular, are functionally important: the legal capacity of the corporation protects the corporation's assets from recourse by shareholders, whilst the limited liability of the shareholders shields their (private) assets from recourse by the corporation's creditors, thereby

* The text is based on a draft by *Eidenmüller*.

1 See *Armour/Hansmann/Kraakman* in: Kraakman/Armour/Davies/Enriques/Hansmann/Hertig/Hopt/Kanda/Rock, The Anatomy of Corporate Law: A Comparative and Functional Approach, 2nd ed., 2009, p. 1.

making share trading and risk diversification possible.[2] These characteristics are in no way morphological features dictated by a legal system. Instead, they are endogenous legal characteristics that accompany critical discourse on particular issues – in the sense of framework conditions taken for granted – rather than forming the basis of it.

The same applies to the criterion of "closeness" as a characteristic of *closed* corporations. Closeness generally means that shares in closed corporations are not tradable on the stock exchange, i.e., the group of shareholders is restricted. In addition, the shares are – at least potentially – subject to restrictions on transfer.[3] If and to what extent these (or other) characteristics stand out as the constitutive elements of a closed corporation in a given legal system depends on the individual case.[4] We should also be mindful of hybrid corporate forms such as the American *limited liability company*; its internal affairs are derived from the *partnership*, and its liability limitations are conceived like those of a *corporation*.[5]

For many corporations, the legal characteristic of closeness results from a practical need: if an entrepreneur forms a corporation and also simultaneously manages the business, third parties are only permitted to become shareholders under restricted preconditions (management "suitability"). This is also true if a corporation – either from its inception or in the course of its development, e.g., through inheritance – is a family business in which individual family members perform management functions ("compatibility" with the family).

At the same time, the characteristic of closeness also produces a series of other typical features of this corporate form that are important for its legal treat-

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2 *Hansmann/Kraakman* 110 Yale L.J. 387 (2000) (affirmative asset partitioning, defensive asset partitioning).

3 See *Armour/Hansmann/Kraakman* in: Kraakman et al., supra (note 1), p. 5 et seq., 11 et seq.; *Cheffins* Company Law: Theory, Structure and Operation, 1997, p. 49 et seq.; *Bainbridge* Corporation Law and Economics, 2002, p. 798 et seq.; *Easterbrook/Fischel* 38 Stan. L. Rev. 271, 273 et seq. (1986). From the point of view of German doctrinal discourse regarding the GmbH, see, for instance, *Fleischer* Münchener Komm. z. GmbHG, 2010, Introduction margin no. 37 et seq.; *Wicke* Komm. z. GmbHG, 2nd ed., 2011, Introduction margin no. 10.

4 In some legal systems, it is sufficient for the shareholders themselves to choose a *closed corporation status*. See, for example, the Companies Act 2006 for the United Kingdom, which restricts itself to excluding a public offer of the shares for a private *company limited by shares* (in contrast to a PLC) (s. 755 Companies Act 2006). Others, by contrast, stipulate objective preconditions for access to this form of corporation, such as a maximum number of shareholders, see for example Art. L223–3 C.com. for the S.à.r.l. for France (maximum of 100 shareholders) or Sec. 342(a)(1) Del. Gen. Corp. L. for Delaware (maximum of 30 shareholders).

5 See in particular in this context the Revised Uniform Limited Liability Company Act (2006) and the Delaware Limited Liability Company Act, 6 Del. C. Sec. 18–101 et seq. (in force since 1 October 1992).

ment: shareholders do not have the possibility of easily leaving the closed corporation and "cashing in" their shares.[6] This increases the desire for active involvement in the closed corporation, particularly since directors' salaries are often the most important form of remuneration for corporate participation.[7] However, from an economic point of view, this has a negative consequence: any advantages of specialisation through the separation of tasks and roles between the shareholders and directors are lost. Shareholders, who invest a significant part of their assets in the closed corporation, are less efficient risk-bearers than well-diversified shareholders of public corporations.[8] On the other hand, the restricted group of shareholders also bears economic advantages: negotiations and agreements between the participants are conducted at relatively low cost.[9]

Unsurprisingly, there is no single form of closed corporation in actual practice. Company founders and established firms alike – both small and large – use this legal form. Moreover, a closed corporation can be structured in either a more "personalized" way or in a more capitalistic way; it can be used as either a single-member corporation or as a group subsidiary; it can operate on either a for-profit or charitable basis, etc. Given this broad array of possibilities, the question necessarily arises whether the rules for this corporate form should be guided by a general concept and, if so, which. A closed corporation is often used in practice as a legal form for new or small/medium-sized firms interested in limiting their shareholders' personal liability.[10] In a closed corporation, the number of shareholders is comparatively low, and a change in shareholders seldom occurs. Consequently, the founder's perspective is of central importance for our investigation. It is also appropriately at the forefront of the Commission's proposal for an SPE Statute. This has consequences for the types of shareholders in question with respect to their behavior, their needs and the regulations meaningful for them. Facts and circumstances concerning groups of companies therefore will not be examined here. However, focus on the founder's perspective should in

6 Hence, they do not have a liquid exit option as described in *Hirschman* Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States, 1970.

7 See *Bainbridge* supra (note 3), p. 798 et seq.

8 See *Easterbrook*/*Fischel* 38 Stan. L. Rev. 271, 274 (1986). However, the directors' risk aversion can also have (economic) advantages: directors may well then avoid entering into risks endangering the continued existence of the corporation and damaging the position of the corporation's creditors – at least at a stage in which substantive insolvency is still (far) away (see, by contrast, Chapter 2 B.III. regarding risk incentives close to insolvency).

9 See *Bainbridge* supra (note 3), p. 798; *Easterbrook*/*Fischel* 38 Stan. L. Rev. 271, 274 (1986).

10 Empirical evidence, for instance, on the use of the German GmbH, is provided by *Fleischer* supra (note 3), Introduction GmbHG margin no. 198 et seq.

no way involve a one-sided view of the regulations on closed corporations towards the needs of founders of corporations. Instead, these regulations must – at least in principle – also be suitable for enabling and structuring other uses of the closed corporation.

B Types of Conflicts (of Interest)

The clearest difference between open, capital market-oriented corporations and closed corporations is found in their respective types of conflicts (of interest).[11] The main findings of economic research on public corporations include the separation between the ownership (shareholder position) and control (management, directors) involving divergent interests and conflicts of interest that produce costs for the corporation.[12] Shareholders' interests are different from those of executive board members: shareholders incur costs by supervising the latter – e. g., establishing a supervisory board. Executive board members undertake expensive measures to present themselves as loyal agents. Finally, residual losses inevitably accrue which cannot be eliminated by increased supervision and self-committing signals.[13] These problems increase with larger numbers of shareholders, because it becomes more difficult for shareholders to coordinate their actions in relation to directors.

I Shareholders – Directors

Conflicts between shareholders and directors rarely occur in closed corporations. To the extent shareholders manage a business themselves, as is the case in four-fifths of all German limited liability corporations (GmbH),[14] opposing interests between shareholders and directors play either no role at all or – in the case of companies where not all of the shareholders are directors – only a limited role. In addition, a smaller group of shareholders can coordinate its actions more easily and is therefore better able to assert its interests against the directors.[15] Due to the shareholders' easier monitoring of the directors, specialised su-

11 For an overview of the economic structure of closed corporations, see *McCahery*/*Vermeulen* Corporate Governance of Non-Listed Companies, 2008, p. 6 et seq.
12 The seminal work is *Berle*/*Means* The Modern Corporation and Private Property, 1932.
13 *Jensen*/*Meckling* 3 J. Fin. Econ. 306 (1976).
14 *Fleischer* supra (note 3), Introduction GmbHG margin no. 203.
15 See *Bainbridge* supra (note 3), p. 798.

pervisory organs, such as a supervisory board, are seldom found in closed corporations.[16]

From a regulatory point of view, conflicts with shareholders therefore also carry less weight as regards directors' positions in closed corporations compared to public corporations. The primary focus, in closed corporations, is instead the duty-bound intermediary role of the directors (if the shareholders make use of the possibility of delegated management) between the different participants in the enterprise, particularly as between the shareholders and the corporation's creditors.[17]

II Shareholders – Shareholders

The relationship between and among shareholders themselves and the conflicts resulting from this relationship are critically important for closed corporations.[18] This relationship is primarily associated with opposing interests between *majority* and *minority shareholders*. In a closed corporation, minority shareholders often find themselves in a particularly vulnerable position because – as mentioned – there is no liquid market to value their shares and hence no place where the shares may be sold. Any share valuation must be undertaken outside an organised capital market on the basis of business valuation methods. It is well-known that these involve significant uncertainties. Hence, a simple exit from the corporation at a market price is impossible. Furthermore, the (majority) shareholder is not disciplined by otherwise applicable capital market regulations and – in an extreme case – by the threat of a public takeover of the corporation.[19]

As a result, conflicts between majority and minority shareholders particularly arise on the issues of open and hidden distributions (of profits) and other forms of remuneration. Typical examples are unbalanced business transactions which the corporation concludes with the majority shareholder (at the majority shareholder's own instigation), inflated directors' salaries which a majority shareholder "awards" him- or herself or the termination of a director's contract of employment with a minority shareholder.[20] Whilst the small number of share-

16 See *Easterbrook*/*Fischel* 38 Stan. L. Rev. 271, 278 (1986).

17 For more detail, see Chapter 4.

18 For more detail, see Chapter 3.

19 On the disciplinary effect of public takeovers, see *Manne* 73 J. Pol. Econ. 110 (1965); *Tirole* The Theory of Corporate Finance, 2006, p. 425 et seq.

20 For other forms/techniques of the exploitation of minority shareholders, see *McCahery*/*Vermeulen* supra (note 11), p. 46.

holders and the resulting (comparatively) low costs of negotiations between the participants promote the minority shareholders' possibilities of self-protection (e. g., in the form of contractually negotiated management or veto rights)[21] this self-protection remains inadequate for a number of reasons.[22] Future conflicts are frequently not anticipated at the time of formation or when shares are acquired. Often, risks are underestimated. Finally, in close personal (family) relationships, there can be a tendency not to proactively address and clarify potential points of dispute. Such clarification requires (financial) resources, which may not be sufficiently available in an individual case. Social codes of conduct, which operate more strongly in closed corporations than in public corporations, also do not offer reliable protection. For this reason, mandatory legal rules may be necessary as protective instruments and advisable in order to close gaps in both the private autonomous self-protection and the social convention structure. These mandatory rules include the important fiduciary duties developed in both continental European and certain Anglo-American legal systems.[23]

Even if possible "exploitation" of minority shareholders by majority shareholders represents the principal shareholder-shareholder problem in closed corporations, opportunistic conduct by a minority of shareholders also occurs and should be examined. For instance, a majority shareholder may have made considerable firm-specific investments, but a minority shareholder may be able to block necessary entrepreneurial decisions, for example, by exercising negotiated veto rights or majority requirements in the articles of association.[24] In this way, special advantages can be obtained. The fiduciary duties just mentioned therefore also constitute – and rightly so – a corrective in the opposite direction. Rights of dissolution or tender as instruments of minority protection should, in the absence of an explicit contractual regulation, be derived (if at all) only by way of exception through supplementary contractual interpretation.[25]

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21 See *Easterbrook*/*Fischel* 38 Stan. L. Rev. 271, 279 (1986); *Bainbridge* supra (note 3), p. 806 et seq.

22 See *Fleischer* supra (note 3), Introduction GmbHG margin no. 203.

23 See *Bainbridge* supra (note 3), p. 816 et seq; *Fleischer* supra (note 3), Introduction GmbHG margin no. 139 et seq., 292. Even today the United Kingdom does not acknowledge inter-shareholder fiduciary duties as such, see *Northern Counties Securities, Ltd v Jackson & Steeple, Ltd* [1974] 1 W.L.R. 1133, 1144; *Davies* Introduction to Company Law, 2nd ed., 2010, p. 238. For a discussion on the capacity to contract out of corporate law fiduciary duties, see *Hellgardt* FS Hopt, 2010, p. 765 (opting out of fiduciary duties should not be considered invalid *per se*).

24 See *Fleischer* supra (note 3), Introduction GmbHG margin no. 276.

25 See *Bainbridge* supra (note 3), p. 825 et seq.; *Easterbrook*/*Fischel* 38 Stan. L. Rev. 271, 286 et seq. (1986); *McCahery*/*Vermeulen* supra (note 11), p. 52 et seq.

Deadlock situations between shareholders constitute distinct conflict risks specific to closed corporations. Such situations are particularly found in cases of equal representation (i.e., a 50 – 50 corporation) and frequently have a family background, which in itself creates conflict. From a legal point of view, the corporation's capacity to act must *prima facie* be ensured by supplementary provisions in case there is a lack of contractual regulations/mechanisms to resolve the situation.[26] On the other hand, it may well be a rational strategy for shareholders to make the resolution of deadlock situations more difficult in order to reduce the likelihood that a corresponding situation arises at all.[27] Legal intervention *ex post* then has undesirable *ex ante* effects for other cases.

III Shareholders – Third Parties (in particular Creditors)

A third field of conflict affecting closed corporations in the same way as open corporations – albeit with a different slant – exists between the shareholders of the corporation and third parties, particularly the corporation's creditors. In this context, the core problem is limited shareholders' liability. It results in misguided incentives for the shareholder(s) if they only (still) have a small amount of equity capital invested in the firm. These misguided incentives are a consequence of asymmetrical participation in profits and losses: the shareholders only bear losses up to the amount of the (remaining) equity capital, whereas they also benefit in full from the profits. Consequently, shareholders may make risky investments with negative net present value but with potentially high returns on the upside. In addition, shareholders may decline to make investments with a positive net present value (i.e., the problem of underinvestment) that would strengthen the equity capital position but which would nonetheless offer a less attractive upside compared to riskier investments.[28]

As the misguided incentives result from the shareholders' participation in a corporation's profits and losses under corporate law, the problem becomes particularly acute where the shareholders (can) strongly influence management, i.e., in case of closed corporations.[29] In public corporations, directors typically

26 See *Fleischer* supra (note 3), Introduction GmbHG margin no. 296.

27 See *Easterbrook/Fischel* 38 Stan. L. Rev. 271, 287 (1986).

28 *Jensen/Meckling* 3 J. Fin. Econ. 306, 335 et seq. (1976); *Myers* 5 J. Fin. Econ. 147 (1977). For more detail, see Chapter 5.

29 This incentive is mitigated in "good" times when the shareholders of a closed corporation have invested a large proportion of their assets in the corporation, and are likely to lose them in

are not the influential shareholders and usually have a greater degree of management independence secured by legal rules. Directors of public corporations only have a risk incentive to the extent that their interests coincide with those of the shareholders.[30]

The legal instruments used to counteract the risk-shifting incentive of shareholders of a closed corporation are varied. Primarily, creditors themselves are able to take corresponding precautions through covenants in loan contracts.[31] In addition, statutory or judge-made liability rules, particularly shareholder liability imposed by "piercing the corporate veil" in favour of certain creditors or groups of creditors,[32] may be put in place. This is especially sensible in the case of closed corporations for which the positive welfare effects of limited liability are significantly less compared with public corporations.[33] Director liability for management decisions harmful to creditors is also conceivable.[34] Ultimately, the initiation of insolvency proceedings usually leads to a loss of control over the corporation's assets and thus to the removal of the risk-shifting incentive for the shareholders/directors.[35]

Apart from the corporation's creditors, other third parties are also potential "conflict partners" of the shareholders of a closed corporation, or of the corporation itself. This especially applies to staff employed in the corporation. It is well-known that a controversial discussion has been waged with respect to public corporations regarding whether their primary aim is to increase the value of shareholders' assets or to improve the welfare of all parties affected by the corporation's activities.[36] In principle, the issue arises in a similar way in the case of closed corporations. However, it is usually mitigated in this context because the

"bad" times if and to the extent they are also personally liable for obligations of the corporation, e. g. because of guarantees.

30 On this problem, see *Davies* 7 Eur. Bus. Org. L. Rev. 301 (2006).

31 See *Tirole* supra (note 19), p. 103 et seq.; *Eidenmüller* Unternehmenssanierung zwischen Markt und Gesetz: Mechanismen der Unternehmensreorganisation und Kooperationspflichten im Reorganisationsrecht, 1999, p. 123 et seq.; *Servatius* Gläubigereinfluss durch Covenants: Hybride Finanzierungsinstrumente im Spannungsfeld von Fremd- und Eigenfinanzierung, 2008.

32 See *Hansmann/Kraakman* 100 Yale L. J. 1879 (1991); *Eidenmüller* JZ 2001, 1041, 1048 et seq.

33 See *McCahery* in: McCahery/Raaijmakers/Vermeulen, The Governance of Close Corporations and Partnerships: US and European Perspectives, 2004, p. 1, 4 et seq.; *Eidenmüller* JZ 2001, 1041, 1049.

34 See *Eidenmüller* ZIP 2007, 1729, 1732 et seq.

35 See *Eidenmüller* supra (note 31), p. 22 et seq.

36 See representatively *Romano* Foundations of Corporate Law, 1993, p. 179 et seq.; *Mayer* Firm Commitment: Why the corporation is failing us and how to restore trust in it, 2013, 27 et seq. et passim; *Mülbert* ZGR 1997, 129; *Eidenmüller* JZ 2001, 1041, 1043 et seq.

number of employees (per firm) is lower. Moreover, shareholders frequently invest a considerable proportion of their assets in the corporation and are more interested in the corporation in the broadest sense – including the avoidance of insolvency – compared to a shareholder with widely diversified investments focused exclusively on returns. If an employee is simultaneously a shareholder – where wages potentially fulfil the function of corporate return – the typical conflict also does not lie in the contrasting interests between work and capital, but rather between majority and minority shareholders. This regularly manifests itself in the director's termination of the employment relationship upon inducement by the majority shareholder.

C Goals, Contents and Forms of Regulation

If we wish to develop or propose rules for closed corporations, it is first necessary to determine the regulatory goals pursued. This then forms the basis for a discussion on the contents and forms of regulation with which to strive for these goals.

I Regulatory Goals

Regulatory goals seldom tend to be explicitly discussed in corporate law. If regulations are proposed, they are usually supported with arguments or evaluations that the proponent author intuitively considers plausible and persuasive. This, for instance, occurs when "protection of the individual", "protection of minorities" or "investor protection" are introduced as decisive "evaluation principles of corporate law" and taken as a basis for the analysis of individual regulatory issues.[37] Such evaluation principles are, however, very generic and therefore hardly selective. Without further specification or balancing against countervailing principles, they offer no guidance in an individual case. Finally, they presuppose what should be proven (e. g. why, under what preconditions and in which respect shall minorities be protected?). Succinctly put, the evaluation principles do not provide the normative justification required. The same applies to the use of "imperatives", which are occasionally applied to attempt to end the search for and discussion about the evaluative bases of private law regulation by means of

37 See *Wiedemann* Gesellschaftsrecht, Volume I, 1980, Chapter 3 (p. 355 et seq.).

a formula.[38] It is equally unconvincing, for instance, to concentrate solely on whether a certain rule is or will presumably be successful in regulatory competition. For national legislation, this success may be a relevant factor for consideration in order to avoid a loss in "market shares". Nevertheless, the mere reference to a situation that forces the lawmaker to act in a specific way does not provide a convincing argument or a sound basis for a particular regulation.

By contrast, it is more fruitful to answer normative questions in corporate law with a view towards the welfare economic consequences of certain legal regulations.[39] This yardstick has a clear – if admittedly not undisputed – philosophical basis (rule utilitarianism),[40] and in many cases – although by no means *all* cases – provides a comparatively distinctive analysis and evaluation of the consequences of different regulatory arrangements. The plausibility and convincing force of this yardstick originate from its universal approach, which does not favor any particular stakeholder group, from the *prima facie* attractive aim of increasing welfare or avoidance of waste and from the compatibility of this aim with the promotion of private contracting (see below). The "impartiality" of this approach to issues of distribution can be justified by the consideration that tax and social welfare law constitute a far more suitable mechanism for the creation of desired distribution patterns than private law.[41]

Focus on the welfare economic consequences of certain legal rules in no way means that, for instance, considerations of fairness must remain disregarded. Market participants are usually also – and sometimes quite especially – motivated by such considerations and therefore include them in their preferences and utility functions.[42] However, the contents of the respective conceptions of fairness usually differ considerably, and their motivational force is likewise specific to each individual.[43] This particularly applies to substantive criteria determining

38 *Grigoleit* Anforderungen des Privatrechts an die Rechtstheorie, in: Jestaedt/Lepsius, Rechtswissenschaftstheorie, 2008, p. 51, 53 et seq.

39 For an overview of the increased importance of the economic efficiency aim in corporate law and in corporate legal scholarship, see *Fleischer*/*Zimmer* in: Fleischer/Zimmer, Effizienz als Regelungsziel im Handels- und Wirtschaftsrecht, 2008, p. 9, 21 et seq., 28 et seq., 36 et seq., 41 et seq.

40 See *Eidenmüller* Effizienz als Rechtsprinzip: Möglichkeiten und Grenzen der ökonomischen Analyse des Rechts, 3rd ed., 2005, p. 173 et seq, 175 et seq, 213 et seq.

41 *Shavell* 71 Am. Econ. Rev. (Papers & Proc.) 414 (1982); *Kaplow*/*Shavell* 23 J. Legal Stud. 667 (1994).

42 From the extensive (economic) literature see, for instance, *Fehr*/*Klein*/*Schmidt* 75 Econometrica 121 (2007); *Fehr*/*Schmidt* 114 Q. J. Econ. 817 (1999); *Falk*/*Fehr*/*Fischbacher* 62 Games & Econ. Behav. 287 (2008).

43 See *Bühring-Uhle*/*Eidenmüller*/*Nelle* Verhandlungsmanagement, 2009, p. 33 et seq., 65 et seq.

fair distribution or a fair result.[44] Nevertheless, there are certain principles of almost universal acceptance. These include, for example, the maxim that results detrimental to one party are only legitimate if that party has had the chance to make its point in the decision-making process (i.e., the principle of "procedural fairness"). While evaluating different legal regulations, these principles or others like them can and should probably be taken into consideration because of their broad prevalence as best expressing the presumed intent of the parties. This is even more applicable if a participant in negotiations over corresponding rules has specifically referred to or emphasised a corresponding principle.

If we can agree on the goal that, for the conception of corporate law regulations, the primary consideration is their welfare economic consequences, this results in a series of recommendations, including how to address the aforementioned conflicts (of interest) in a closed corporation. Generally, a legal system should endeavour to limit the costs associated with such conflicts as much as possible. Such costs reduce the aggregate net welfare position of all participants. Likewise, it is also a sensible recommendation to keep the (transaction) costs associated with the formation of a corporation, its business activities and the transfer of shares as low as possible. These costs also reduce welfare. This policy recommendation, however, is particularly important due to the significance of transaction costs for negotiation and contracting processes of the market participants. We now discuss this in greater detail.

II Contents of Regulation

1 Promotion of Private Autonomous Arrangements

It has already been mentioned that, in the case of closed corporations, negotiations and agreements between the shareholders are generally easier to consummate due to the comparatively small group of shareholders. Such negotiations and agreements are very important for a welfare-increasing allocation of rights and duties, since private autonomous arrangements tend to result in an optimal allocation of resources (maximising welfare).[45] If a stakeholder originally has a legal position of lesser value to him than to another, the latter will purchase this position for a certain price, just as goods are traded on product markets.

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44 See, for instance, *Brams/Taylor* Fair Division: From Cake-Cutting to Dispute Resolution, 1996; *Duve/Eidenmüller/Hacke* Mediation in der Wirtschaft: Wege zum professionellen Konfliktmanagement, 2nd ed., 2011, p. 213 et seq.

45 *Coase* 3 J.L. & Econ. 1 (1960).

This assessment presupposes that the participants behave rationally with the aim of maximising utility, i. e., that their actions fundamentally correspond to the general economic concept of *homo oeconomicus*.[46] Undoubtedly, this is not always the case. In particular, cognitive psychological research has identified numerous forms and phenomena of systematically irrational human behaviour, including in the business sphere.[47] Notwithstanding this, it is correct at the outset in precisely this context to follow the general concept of *homo oeconomicus*, i. e., the rational businessman, for two reasons: (1) the reality of this type of person (business people typically act in a predominantly rational way and "know what they are doing"), and (2) such a normative assumption also has desired economic effects in the long term, because it "encourages" rationality. However, the legal system must then react to systematic deficits in rationality if they are widespread and have grave consequences for the parties affected in any individual case. We will return to this later.[48]

As negotiation processes between the affected parties tend to result in economically sensible solutions, corporate law regulations should, in principle, not be mandatory, but optional (default rules).[49] Arrangements that correspondingly increase welfare are only possible if the participants can choose a regulation which differs from the statutory position. Mandatory corporate law regulations must therefore be the exception requiring specific justification (discussed in more detail below). In addition, the law should support the negotiation processes of participants by reducing their costs.[50] In this context, provisions on the formation of a corporation and on the structure of its articles of association, for example, are relevant alongside those provisions on the attribution of corporation-related conduct in legal transactions and on the transfer of shares. Potential benefits of cooperation can be canceled out by (excessive) transaction costs. The underlying rationale of the recommendation here is to reduce such costs. Not only

46 On this (critically), *Eidenmüller* supra (note 40), p. 28 et seq.

47 For an overview see *Kahneman* 150 J. Inst. Theor. Econ. (JITE) 18 (1994); monographically *Kahneman* Thinking, Fast and Slow, 2011; from the German literature see, for example, *Bühring-Uhle/Eidenmüller/Nelle* supra (note 43), p. 38 et seq.; *Eidenmüller* JZ 2005, 216, 218 et seq.; *Fleischer/Schmolke/Zimmer* in: Fleischer/Zimmer, Beitrag der Verhaltensökonomie (Behavioral Economics) zum Handels- und Wirtschaftsrecht, 2011, p. 9, 17 et seq.; *Altmann/Falk/Marklein* in: Fleischer/Zimmer, supra (note 39), p. 63 et seq.; *Eidenmüller* JZ 2011, 814, 816 et seq.

48 In this context, (mandatory) rules on severance settlement and termination rights particularly come into consideration as regulatory instruments.

49 *Easterbrook/Fischel* The Economic Structure of Corporate Law, 1991, p. 15 et seq., 22 et seq. For a historising analytical reconstruction of the "contractualisation" of corporate law, see *Hansmann/Kraakman* FS Hopt, 2010, p. 747.

50 See *Eidenmüller* supra (note 40), p. 64.

by their very nature do costs reduce welfare, they may also prevent the creation of useful party arrangements.[51]

2 Replication of Hypothetical Negotiation Solutions

In many constellations, such private arrangements will nevertheless be impossible to reach and will simply not arise due to prohibitively high anticipated transaction costs. An example would be potential agreements between the shareholders of a closed corporation and its creditors on the issue of whether – and, as the case may be, under what preconditions – the former should be personally liable for the corporation's debts by way of exception. In the case of public corporations, supplementary agreements between shareholders with diversified holdings can fail to be concluded due to high transaction costs. What should corporate law regulations look like in this case *as regards content?*

To start, the issue of the parties' "implicit will" will be raised in this context. It may have been only insufficiently expressed in the corporation's articles of association. Can a plan of regulation be explained that is at least rooted in a private autonomous decision by the parties? If this question must be answered in the negative, then in a second step it is helpful to consider a hypothetical negotiation solution: what would prudent parties have agreed to if they had been able to conclude an agreement?[52] This question reflects the normative general concept of *homo oeconomicus* (rational parties) referenced above, and which can – usually – be considered a reasonable assumption of behaviour for participants in business life or in the context of corporate law. However, the fewer the number of participants in a particular case whose behaviour corresponds to this general concept – for whatever reason –, the more important the hypothetical will of precisely *these* participants will be – and not that of the *homo oeconomicus*.[53] However, this is the exception and not the rule, as already discussed.

In order to answer the question about a hypothetical agreement of rational parties, a glance at usual corporate law problem solutions in similar cases can be helpful. For instance, a party agreement may be lacking in a "small" closed corporation, whereas it may be concluded in a "large" one where costs are compa-

51 However, these potential losses of allocation efficiency cannot be greater than the transaction costs themselves. The latter therefore caps the former.

52 *Eidenmüller* supra (note 40), p. 65 et seq.; *Eidenmüller* JZ 2001, 1041, 1043; *Easterbrook/Fischel* supra (note 49), p. 15; *Cheffins* supra (note 3), p. 264 et seq.

53 *Eidenmüller* supra (note 40), p. 456 et seq.

ratively less important.[54] The question then is: what can we learn from the practice of the latter for the former?

It is easy to see that the model of a "hypothetical contract" takes into consideration the regulatory goal of increasing welfare. At the same time, it must be emphasised that this only constitutes a statement about the *contents of regulation*. But it in no way constitutes a statement about the mandatory or optional character of a regulation. If private autonomous agreements, for example, fail as a result of prohibitively high transaction costs, this supports structuring legal rules in ways where the effect of a (hypothetical) agreement to promote welfare is achieved. However, this does not mean that the law should in principle make actual agreements completely impossible by mandatory regulation. Whether mandatory provisions are justified in an individual case is a separate issue from the content of these provisions and must be addressed separately.

III Forms of Regulation

1 Mandatory, Default and Enabling Rules

Analytically, it is initially helpful to distinguish between mandatory, default and enabling rules. If the object of the present investigation is the provisions for the closed corporation (in Europe), mandatory rules are those which automatically apply *when* the founders have decided in favour of the legal form created by these provisions. The relevant rules are therefore only mandatory within the framework of this legal form. Their choice as such, i. e., the formation of a corresponding corporation, is, by contrast, free. In this sense, we can say that mandatory corporate law is optional at a meta-level if and to the extent entrepreneurs can choose between different corporate forms to realize their entrepreneurial activities.[55] Non-negotiable issues on the primary level have optional character at the meta-level.

Default rules, by contrast, are rules which can be contracted away under private autonomy without further ado. Such rules inform about tried and tested patterns of regulation, relieve the parties of the necessity of having to contractually agree on every detail and fill gaps in such agreements.[56] The distinction from enabling rules is as yet unclear. The difference is frequently seen in default rules applying if and to the extent there has not been an opt-out, whereas enabling pro-

54 See *Cheffins* supra (note 3), p. 273 et seq.

55 See *Armour/Hansmann/Kraakman* in: Kraakman et al., supra (note 1), p. 22 et seq; *Bachmann* JZ 2008, 11, 13, 15 et seq.

56 See *Fleischer* ZHR 168 (2004), 673, 692.