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Science**

**The Sell-Out Right as an Agency Control
Mechanism**

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Abstract

This work seeks to demonstrate why current strategies aimed at limiting the exploitation of minority shareholders by majority shareholders in private companies are insufficient and argues in favour of the introduction of an agency theory-based control mechanism in the form of a sell-out right, under certain circumstances to be assessed in court.

This stems from the observation that certain corporate governance failures are inherent in the very nature of the private company, which is dominated by an individual and/or a family or by a company acting as controlling shareholder when the private company is a subsidiary of a group of companies. Because of the divisive nature of the majority principle, ownership is separated from control in private companies, whether the company is majority owner-managed or managed by professional managers. Thus, much like public companies, private firms dominated by one single shareholder or by a group of shareholders are prone to agency costs resulting from adverse selection and moral hazard. We address throughout this work the specific agency problems arising in companies in which power is divided along a line separating controlling shareholders from non-controlling shareholders. Such agency problems are exacerbated in private companies because no market exists for the shares such that minority shareholders may be trapped in an irremediably adverse situation. We argue that a sell-out right is the best remedy to such agency costs.

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INTRODUCTION

This work aims to demonstrate why current strategies aimed at limiting the exploitation of minority shareholders by majority shareholders in private companies are insufficient and will argue in favour of the introduction of an agency theory-based control mechanism in the form of a sell-out right, under certain circumstances to be assessed in court. This stems from the observation that certain corporate governance failures are inherent in the very nature of the private company, which is dominated by an individual and/or a family¹ or by a company acting as controlling shareholder when the private company is a subsidiary of a group of companies. The expression “private company” used throughout this work can be understood in at least three ways: firstly, according to private (as opposed to public) law, a private company is any company owned by private persons as opposed to a state-owned company; secondly, according to company law, a private company is any company not permitted to offer its shares for sale to the public; thirdly, from the point of view of securities law, a private company is any company whose shares are not listed on a stock exchange. Whereas a private company in the company law sense will be prohibited from trading its shares on a public market, a public company as defined by company law may or may not trade its shares on a public market. This means that a company which is public according to company law may be private as defined by securities law. For example, this would be the case under French law for an unlisted *société anonyme*, a type of company whose shares may potentially be listed. In this work, we will seek to address the specific agency problems arising in companies in which power is divided along a line separating controlling shareholders from non-controlling shareholders, because of the concentration of the shareholding structure, rather than the agency problems arising where the power structure is divided between management and shareholders. This is the pattern seen within private and public companies respectively. Such agency problems are exacerbated if no market exists for the shares as it is always preferable to be able to cut one’s losses rather than be trapped in an irremediably adverse situation. In addition, where a market for the shares does exist, there are usually sell-out mechanisms aimed at providing liquidity. For these reasons, we will focus here on unlisted companies, that is to say on private companies as defined by securities law.

The existence of a single controlling shareholder in private companies generates agency costs due to the impact of the majority principle. On the contrary, in widely held firms, the existence of one dominant shareholder may limit potential agency costs arising out of the agency relationship between

¹ See Part I, Chapter 1. See on family firms, in addition to the references cited in Part I, Chapter 1: Beckhard R. and Dyer W. G., Jr. (1983) Managing Continuity in the Family Owned Business, *Organizational Dynamics*, 12, 5-12; Gersick K. E., Davis J. A., McCollom Hampton M. and Landsberg L. (1997) *Generation to Generation: Life Cycles of the Family Business*, Harvard Business School Press; Westhead P. and Cowling M. (1998) Family Firms Research: The Need for a Methodological Rethink, *Entrepreneurship Theory and Practice*, 26, 91-100; Chrisman J. J., Chua J. H. and Steier L. (2002) The Influence of National Culture and Family Involvement on Entrepreneurial Perceptions and Performance at the State Level, *Entrepreneurship Theory and Practice*, 26, 113-130.

management and the majority shareholder since the latter has an incentive to avoid mismanagement because he has a large proportion of his wealth tied up in the company. However, the same cannot be said about closely held companies dominated by a single shareholder or group of shareholders. This is because thanks to schemes such as pyramiding, the financial interest held by the dominant shareholder in the lower tiers of a pyramid is so small that he lacks the aforementioned incentive due to the relatively small amount of wealth tied up and he may therefore spend corporate funds in a way that does not build value for the company and thus for other shareholders. In the lower tiers of the pyramid, voting power combined with the fact that the financial interests of the dominant shareholder are not aligned with those of the company therefore presents a source of risk. In addition, if the widely held company dominated by a single shareholder referred to above is listed on a stock market, agency problems are even less likely to occur because the actions of the dominant shareholders and the management have an impact on the share price. A drop in the share price may trigger lawsuits brought by shareholders, unsolicited takeovers and eventually the ousting of the incumbent management. The existence of a public market for the shares thus limits both strategies that depart from value maximization and management entrenchment strategies. Listed companies are nonetheless at risk from adverse selection and moral hazard because of the separation of ownership and control between the owners and the manager, and the work of the pioneers in the field of agency theory was carried out in the context of such companies. This implied that closely held companies had no separation between ownership and control and that agency costs were therefore not an issue². This observation stems from the fact that early analyses focused on the rise of a class of professional managers and its impact on the company's controlling shareholders. However, from the point of view of the minority shareholders, because of the divisive nature of the majority principle, ownership is also separated from control in closely held companies, whether the company is majority owner-managed or managed by professional managers. Thus, much like public companies, closely held firms dominated by one single shareholder or by group of shareholders are prone to agency costs resulting from adverse selection and moral hazard³.

One particular empirical study⁴ has concentrated on comparing family firms and non-family firms with regard to the efficiency of agency control mechanisms. The study was conducted among 5,800 small business clients (family and non-family firms) of the consulting activities of the Small Business Development Center programme in the United States with the aim of determining whether (i) family firms perform better independently of the effects of agency cost control mechanisms, (ii) agency cost control mechanisms, such as strategic planning and board of directors, do actually improve performance and (iii) the same agency cost control mechanisms improve performance in family firms to a greater degree than

² What Jacky Yuk-Chow So writes is illustrative of this trend: "...since control is not separate from ownership, these small firms should, by definition, have no agency problem" in Agency costs and ownership structure: Evidence from the Small Business Finance Survey data base (2005) Working Paper, Texas A&M International University.

³ See Part 1, Chapter 1.

⁴ Chrisman J. J., Chua J. H. and Litz R. A., Comparing the Agency Costs of Family and Non-Family Firms: Conceptual Issues and Exploratory Evidence in Entrepreneurship: Theory and Practice, vol. 28, no. 4, June 2004, 335-354.

in non-family firms. The answer on the first issue is no, that is to say that family participation in a company, independent of the effects of these agency cost control mechanisms, has no impact on performance, as measured by short-term sales growth. The response to the second issue is yes, that is to say these agency control mechanisms improve the performance of both types of companies, and the answer for issue (iii) is that strategic planning, against which minority shareholders can assess management's actions, has greater positive effects on the performance of non-family firms than on that of family firms. In terms of impact on the performance of the company, these findings show that agency control mechanisms seem to be more efficient in non-family firms, stressing the specific nature of this type of corporate structure.

On the basis of the conclusion that strategic planning and the board of directors, as agency control mechanisms, improve the performance of private companies, we will argue that it is necessary to go further and introduce a sell-out right so as to complete existing agency control mechanisms that are not sufficient to limit certain agency costs, which are those that cannot be mitigated by information disclosure requirements, by supervision of management actions and by incentives to align the interests of the various shareholders. The reason why these costs cannot be eliminated is that they result from a combination of the majority shareholder's behaviour and an organizational aspect inherent in the very structure of the limited liability company, *i.e.* the majority principle. As long as the company is run pursuant to the majority principle, majority shareholder opportunism cannot be fully contained because it is of the essence of the majority principle to give the majority a free rein to take the major decisions affecting the company. As this agency issue results from a defining feature of limited liability companies, it can only be solved by exiting the company which is why this particular agency issue is more acute in private companies where no market exists for the shares, thus making an exit at fair value unlikely. Therefore, we will argue here in favour of the introduction of a sell-out right for minority shareholders for valid reasons within closely held companies.

While there is no general sell-out right for shareholders within private companies, such a right usually exists in favour of shareholders of listed companies in the form of mandatory public offer rules and specific sell-out opportunities⁵. However, the absence of any general right in private companies does not mean that such a right cannot be granted in specific companies where the *intuitu personae* between the shareholders is strong or where required for investment liquidity purposes. Under French law, several provisions thus permit the redemption of the shares of a given shareholder⁶ and such redemption mechanisms exist in the *société civile* (the equivalent of a partnership) in companies with a variable share capital (*société à capital variable*), in the *SICAV* (unit trust), in the *société en nom collectif* and in *société*

⁵ Burkart M. and Panunzi F., Mandatory Bids, Squeeze-out, Sell-out and the Dynamics of the Tender Offer Process, June 2003, ECGI - Law Working Paper No. 10/2003.

⁶ Art. 1869, French Civil Code (*Code civil*); Art. 48 and 52, L. 24 June 1867; Art. 2, L. 23 December 1988; Art. L.231-8, French Commercial Code (*Code de commerce*); Art. 18, L. 29 November 1966.

civile professionnelle (both forms of partnership). The reason why these provisions have been limited to these types of company is either because the *intuitu personae* nature of the relationships between members is very strong or, in the case of the *SICAV*, so as to allow the freedom to withdraw an investment, necessary for a unit trust to function properly.

We will use the notion of breach of corporate contract, common to all types of companies, as a foundation for the sell-out right and thereby avoid the need to make a distinction between private and public companies in this respect. What we call the “corporate contract” is a notion that implicitly combines the company’s articles of association, any disclosed shareholder agreements, informal arrangements between the members and resolutions of corporate bodies which are consistent with the shareholder value maximisation approach. We will draw on this notion of shareholder value maximisation because, as we explain below, in terms of agency costs, pursuing considerations of social responsibility is potentially more costly than aiming at maximizing shareholder value, since management and/or the majority shareholders are given clearer goals, the achievement of which is more easily monitored by shareholders.

This is not the place to give a definitive answer as to whether the goal of the company is to create shareholder value or to contribute to a stakeholder society. This debate centres on the notion that, in a world of scarce resources reflected in prices, the aim of management is to maximise value for shareholders, as opposed to the idea that the company has redistributive obligations and is therefore accountable to stakeholders within society at large, such as the company’s employees, the external communities with which the company maintains relationships, and its creditors, whilst also referring to various ethical considerations⁷. Duties owed by the company to employees in this view generally include obligations to refrain from making redundancies in times of high profits and to be proactive in protecting minorities, providing training and fostering well-being in the workplace. Companies should, if possible, refrain from closing down sites in economically disadvantaged areas and should contribute to the public life of the communities within which they operate. Moreover, the company should not maximise shareholder value to the detriment of creditors. Acting ethically means for instance that, even to increase profitability, the company should not work with countries with oppressive governmental regimes and should also not pursue any potentially profitable project that could result in any form of environmental damage. Company managers themselves have an incentive to support the stakeholder approach because this is likely to increase their prerogatives and personal prestige. By doing so however, these managers may become agency cost centres⁸.

⁷ See Tirole J. (2006) *The Theory of Corporate Finance*, Princeton University Press, 56.

⁸ Cash flows are usually seen as the best measure to assess a firm’s wealth maximisation and to consider, for instance, whether the hiring of a manager, itself a potential source of agency costs in the case for instance of self awarding of benefits, will not outweigh the extra cash flow. Financial measures of agency costs resulting from the separation between ownership and control include free cash flows (Jensen M. (1986) *Agency Costs of Free Cash Flow*, *Corporate Finance and Takeovers*, *American Economic Review*, 76, 323-329), the ratios of operating expenses to sales and asset utilization ratios where the expense ratio is defined as operating expenses scaled by annual sales and the utilization ratio is annual sales divided by total assets. The first ratio
(*cont’d*)

When inclined to represent all stakeholders, managers might then become patrons of the arts, decide to contribute corporate funds to political parties, etc⁹. Milton Friedman has shown most convincingly that it is not the goals which are obviously questionable but rather the rationality of having a corporate executive, when power has been handed to a professional manager, or of having a majority shareholder act as principal with other people's time and money¹⁰. This is a classic agency problem¹¹. There is indeed arguably little debate over the merits of these goals; what is of interest to us here is that the attainment of these goals gives rise to agency costs.

Proponents of the stakeholder society are currently divided as to whether the company should give up long-term profits in favour of its employees, customers, creditors or the community at large. Some assert that a company in which employees benefit from better facilities, work conditions and job security than offered elsewhere will attract the best work force which will generate high returns and that, given the job security, those employees will be encouraged to invest in the company. The same can be said of suppliers and communities being offered lower prices and larger subsidies respectively in return for a more accountable company. This conception of stakeholder society is not really different from shareholder value maximisation, however it does insist on the potential need to abandon some short-term gains in favour of long-term profits. Corporate actions aimed at improving the company's image through

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measures how effectively the management uses the firm's assets and a high ratio is positively correlated with agency costs. On the contrary, the asset utilization ratio is inversely correlated with agency costs which means that bad investment decisions or the award of excessive benefits will lower the asset utilization ratio and increase agency costs (on which see Jacky Yuk-Chow So, (2005) op. cit), administrative expenses (Ang J. S., Cole R. A. and Lin J. W. (2000) Agency Costs and Ownership Structure, *Journal of Finance*, 55, 81-106); See Singh M. and Davidson W. (2003) Agency Costs, Ownership Structure and Corporate Governance Mechanisms, *Journal of Banking and Finance*, 27, 793-816; Anderson R. C., Mansi S. and Reeb D. (2003) Founding Family Ownership and the Agency Cost of Debt, *Journal of Financial Economics*, 68, 263-285).

⁹ See Blair M. (1995) *Ownership and Control: Rethinking Corporate Governance for the twenty-first century*, Brookings Institution.

¹⁰ "In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom. Of course, in some cases his employers may, of course, have a different objective. A group of persons might establish a corporation for an eleemosynary purpose – for example, a hospital or a school. The manager of such a corporation will not have money profit as his objective but the rendering of certain services.

Of course, the corporate executive is also a person in his own right. As a person, he may have many other responsibilities that he recognizes or assumes voluntarily – to his family, his conscience, his feelings of charity, his church, his clubs, his city, his country. He may feel impelled by these responsibilities to devote part of his income to causes he regards as worthy, to refuse to work for particular corporations, even to leave his job, for example, to join his country's armed forces. If we wish, we may refer to some of these responsibilities as 'social responsibilities'. But in these respects he is acting as a principal, not an agent; he is spending his own money or time or energy, not the money of his employers or the time or energy he has contracted to devote to their purposes. If these are 'social responsibilities', they are the social responsibilities of individuals, not of business.

The stockholders or the customers or the employees could separately spend their own money on the particular action if they wished to do so. The executive is exercising a distinct 'social responsibility' rather than serving as an agent of the stockholders or the customers or the employees, only if he spends the money in a different way than they would have spent it.

But if he does this, he is in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other.

Here the businessman – self-elected or appointed directly or indirectly by stockholders – is to be simultaneously legislator, executive and jurist. He is to decide whom to tax by how much and for what purpose, and he is to spend the proceeds – all this guided only by general exhortations from on high to restrain inflation, improve the environment, fight poverty and so on and on", Friedman M. (1970) *The Social Responsibility of Business is to Increase Profits*, *The New York Times Magazine*, September 13, cited in Tirole J. (2006) op. cit., 57.

¹¹ See Hellwig M. (2000) *On the Economics and Politics of Corporate Finance and Corporate Control*, in *Corporate Governance: Theoretical and Empirical Perspectives*, ed. X. Vives, Cambridge University Press, 95.

investment in sustainable development belong to this concept, pursuant to which long-term profits for the company nevertheless remain a legitimate goal.

Another school of thought among stakeholder society proponents asserts that the business model of companies ought to include the cost of negative externalities in the pricing of goods and services. The general idea is that goods and services that directly or indirectly cause harmful consequences to populations or the environment ought to be taxed to reflect these hidden costs. This forms part of a criticism of neoclassical economic theory on the grounds of its perceived lack of ethical considerations. One may wonder about the economic practicability of such “true cost” economics as many goods and services would become prohibitively expensive if this enlarged concept of costs were to be taken into account. It has for example been calculated that the price of a new car would rise by 40,000 USD if the air, noise and other pollution caused by automotive manufacturing were to be taken into account¹².

One argument against the stakeholder society model is that giving controlling rights to non-investors rather than shareholders may deter financing in the first place. Germany provides an example of stakeholders being given controlling rights in the form of codetermination¹³. As J. Tirole argues: “For example, suppose the community of “natural shareholders” is composed of management and employees, who do not have the funds to pay for investments themselves, and that the investors are concerned that they will not be able to recoup their investment in the firm if they share control with the stakeholders; that is, there may not be enough “pledgeable income” that the stakeholders can credibly promise to pay back when they have a say in the governance structure. The stakeholders probably will then want to hand control over to the investors, even in situations in which control by investors reduces total surplus. “Shareholder value” may be the only way to obtain the required money”¹⁴. Another argument related to the sharing of controlling rights with stakeholders is that this may result in deadlock over decision-making, as shareholders and stakeholders often have different goals. A third issue is management accountability: as mentioned above, pursuing objectives in areas as diverse as, for instance, the arts, politics or community work makes it harder for shareholders to supervise management because performance is more difficult (not to say impossible) to assess¹⁵ than via traditional shareholder value measures such as profits or share prices. This accountability issue gives rise to agency problems as the vagueness of the objectives given to management and the difficulty of measuring its performance may hide self-serving strategies. For instance, a manager or majority shareholder will invest on behalf of the company in a certain area in order to improve its local political connections. In public companies, one classic example is when the manager takes anti-takeover measures on the ground that jobs would be at risk if a hostile

¹² See <http://www.investopedia.com/terms/c/truecosteconomics.asp>

¹³ See Porter N. (1992) Capital Disadvantage: America’s Failing Capital Investment System, Harvard Business Review, 70, 65-82.

¹⁴ Tirole J. (2006) op. cit., 59.

¹⁵ See Dewatripont M., Jewitt I. And Tirole J. (1999) The Economics of Career Concerns. Part II. Application to Missions and Accountability of Government Agencies. Review of Economic Studies, 66, 199-217; Hermalin B. and Katz M. (1991) Moral Hazard and Verifiability: the Effects of Renegotiation in Agency, Econometrica, 59, 1735-1753.

takeover bid by a profit-maximizing raider were to be successful¹⁶. Finally, another argument is that pursuing social goals imposes a tax on the firm whose use is controlled not by a “politically” accountable body but rather by corporate executives or majority shareholders who may act opportunistically in favour of their own constituencies.

Again, what is under debate here are not the objectives of stakeholder society per se but rather how this affects the agency relationship between shareholders, minority and majority. The notion of shareholder value maximisation does not therefore deny the fact that doing business produces externalities, but instead focuses on finding contractual schemes to alleviate rather than internalize such externalities in the operation of the company through discretionary actions by corporate executives and/or majority shareholders. For instance, in the relationship between shareholders and creditors, the risk of the latter being expropriated by the former taking on too much risk, spending the company’s cash flow or selling off corporate assets is limited by the terms and conditions of loan agreements which provide for protective covenants. Also, between shareholders and employees, the well-being of the latter can be made subject to collective contracts governing issues such as working hours, severance pay and so on¹⁷. The efficiency of the protection of stakeholders, in the context of shareholder value maximisation, results from two methods of contracting¹⁸. The first method is to draft contractual provisions which limit the shareholders’ potential to act in a manner that could generate negative externalities for other stakeholders. The second method is to make the stakeholders’ claims independent from any potentially risky decision made by the shareholders. In loan agreements, the first method translates into positive and negative covenants setting out what can and cannot be done by the company. The second method translates into a fixed nominal claim and the provision of collateral, as well as early exit options, in the form of material adverse change clauses which provide for the early reimbursement of the principal plus interest if certain risks materialise, or, for certain subordinated debt, the option to convert debt into equity and thus realign the creditors’ interests with those of the shareholders. In addition to the contractual environment created by the parties, the legal system (*i.e.* laws, courts, regulators, etc.) fill in the gaps in any incomplete contracts in the event of unforeseen negative externalities¹⁹.

We will refer below to wealth maximisation in order to assess breaches of the corporate contract as an event triggering the right of the minority to sell out at the expense of the majority.

One expected effect of the implementation of a sell-out right in private companies is that it would limit departures from the shareholder value maximisation approach, in the form of conflicts of interest,

¹⁶ See Grossman S. and Hart O. (1980) Takeover Bids, the Free Rider Problem and the Theory of the Corporation, *Bell Journal of Economics*, 11, 42-64.

¹⁷ See Blanchard O. and Tirole J. (2004) Redesigning the Employment Protection System, *The Economist*, 152, 1-20.

¹⁸ Tirole J. (2006) *op. cit.*, 60.

¹⁹ Admittedly, the legal system can be subject to lobbying and thus be a somewhat biased substitute for incomplete contracts: see Pagano M. and Volpin P. (2005) The Political Economy of Corporate Governance, *American Economic Review*, 95, 1005-1030.

often faced by private companies²⁰, thereby serving its function as an agency cost control mechanism. The mere threat of such implementation should act as a deterrent as “The fear of compulsion for such an acquisition can dissuade the majority from misusing its power, to seek [the satisfaction of] an interest external to [its] shareholder [quality], or to cover behaviour likely to be defined as a personal use of the company’s assets detrimental to the interests of the shareholders”²¹. For the controlling shareholder, the risk of being obliged to purchase the minority shares, with his own money rather than with corporate funds, added to the often existing sanction for misuse of the company’s assets (if applicable to majority shareholders), will constitute a strong incentive to abide by the implicit corporate contract. The more general idea is that “a fair value exit reclaims for minority shareholders the wealth that the directors or the controlling shareholders attempted to appropriate”²². In addition, since the sell-out right ought not to be limited to the sanctioning of wrongful behaviour, but should also be triggered when a controlling shareholder wishes to alter profoundly the corporate contract, it will sometimes force the majority to find new partners rather than oblige the minority to find a purchaser for its shares. This demonstrates that the sell-out right as a cash exit right at fair value works as both an *ex ante* and an *ex post* mechanism to monitor the controlling shareholder and management behaviour.

Also, the introduction of a sell-out right would improve the attractiveness of the private company as an investment opportunity. Potential investors would no longer be afraid of an intentional breach of the corporate contract, or even of being held “captive”²³ due to an objective breach of the corporate contract resulting simply from the combination of the majority principle and the absence of any viable exit. The introduction of a statutory provision aimed at encouraging investments in private companies is in line with the idea that company law must be an enabling body of laws²⁴. The sell-out right as an investment incentive contrasts with the view that this mechanism could discourage innovation and limit companies’ responses to changing market conditions²⁵. On balance, facilitating investors’ exits should facilitate access to the sources of capital necessary in order to innovate and keep up with the markets. However this is not to say that there are no potential adverse effects attached to the introduction of a general sell-out right in the private company: these do indeed exist and we will address them in Part 3. The response to such potential adverse effects is essentially to avoid granting an automatic sell-out right and to give the

²⁰ Frison-Roche M.-A., L’hypothèse d’un Droit Général de Retrait des Minoritaires, JCP, E, mai-juin 1996, p. 19; Schmidt D., Les Conflits d’Intérêts dans la Société Anonyme, coll. Pratiques des Affaires, Joly éditions, 1999, p. 234.; Marini P., Le Droit de Retrait des Actionnaires Minoritaires dans la Société Non Cotée, P.A., 04/11/1998, p. 27.

²¹ Schmidt D., op. cit., p. 235.

²² Siegel M., op. cit., 108

²³ Frison-Roche M.-A., op. cit., p. 20.; D. Schmidt, op. cit., p. 235; P. Marini, op. cit., p. 27.

²⁴ Professor Paul L. Davies thus writes: “Company legislation has two main functions: (i) enabling and (ii) regulatory” in Gower’s, Principles of Modern Company Law, 6th ed., by P. L. Davies, London, Sweet & Maxwell, 1997, p. 7 (now in its 8th edition). In the same way: “The corporate code in almost every state is an ‘enabling statute’”, Easterbrook H. and Fischel D. R., The Corporate Contract, in Foundations of Corporate Law, Oxford University Press, ed. Romano R., 1993, p. 101. It should be noted that in the history of company law, the majority rule itself, whose excesses the sell-out right aims at correcting, gradually replaced the unanimity principle in order to encourage entrepreneurship.

²⁵ In his opinion, certain classes of changes should be submitted to shareholder approval by majority vote, as is the case in some jurisdictions. However, this solution precisely fails to address the very reason for a sell-out right, *i.e.* majority rule dysfunctions.

courts the ability to assess the triggering events and the majority the possibility to oppose counterarguments to the petitioners in court.

In its function as a sanction of an intentional breach of the corporate contract, the sell-out right could supplement the award of damages, the cancellation of corporate resolutions or, if applicable, the winding up of a company²⁶ which are currently used to punish majority opportunism. These sanctions are however most often inappropriate because they are either too weak or too harsh. With the sell-out right, the sanctioning effect would also derive from the fact that the cost of the purchase of the minority shares is borne by the majority, since this majority is at fault if the triggering event is minority exploitation (subjective breach of the corporate contract). The majority would also be responsible for payment for the minority interest if the majority shareholders' intent, without abusing their position, was to make considerable alterations to the corporate contract (objective breach of the corporate contract).

The debate concerning corporate goals considered briefly above revolves around decision-making within the company, a microeconomics issue, and the impact of corporate behaviour as a whole, a macroeconomics issue. Before we consider developments in the area of microeconomics based on the stewardship theory and, above all, on agency theory, we shall give a brief account of the macroeconomic situation of closely held companies.

Studies usually find that the concentration of economic power relative to GDP seems to cause some countries to grow more slowly than others areas in which wealth is less concentrated²⁷. This may be because non-financial goals are more likely to be pursued in family firms than in other forms of companies²⁸. If the managers pursue non-financial goals in keeping with the wishes of all of the shareholders and provided that the utility function of all these shareholders is the same, then the interests of the principal and the agents are aligned and there are no agency costs. However, should some of the minority shareholders, be they family members or external shareholders²⁹, pursue financial goals, then the pursuit of non-financial goals would generate agency costs because the interests of management and

²⁶ The French *Cour de cassation* forbids partners, in the absence of a statutory provision, to force a sale of shares by a member petitioning for the dissolution of the company in court, see Com., 12 March 1996, Quot. Jur. 9 May 1996.

²⁷ See for example Morck R., Stangeland D. and Yeung B. (2000) *Inherited Wealth, Corporate Control and Economic Growth: The Canadian Disease* in Morck R. ed. *Concentrated Corporate Ownership*, National Bureau of Economic Research, University of Chicago Press.

²⁸ Lee M. and Rogoff E. G. (1996) *Comparison of Small Businesses with Family Participation versus Small Businesses without Family Participation: An Investigation of Differences in Goals, Attitudes, and Family/Business Conflict*, *Family Business Review*, 9, 423-437. Sharma P., Chrisman J. J. and Chua J. H. (1997) *Strategic Management of the Family Business: Past Research and Future Challenges*, *Family Business Review*, 10, 1-35. Some authors argue however that pursuing non-economic goals gives a competitive advantage to family firms because these goals yield non-pecuniary return, see Chua J. H. and Schnabel J. A. (1986) *Non-Pecuniary Benefits and Asset Market Equilibrium*, *Financial Review*, 21, 185-190. See also Chrisman J. J., Chua J. H. and Litz R. A., June 2004 op. cit., 335-354.

²⁹ On the situation of external shareholders in family firms, see Slator R. (2002) *Investing with Families in Business: A Venture Capitalist's View*, in Chrisman J. J., Holbrook J. A. D. and Chua J. H. (eds.), *Innovation and Entrepreneurship in Western Canada: from Family Business to Multinational*, 259-267, University of Calgary Press.

the majority shareholders would be contrary to the interests of the minority. For example, providing jobs to unqualified members of one family group is one illustration of just such a non-financial goal. Another illustration of the relative underperformance of family firms is the comparatively low level of spending on research and development, although empirical studies are divided on this subject. Also, on the basis of personal connections, access to bank lending also seems to have been easier for “old money” controlling families in the past. On the other hand, it can be argued that family firms may now be at a disadvantage when raising capital in the debt markets if they are perceived as being lacking in transparency, or in the equity capital markets due to there being no market for the control of such companies.

Other theories have tried to explain the reasons for the underperformance of family-led closely held companies in the long term via the effects of the handing down of the business by a founder to an heir³⁰. Morck, Stangeland and Yeung (2000) found that countries where family groups of companies are significant, measured by the wealth of billionaire heirs relative to the country's GDP, grow statistically more slowly than countries with comparable initial socio-economic conditions including levels of per capita GDP and this would appear to be due to the transmission of businesses by inheritance³¹. The basic psychological premise which comes to mind here is that in so far as business acumen is a form of intelligence, it is only partly inherited and also depends on cultural factors. Heirs are thus not expected to possess business skills equivalent to those of their forebears and consequently companies run by heirs end up consistently underperforming in comparison to similar companies run by founders³² and this situation has two possible explanations: heirs are less able or less hardworking than founders hence the disappointing results³³, or a more sociological view: over the long-term, family firms are reluctant to innovate because innovation means destroying the value of old capital, *i.e.* “creative destruction”.

This second explanation obviously rests on the theory developed by Joseph Schumpeter at the beginning of the twentieth century that innovation is a key determinant of economic growth³⁴. The process is that innovation triggers higher productivity from production factors, *i.e.* labour and capital, and thus fosters economic growth. Alongside these advantages, innovation also renders obsolete certain existing techniques and their associated production factors. This is why the “old money” behind the

³⁰ See for example Morck R., Stangeland D. and Yeung B. (2000), *op. cit.*

³¹ See Ambrose D. M. (1983) Transfer of the Family-owned Business, *Journal of Small Business Management*, 21, 49-56; Dyer, Jr., W. G. (2003) The Family: The Missing Variable in Organizational Research, *Entrepreneurship Theory and Practice*, 27 (4), 401-416; Malone S. C. (1989) Selected Correlates of Business Continuity Planning in the Family Business, *Family Business Review*, 2, 341-353; Wortman M. S., Jr. (1994) Theoretical Foundations for Family-owned Business: A Conceptual and Research based Paradigm, *Family Business Review*, 7, 3027.

³² See Shleifer A. and Vishny R. W., (1997) A Survey of Corporate Governance, *Journal of Finance*, 52, 737-783; La Porta R., Lopez-de-Silanes F., Shleifer A. and Vishny R. W. (1997) Legal Determinants of External Finance, *Journal of Finance*, 52, 1131-1150; La Porta R., Lopez-de-Silanes F., Shleifer A. and Vishny R. W. (1998) Law and Finance, *Journal of Political Economy*, 106, 1113-1155.

³³ Holtz-Eakin D., Joulfaian D. and Rosen H. (1993) The Carnegie Conjuncture: Some Empirical Evidence, *Quarterly Journal of Economics*, 108, 413-435.

³⁴ Schumpeter J. A. (1912) *Theorie der Wirtschaftlichen Entwicklung*, Dunker und Humboldt, translated by Opie R. (1934) *The Theory of Economic Development: an Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle*, Harvard University Press; Schumpeter J. A. (1942) *Capitalism, Socialism and Democracy*, Harper.

techniques whose value is reduced by innovation is expected to resist such changes. Various studies argue that family firms, having used existing institutions to establish their position, then use their political influence to undermine challengers³⁵. We find this argument regarding the limitation of innovation by family firms more convincing when it comes to external innovation, based on the political capital amassed over time, than with respect to internal innovation. The argument that family firms limit innovation within their own organisation because a new line of products would disrupt an existing one does not seem to be specific to family firms. It has perhaps more to do with the fact that, as groups of companies, family firms can take the form of conglomerates prone to such cannibalizing effects³⁶. However, a different conception of innovation has developed under the name of endogenous growth theory where innovations and the value of existing processes are less mutually exclusive³⁷ than has previously been acknowledged. Pursuant to this theory, innovation has positive externalities since once an innovation has become an established process, new functions can still be introduced. One example is the compact disc, originally conceived to play music but which has subsequently found an application as a digital data storage device. That is to say that, at least conceptually, the relationship among family firms between old capital and innovation is not necessarily negative for the former and that innovation can be a positive sum game³⁸. Going further in this debate on the macroeconomic effects of family firms on innovation would be outside the scope of this work so it will suffice here to refer the reader to empirical studies which cite the negative correlation between private sector research and development and inherited wealth as a percentage of GDP³⁹ as an illustration of how family firms, where capital is hypothetically concentrated, are hindered by agency costs.

We will now consider empirical data on the ownership of private companies and identify policy issues arising therefrom and also focus on the majority principle, a crucial issue in the private company (Part 1). We will then examine existing strategies for dealing with the issues identified in Part 1. We have identified two main strategies: disclosure of information and fiduciary duties (Part 2). Finally, we will argue that the sell-out right is the agency cost control mechanism necessary to offset the adverse effects of the majority principle in private companies (Part 3).

³⁵ See Rajan R. and Zingales L. (2001) The Great Reversals: The Politics of Financial Development in the 20th century, National Bureau of Economic Research, no. 8178. See also Olson Jr., M. (1963) Rapid Growth as a Destabilizing Force, *Journal of Economic History*, 23, 529-552; Krueger A. O. (1974) The Political Economy of the Rent-seeking Society, *American Economic Review*, 64, 291-303.

³⁶ See however empirical results showing a statistically negative relationship between private sector research and development and inherited wealth as a fraction of GDP in Morck R., Stangeland D. and Yeung B. (2000) op. cit.

³⁷ See Romer P. M. (1986) Increasing Returns and Long-term Growth, *Journal of Political Economy*, 94, 1002-1038.

³⁸ See Murphy K. M., Shleifer A. and Vishny R. W. (1989) Industrialization and the Big Push, *Journal of Political Economy*, 97, 1003-1026.

³⁹ See for example, Morck R., Stangeland D. and Yeung B. (2000) op. cit.

PART 1. ANALYTICAL FRAMEWORK AND IDENTIFICATION OF POLICY ISSUES

CHAPTER 1 ANALYSIS OF EMPIRICAL DATA ON OWNERSHIP OF PRIVATE COMPANIES

Observations regarding the governance of companies based on their share capital structure usually refer to “The Modern Corporation and Private Property”, the seminal work by Adolf Berle and Gardiner Means published in 1932 in which the authors place the emphasis on companies with widely dispersed capital and control concentrated in the hands of professional managers⁴⁰. However, studies of corporate ownership around the world show that is far from being the most commonly found structure⁴¹. Quite the contrary in fact, as it appears that the vast majority of companies are privately held and controlled by a small number of large shareholders or even by one single controlling shareholder. In Europe in particular (except in the UK and Ireland where companies are most likely to be widely held), the majority of companies are family controlled. Given that this capital structure is the most widespread, this work addresses the specific agency relationship between controlling shareholders and minority shareholders, exacerbated by the lack of any market for the shares⁴², and not the more traditional relationship between dispersed shareholders and management.

In this chapter, we will analyse empirical data on the ownership of private companies and identify the policy issues arising therefrom. These issues stem from the observation that private companies are often dominated by a single shareholder and that this shareholder is often a family group. We will describe the agency issues to which these distinct features shown in the empirical data give rise as we encounter them.

1.1 Interpretation of the degree of concentration of ownership and control in private companies

1.1.a. Geographical breakdown

Data gathered in studies of company ownership reveal the coexistence of two main models: this split basically divides the U.S., the UK and Ireland from the rest of the world. A classification of the ultimate owners of corporations shows that the majority of companies in the first group of countries are

⁴⁰ As argued notably by Margaret Blair, another link between a dispersed capital and the existence of professional managers is the contribution made by the latter to the former by enabling financial investors to play a passive role and making investments easier to trade and therefore diversify (See, Blair M., Locking In Capital: What Corporate Law Achieved for Business organizers in the Nineteenth Century, 51 UCLA Law Review 387 (2003), 393.).

⁴¹ See La Porta R., Lopez-De-Silanes F. and Shleifer A., Corporate Ownership Around the World, Journal of Finance, vol. LIV., no. 2, April 1999, p. 471; Faccio M. and Lang L. H. P., The Ultimate Ownership of Western Corporations, Journal of Financial Economics, 65, 2002, 365-395; Bloch L. and Kremp E., Ownership and Voting Power in France, FEEM Working Paper No. 62-99, September 1999; Crama Y., Leruth L., Renneboog L. and Urbain J.-P., Corporate Governance Structures, Control and Performance in European Markets: A Tale of Two Systems.

⁴² The means used by majority shareholders to achieve control rights in excess of their ownership rights, such as dual class share structures, pyramiding and cross-holdings, will not be addressed as such.

widely held corporations with separation of ownership and control, whereas the second group is characterized by a concentration of ownership and control. We will focus here on the consequences of the latter with regard to governance issues as the consequences of the former can, in the last resort, be resolved by the sale of shares on the market, even if at a discount. In the first case, a market solution does exist but this is missing in the second case where a regulatory answer is therefore needed. Another reason for focusing on private companies is that the issues relating to public companies are and have been discussed much more extensively in existing corporate governance literature than those of private companies. We will start by drawing on the findings of the aforementioned studies of corporate ownership structures in large economies in order to illustrate the ownership patterns of both groups.

We will take three examples from countries where statistics show a concentration of ownership and voting power: France, Germany and Italy. Out of a sample of 500 unlisted companies in Germany, it was found that 90.6% of these were owned by a family or an unlisted company⁴³ and that the average controlling stake is 89.44%. In Italy, a sample of 3,800 unlisted firms revealed that in 99.4% of cases, the largest shareholder was a family or an unlisted company which held a direct stake of 70.71% on average. Another more detailed study revealed that out of a sample of 1,000 manufacturing firms, the largest owners were individuals in 48% of cases, or 36.9% for non-financial firms⁴⁴. Interestingly, the latter figure illustrates that the controlling/minority shareholder agency problem is likely to be found not only in family firms but also in groups of companies. The same observation can be made regarding France where a study on the ownership structure of 282,322 mostly unlisted firms shows that in 56% of cases, the largest single owner is a family, and is a company in the remaining 44%⁴⁵. As part of a survey based on 5,232 Western European public and private companies, M. Faccio and L. H. P. Lang examined 607 French companies. They found that 64.82% of these companies were controlled by a family or an unlisted firm and that only 14% were widely held. According to the same survey, the figures for Germany are 64.52% and 10.37% respectively, and 59.61% and 12.98% for Italy.

France, Germany and Italy have the smallest proportion of widely held companies among the countries considered in the survey⁴⁶ by Faccio and Lang. This information, combined with the fact that the average controlling stake is over 70% as noted above, shows that these three countries form a group in which corporate ownership and voting power are highly concentrated. Another group of countries in which this pattern exists, albeit to a lesser extent, consists of Belgium, Finland, Norway, Spain, Sweden and Switzerland. In these countries, the breakdown of corporations according to type of controller ranges between 20% and 40% for widely held firms and between 38% and 56% for family- or unlisted company-owned firms. At the other end of the spectrum, the UK and Ireland have 63.08% and 62.32% of widely

⁴³ Faccio M. and Lang L. H. P., (2002) *op. cit.*, 374.

⁴⁴ Bianchi et al. (1998).

⁴⁵ Bloch L. and Kremp E., (1999).

⁴⁶ Austria, Belgium, Finland, France, Germany, Ireland, Italy, Norway, Portugal, Spain, Sweden, Switzerland and the UK.

held firms respectively and 23.68% and 24.63% of companies controlled by a single family or an unlisted company.

Specific governance issues arise in companies where corporate ownership and voting power is concentrated and a family is the dominant shareholder, such as in the countries belonging to the first two groups above. Amongst such issues, we have identified agency costs resulting from the following specific circumstances: lengthy tenures for chief executive officers, the presence of a family member in the management team, the consequences of an emotional bond between the controlling shareholder and the company, and the particular attention paid to future generations of family members. Before we go on to describe why these circumstances can in the end lead to corporate governance failures, it must however be noted that private companies, and especially private family firms, can seriously rival listed companies precisely thanks to some of their corporate governance characteristics. We will mention these advantages before turning to the disadvantages, which generate agency costs⁴⁷.

Whereas agency theory describes how certain features of private company governance give rise to agency costs⁴⁸, stewardship theory provides a systematic explanation of the advantages of such governance⁴⁹. According to stewardship theory, the managers of a firm are not self-serving economic agents but rather persons who act for the greater good of the company and its stakeholders and who even display a certain degree of altruism⁵⁰. The dividing line between agency theory and stewardship theory reflects the radically different conceptions of the goal of the firm, *i.e.* the maximisation of shareholder value or the satisfaction of the various stakeholders' interests, already touched on above. Stewardship theory has its natural home in private companies dominated by one family since an emotional bond exists between the company and its owners and managers. Also, stewardship theory is based on psychology rather than economics, which is why its premises are different from those of the agency relationship. Under the stewardship theory, even though the interests of the managers and the

⁴⁷ On agency costs, see the seminal article of Jensen M. C. and Meckling W. H. (1976) Theory of the Firm: Managerial Behaviour, Agency Cost, and Ownership Structure, *Journal of Financial Economics*, 3, 305-360; see also Ross S. (1973) The Economic Theory of Agency: The Principal's Problem, *American Economic Review*, 63, 134-139; Eisenhardt K. M. (1989) Agency Theory: An Assessment and Review, *Academy of Management Review*, 14, 57-74.

⁴⁸ Although some authors argue that when the owner of a private company is also its manager, free-rider costs are lowered because they are not driven by short-term motives, and they have the inside knowledge and the incentive to run the company well (see Jayaraman N., Khorana A., Nelling E. and Covin J. (2000) Chief Executive Officer Founder Status and Firm Financial Performance, *Strategic Management Journal*, 21, 1215-1224).

⁴⁹ See Davis J., Schoorman R., Mayer R. and Donaldson L. (1997) Towards a Stewardship Theory of Management, *Academy of Management Review*, 22, 20-47; Donaldson L. and Davis J. (1991) Stewardship Theory or Agency Theory, *Australian Journal of Management*, 16, 49-64; Fox M. and Hamilton R. (1994) Ownership and Diversification: Agency Theory or Stewardship Theory, *Journal of Management Studies*, 31, 69-81.

⁵⁰ See Schulze C. R., Lubatkin M. H. and Dino R. N. (2003) Toward a Theory of Agency and Altruism in Family Firms, *Journal of Business Venturing*, 18, 473-490. See also Stewart A. (2003) Help one another, Use one another: Toward an Anthropology of Family Business, *Entrepreneurship Theory and Practice*, 27, 383-396; Becker G. S. (1974) A Theory of Social Interaction, *Journal of Political Economy*, 82, 1063-1093; Parsons D. (1986) The Employment Relationship: Job Attachment, Work Effort, and the Nature of Contracts, in Ashenfelter O. and Layard R. (eds.), *The Handbook of Labor Economics*, 789-848; Eisenhardt K. M. (1989) *op. cit.*, 57-74; Daily C. M. and Dollinger M. (1992) An Empirical Examination of Ownership Structure in Family and Professional Managed Firms, *Family Business Review*, 5 (2), 17-36; Fehr E. and Schmidt K. (2003) Theories of Fairness and Reciprocity. Evidence and Economic Applications, in *Advances in Economics and Econometrics*, ed. Dewatripont M., Hansen L. P. and Turnovski S., vol. 1, 208-257, Cambridge University Press.

principals differ, the managers will cooperate rather than defect as the economic rationale of the theory is that the manager finds greater utility in doing so. A concrete corporate governance consequence of this theory is that the role of directors should be to empower and facilitate the cooperative behaviour of the steward-manager⁵¹. This stance is different from that taken by agency theory, according to which the directors' role is to monitor and control the managers who would otherwise be likely to engage in strategies to maximise their own self interest. According to stewardship theory, the link between the directors' role and the performance of the company is that cooperative behaviour is expected to boost the financial performance of the company and therefore to be beneficial to the shareholders.

Although the positive aspects of the governance of private companies, *i.e.* the stewardship effects, cannot be denied (and this is certainly why the model of the company with a dominant shareholder or group of shareholders still survives today in opposition to widely held firms⁵²), it is hard to predict such behaviour and its duration, if applicable, because this is based on moral grounds, with agents "who are committed to make [the organization] succeed, even at personal sacrifice"⁵³. If the analytic instruments of neo-classical economics are used in this context and the agent is considered as being a self-serving agent, then agency issues arise⁵⁴. These agency problems result from the fact that it is more difficult in family firms to solve certain conflicts between the owners and to control unproductive actions⁵⁵. Paradoxically, the attitude of the neo-classical school of thought, often criticized for its aridity as it tends to ignore the psychological factors of decision making, is more realistic than that adopted by the stewardship approach which might seem overly optimistic.

We see that the emotional bonds between a founder, his family members whilst still in charge or his heirs subsequently and the company are used to explain the effects of stewardship theory. If this psychological aspect is often present in closely-held companies, its consequences are not always positive: the bond with the firm may backfire and generate intra-familial quarrels. So, the motive behind the advantages of closely-held companies itself turns out to generate specific agency costs for minority shareholders resulting, for instance, from the pursuit of two competing corporate strategies by two family clans.

⁵¹ See Chin Huat Ong and Soo Hoon Lee, Board Functions and Firm Performance: A Review and Directions for Future Research, *Journal of Comparative International Management*, Vol 3, no. 1 (2000).

⁵² According to a sociological approach, the survival of certain companies controlled by a single shareholder or a group of shareholders is due to the political connections that they have built within their jurisdiction, independently of their financial performances relative to industry peers. See for such an account Morck R., Stangeland D. and Yeung B. (2000), *op. cit.*; and also Morck R. and Yeung B. (2003), Family control and the "rent-seeking" society, *Entrepreneurship, Theory and Practice*.

⁵³ Miller D. and Le Breton-Miller I., Family Governance and Firm Performance: Agency, Stewardship, and Capabilities (2006) *Family Business Review*, 19, 74. See also Davis J., Schoorman R., Mayer R. and Tan H. (2000) The Trusted General Manager and Business Unit Performance, *Strategic Management Journal*, 21, 563-576.

⁵⁴ See for a criticism: Bruce N. and Waldman M. (1990) The Rotten Kid Theorem Meets the Samaritan's Dilemma, *Quarterly Journal of Economics*, 105, 155-165.

⁵⁵ See Handler W. and Kram K. (1988) Succession in Family Firms: The Problem of Resistance, *Family Business Review*, 1, 361-381.

It is not only in accordance with stewardship theory that the corporate governance of private companies is sometimes described as being beneficial to the principals. It has also been argued under agency theory that when there is only one single controlling shareholder, such shareholder has the incentive, power and information required to monitor the managers⁵⁶. In the same way, eliminating the separation between owners and managers, which is a frequent situation in private companies, is also sometimes said to lower agency costs because here again the owner-manager⁵⁷ has the incentive, power and information required to conduct the company's affairs well. The benefits to shareholders result from the fact that savings made by the reduction in agency costs then generate superior returns⁵⁸. Taking this argument to its logical extreme, some consider the sole-owner managed company as the zero agency cost model⁵⁹. Altruism has also led some authors to consider that family firms are best run without any formal corporate governance system⁶⁰ or that they are indeed the best form of corporate organisation⁶¹. According to one author, in family firms "Clan control implies goal congruence between people, and therefore, the reduced need to monitor behaviour or outcomes"⁶². However, if the controlling shareholder or owner-manager maximizes his self-interest, and that interest is different from the company's wealth maximization, we see on the contrary a strong possibility of minority shareholder abuse and therefore many reasons to bring the majority owner back within the scope of the control of principals.

Another characteristic of the corporate governance of companies controlled by a single shareholder or a group of shareholders acting in concert, usually a family, is that the average chief executive officer tenure in such companies is longer than in companies with no single controlling shareholder. The average tenure is 15 to 25 years against 3 to 4 years and sometimes less in large listed companies⁶³, which means that the chief executive officer of a family firm is expected to be more farsighted than his counterpart in other types of companies⁶⁴. This long duration of tenure can be explained by reputational effects, given that in these companies the family name is at stake⁶⁵.

One consequence of lengthy chief executive officer tenures is that these managers are expected to make fewer opportunistic, short term decisions that may have adverse effects in the future. This is certainly true to some extent of all non-listed companies, be they controlled by a single shareholder or by group of shareholders, because there is no pressure to show quarterly results to financial markets analysts. Actions which are potentially destructive of shareholder value such as the acquisition of

⁵⁶ See Anderson R. C., Mansi S. and Reeb D. (2003) op. cit., 263-285.

⁵⁷ See James H. S. Jr (1999) Owner as Manager: Extended Horizons and Family Firms, *International Journal of the Economics of Business*, 6, 41-56.

⁵⁸ See Jayaraman N., Khorana A., Nelling E. and Covin J. (2000) op. cit.

⁵⁹ Ang J. S., Cole R. A. and Lin J. W. (2000) op. cit.

⁶⁰ Jensen M. C. and Meckling W. H. (1976) op. cit., 305-360.

⁶¹ Daily C. M. and Dollinger M. (1992) op. cit.

⁶² Eisenhardt K. M. (1989) op. cit., 64.

⁶³ See Miller D. and Le Breton-Miller I. (2005) *Managing for the Long Run: Lessons in Competitive Advantage from Great Family Businesses*, Harvard Business School Press.

⁶⁴ See Davis J., Schoorman R., Mayer R. and Donaldson L. (1997) op. cit., 20-47.

⁶⁵ See Donaldson L. and Davis J. (1991) op. cit.

companies outside the scope of expertise of the company⁶⁶ or drastic cost cutting which damages the image of the company with its stakeholders are for this reason likely to be resisted by managers⁶⁷. Scientific studies also show that chief executive officers of this type of company are willing to make long term investments⁶⁸, although similar studies comparing investment in research and development by family and non-family firms vary according to country. Indeed, we found one study favourable to family firms in this regard⁶⁹, whilst another focusing on Canadian heir-controlled companies⁷⁰ argued that these companies under-invest in research and development compared to their industry peers⁷¹, and one final report on Swedish family firms concluded that they were over-investing in physical assets which itself causes problems⁷². Moreover, if a chief executive officer takes a more long-term view and resists hazardous investments and the company's financial returns are therefore boosted, the question of the payment of dividends then arises. Because of the absence of heavy capital expenditure strategies, several papers show that the dividend pay-out ratio (dividends/net income) is higher in family firms than in non-family firms⁷³. Despite the aforementioned stewardship effects, decisions on the payment of dividends are likely to give rise to agency problems between owner-managers or majority shareholders, on the one hand, and minority shareholders, on the other hand. It is interesting to note that historically, in the US, early charters and statutes provided that members could not withdraw their capital unless the company was dissolved. However these charters and statutes expressly provided that members could receive dividends out of operating profits, if not out of the permanent capital of the company⁷⁴. A link was thus established early on between the liquidity of the financial commitments of the investors, *i.e.* the right to exit the venture, and the right to receive payments out of it. Restrictions on the liquidity were offset by some degree of certainty as to the return on the investment.

In addition, there is mixed evidence regarding the argument above that companies dominated by one single shareholder or a group of shareholders are expected to be run with the long term interests of the company in mind because such shareholders remain with the company for a long time, as do the chief executive officers, and possibly with a view to transmission to their heirs. This is supposed to be one of the comparative advantages of these companies over widely held firms in which there is a risk that

⁶⁶ See Amihud Y. and Lev B. (1999) Does Corporate Ownership Structure Affect Corporate Diversification, *Strategic Management Journal*, 20, 1063-1039; Fox M. and Hamilton R. (1994) *op. cit.*

⁶⁷ Lavery, K. J. (1996) Economic "short-termism": The Debate, the Unresolved Issues, and Implications for Management, *Academy of Management Review*, 21, 825-860.

⁶⁸ The long tenure of chief executive officers also make it possible to run "executive apprenticeships" (Miller D. and Le Breton-Miller I. (2006), *op. cit.*) for future executives of the company through which they assist the outgoing managers and benefit from their inside knowledge and from their personal contacts.

⁶⁹ Weber J., Lavelle L., Lowry T., Zellner W. and Barrett A. (2003) *Family Inc.*, *Business Week*, November 10, 100-114.

⁷⁰ Empirical studies consistently find that companies run by heirs underperform their industry peers run by founders or professional managers, see Shleifer A. and Vishny R. W., (1997) *op. cit.* 783; La Porta R., Lopez-de-Silanes F., Shleifer A. and Vishny R. W. (1997) *op. cit.*, 1131-1150; La Porta R., Lopez-de-Silanes F., Shleifer A. and Vishny R. W. (1998) *op. cit.* 1113-1155. Also, on public markets, the announcement of the replacement of the founder by a scion usually triggers stock price declines and the control of the family firm passing to an outsider is usually greeted by a stock price appreciation.

⁷¹ Morck R., Stangeland D. and Yeung B. (2000) *op. cit.*

⁷² Högfeldt P., *The History and Politics of Corporate Ownership in Sweden*, working paper, Stockholm School of Economics.

⁷³ See Anderson R. C., Mansi S. and Reeb D. (2003) *op. cit.*, 263-285; Daily C. M. and Dollinger M. (1992) *op. cit.*; Gallo M. and Vilaseca A. (1996) *Finance in Family Business*, *Family Business Review*, 9, 387-401.

⁷⁴ See M. Blair, *Locking in Capital*, *op. cit.*, p. 430.

managers will focus on short term results with a view to triggering pay incentive mechanisms⁷⁵. However, as already stated above, the results of studies on research and development spending in family firms which is a sign of a long-term agenda are mixed, thereby weakening the assertion that long-term planning is necessarily better in companies dominated by a single shareholder or group of shareholders.

More generally, family firms share a characteristic with consequences for their corporate governance style in that they are supposedly run with the interests of the future generations of the family in mind. This is expected to generate stewardship effects for the company, as current managers will have an incentive to run the company with a degree of caution, in terms of debt strategy⁷⁶ for instance. Also, getting the company ready for transmission to the next generation of the controlling family puts particular pressure on management to maintain the company's reputation by building a strong brand for its products or by developing community involvement⁷⁷. Another advantage of this process is that ties with suppliers and clients are likely to take the form of long-term partnerships⁷⁸. The long-term view imposed by the perspective of a transfer of the control of the company to future generations is illustrated by one particular study conducted among French family firms which found that these companies invest significantly more in human resources than non-family firms⁷⁹.

In addition to the concentration of capital ownership, the nature of the agency relationship also depends on the degree of concentration of voting power. Further statistics on the control itself can help identify patterns in the connection between the degree of capital ownership and the degree of voting power. Two features may be used in this regard: firstly, the proportion of companies in which no shareholder other than the controlling shareholder owns more than 10% of the voting rights, *i.e.* where there is only one major shareholder, and secondly, the proportion of companies in which a member of the controlling family is in a management position, *i.e.* chief executive officer, honorary chairman, chairman or vice-chairman. Out of a sample of 3,300 closely held Western European companies, it was found that 53.99% had only one major shareholder and that 68.45% had a member of the controlling family in management⁸⁰. These figures show that power in the average closely held company in Western Europe is very highly concentrated as no shareholder other than the controlling shareholder holds more than 10% of the voting rights. This trend is even more pronounced in family-controlled companies as nearly 70% have a member of the family in management, further strengthening the controlling shareholder's grip on the company.

⁷⁵ Various studies have demonstrated that it is not the market itself that is short-termist as long-term capital expenditures generally boost the share price, see for example Hall B. (1993) *Industrial Research in the 1980s: Did the Rate of Return Fall?*, *Brookings Paper on Economic Activity*, 2, 289-343.

⁷⁶ Anderson R. C. and Reeb D. (2003) *Founding Family Ownership and Firm Performance; Evidence from the S&P 500*, *Journal of Finance*, 58, 1301-1328; Daily C. M. and Dollinger M. (1992) *op. cit.*; Gallo M. and Vilaseca A. (1996) *op. cit.*

⁷⁷ Ward J. (2004) *Perpetuating the Family Business*, Family Enterprise Publishers.

⁷⁸ Palmer D. and Barber B., *Challenges, Elites and Owning Families: A Social Class Theory of Corporate Acquisitions*, *Administrative Science Quarterly*, 46, 87-120.

⁷⁹ Allouche J. and Amman B. (1997) *Le Retour du Capitalisme Familial*, *L'Expansion*, 85, 92-99.

⁸⁰ Faccio M. and Lang L. H. P., *op.cit.*, 389.

The presence of family members in the management team gives rise to agency costs because these individuals will most certainly be entirely dependent on the majority shareholder. It is possible however that in companies where the chief executive officer is a member of the controlling family, agency costs may be reduced by having other family members among the top executives as they are probably the only persons capable of challenging an otherwise all-powerful chief executive officer: "family executives with common interests, mutual trust and job security are in an ideal position to present frankly their points of view to the leader, thereby countering excesses or blind spots"⁸¹. On the contrary, there is a risk that such an organisation may lack real dissenting views, for instance if the chief executive officer is also the family patriarch, and one possible solution would be to bring in outsiders so as to re-establish the balance of power amongst the controlling shareholders. The arguments mentioned above regarding the incentive to perform well for the company and knowledge required by a chief executive officer belonging to the controlling group of shareholders, typically a family, are also valid for other managers belonging to that same group. However, having several family members or members of the controlling group of shareholders within the company's management can have paralysing effects for the company if these individuals do not get along and if the company is therefore run by factions following personal strategies which may differ from the common interests of all shareholders.

We would adopt a more critical position regarding the corporate governance of private companies in which the owner acts as manager or where the manager has no autonomy with respect to the owner, and believe that the shareholding and governance structures of these companies generate agency costs more than they solve agency problems⁸². Lengthy tenures of chief executive officers may be a sign that the company's executives do not compete on the market for professional managers and choosing executives from among family members may mean that outside competence is lacking⁸³. One study shows that family firms run by family members are more likely than other types of company to be lacking in expertise and to encounter straightforward problems of incompetence because of the limited pool of potential managers on which to draw⁸⁴. Family management may therefore just be a nice way of talking about nepotism⁸⁵ and obviously the unbalanced exercise of power potentially leads to minority shareholder exploitation and agency costs.

⁸¹ Miller D. and Le Breton-Miller I. (2006), op. cit. See also Finkelstein S. and Hambrick D. (1996) *Strategic Leadership*, St Paul, West.

⁸² This statement is in contradiction with Jensen M. C. and Meckling W. H. (1976) op. cit., 305-360; Fama E. and Jensen M. C. (1983) *Separation of Ownership and Control*, *Journal of Law and Economics*, 26, 301-325; Ang J. S., Cole R. A. and Lin J. W. (2000) op. cit., 81-106.

⁸³ This is another example of the consequences of altruism which is hardly compatible with the necessity to sanction underperforming family members in management because it may have consequences on family relationships outside the realm of the company (See Schulze C. R., Lubatkin M. H. and Dino R. N. (2003) op. cit.).

⁸⁴ Hendry J. (2002) *The Principal's Other Problems: Honest Incompetence and the Specification of Objectives*, *Academy of Management Review*, 27, 98-113.

⁸⁵ See Ewing D. W. (1965) *Is Nepotism So Bad?* *Harvard Business Review*, 43, 22.

Various studies also paint a grim picture of companies dominated by a single shareholder or group of shareholders⁸⁶: low level of product innovation⁸⁷, entrenched executive management⁸⁸, frequent payouts in various forms⁸⁹ and risks of a general transfer of wealth from the company to the majority shareholders⁹⁰. What these problems have in common is that they are in various ways the result of an expropriation of the company's wealth which should have generated returns for all the shareholders. It is made possible because the majority shareholder or group of shareholders and the managers have access to, and control over, information resources in the company, whereas the minority shareholders do not. It therefore follows from this information asymmetry between the minority shareholders, *i.e.* the principals, and the majority shareholders and the managers appointed by them, *i.e.* the agents, that the latter can exploit the former if both parties do not share the same interests⁹¹.

This information asymmetry gives rise to two categories of agency problems: moral hazard and adverse selection. Moral hazard refers to situations in which the actions or omissions of the agent are harmful to the principal. Traditional illustrations of such actions or omissions include insufficient effort or "shirking" by agents⁹², spending on perks⁹³ and self-dealing in general, extravagant investments⁹⁴ or entrenchment strategies⁹⁵. Adverse selection occurs when the principal enters into a contract with an agent who is going to be less able or principled than expected and who is going to show interests which

⁸⁶ See for example Miller D. and Le Breton-Miller I. (2006), *op. cit.*

⁸⁷ See Ellington E. and Deane R. (1996) TQM Adoption Practices in the Family Owned Business, *Family Business Review*, 9, 5-14.

⁸⁸ See Gomez-Meja L., Nunez-Nickel M. and Gutierrez I. (2001) The Role of Family Ties in Agency Contracts, *Academy of Management Journal*, 44, 81-95.

⁸⁹ The financial health of family companies may be affected if a large number of family members who are shareholders rely on dividend payments to make a living and thus organize a permanent drain of capital from the company (see Chandler A., (1990) *Scale and scope*, Free Press).

⁹⁰ Burkart M., Panunzi F. and Shleifer A. (2002) Family Firms, *Journal of Finance*, 58, 2167-2202.

⁹¹ Companies with a dominant shareholder or group of shareholders seem to flourish where there is no other alternative due to poor public institutions (See Morck R. and Yeung B., *Special Issues Relating to Corporate Governance and Family Control*, World Bank Research Policy Paper 3406, September 2004, 10). This is how the prevalence of such companies in developing countries is often explained. Where the quality of public education is poor, the supply of well-trained managers will be low, which implies that there is a need for family members trained overseas to become managers. In addition, the demand for external managers is likely to be limited too if no corporate laws exist to limit management opportunism (Morck R. and Yeung B. (September 2004), *op. cit.* 5). It is in this context of weak institutions that reputation and long-term commitments are most beneficial because the State is too weak to infuse a sense of reliance in the economy. This context also affects the price of shares, which in turn gives no incentive to the family to sell out to a third party and thus family firms perpetuate as do adverse institutional factors (See Shleifer A. and Wolfenson D. (2002), *Investor Protection and Equity Markets*, *Journal of Financial Economics*, 66, 3-37; see also La Porta R., Lopez-de-Silanes F., Shleifer A. and Vishny R. W., (1999) *op. cit.*, 471-520). One might conclude that improving these institutional factors would see this type of company recede. However, this conclusion cannot be drawn in the various countries with efficient institutions where this type of company is prevalent, for example, in continental Europe. In those countries, certain provisions of the relevant tax codes provide a more plausible explanation, especially the absence of double taxation on dividends and the low level of inheritance tax.

⁹² Ross S. (1973) *op. cit.*, 134-139. See also for examples, Lansberg I. (1983) *Managing Human Resources in Family Firms: The Problem of Institutional Overlap*, *Organizational Dynamics*, Summer, 39-46.

⁹³ Jensen M. C. and Meckling W. H. (1976) *op. cit.*, 305-360.

⁹⁴ Michael Jensen gives a standard illustration of this with the example of investments by oil industry executives in the exploratory drilling in the 1970s at a time when real interest rates and exploration costs were high and increases in future oil prices were expected to fall, etc. These executives also invested large amounts of cash outside of their core business, see Jensen M. (1988) *Takeovers: Their Causes and Consequences*, *Journal of Economic Perspectives*, 2, 21-48.

⁹⁵ Entrenchment strategies include investing in lines of business where the decision-making executive is indispensable, for instance, investing in a declining industry where this executive has particular practical expertise, or using creative accounting methods so as to make the company's accounts look better, or being excessively conservative or taking excessive risks depending on whether the management performance is satisfactory or if it desperately needs to deliver good news to the owners, or resisting takeovers because the management's future position is at risk and thereby missing out on a good selling price for shareholders, or devising legal arrangements such as cross-ownership and holding structures that limit the power of shareholders.

depart from those of the principal. If information disclosure were perfect and costless and the parties' capabilities unbounded, complete contracts providing for any eventuality could be drafted whereby no moral hazard would arise since contractually-defined sanctions would be enforceable upon the agent by the principal⁹⁶. However, in real life, individual rationality is bounded, that is to say that the ability to process information and complexity and to make optimal decisions is limited⁹⁷, which is why contracts between principals and agents are incomplete⁹⁸. In addition, information is costly to obtain and thus partial, which implies that the principal is not in a position to monitor his agent efficiently. Adverse selection generates costs because the principal must engage in investigation and verification strategies, whereas moral hazard issues can be resolved through the use of incentive schemes, systems of sanctions and management practices aimed at aligning the interests of the agent with those of the principal. Mandatory information disclosure regimes and other corporate law provisions are designed for this purpose. However, according to the share capital structure, more information and increased incentives are not always sufficient to align the interests of minority shareholders, acting as principal, and majority shareholders, acting as agent, in closely held companies, and, in the last resort, an agency control mechanism in the form of a right for the principal to sell out will need to become a statutory provision.

These agency costs arise in the context of various distributions of ownership, *i.e.* if the manager is the largest shareholder or if the share capital is more widely dispersed and evenly shared between groups of shareholders and these groups have competing agendas. For instance, in the latter situation, which may be found in family firms, agency costs will arise for minority shareholders if they find themselves held hostage in the context of opposing strategies, for instance one group seeking payment of dividends opposed to another group supporting increases in capital expenditure⁹⁹. This view contradicts the aforementioned opinion that altruism makes the family firm the best model of corporate organization. A family is not a uniform entity and it is unlikely that its members will all have altruistic feelings toward each other when it comes to how their main source of revenue should be run. Quite the opposite in fact, and this is why these companies are on the contrary more prone than others to agency costs¹⁰⁰. Self-dealing also seems to be more frequent in family firms than non-family firms and the power of the controlling shareholder "keeps the potential whistle-blowers out of major corporate decisions, and thus reduces the risk of getting caught"¹⁰¹.

⁹⁶ Williamson O. (1975) *Markets and Hierarchies*, Free Press.

⁹⁷ Simon H. (1957) *Models of Man*, John Wiley.

⁹⁸ Williamson O. (1975) *op. cit.*

⁹⁹ Miller D., Le Breton I, Lester R. and Cannella A. (2005) *Family Involvement, Agency and Financial Performance in the Fortune 1000*, Working paper, HEC Montreal.

¹⁰⁰ Bergstrom T. C. (1989) *A Fresh Look at the Rotten Kid Theorem and Other Household Mysteries*, *Journal of Political Economy*, 97, 1138-1159.

¹⁰¹ La Porta R., Lopez-de-Silanes F., Shleifer A. and Vishny R. W., (1999) *op. cit.*, 510. See also Chrisman J. J., Chua J. H. and Litz R. A., June 2004 *op. cit.*, 335-354.

We will extend this analysis across the spectrum of voting power concentration and come back to the three groups identified above in relation to the dispersal of capital ownership, before considering whether the findings regarding these three groups remain consistent with regard to the concentration of voting power.

Closely held companies with a single major shareholder make up 64.75%, 59.90% and 58.76% of all closely held companies in France, Germany and Italy respectively which means a higher than average degree of concentration of voting power. The family-member-in-management factor is found in 62.20%, 61.46% and 70.00% of closely held companies in France, Germany and Italy respectively, a percentage slightly lower than the European average of 68.45% for the first two but still high. The high proportion of family members in management confirms that the agency problems requiring resolution in this type of company are different from those traditionally addressed by corporate governance literature and generated by the separation between ownership and management. These statistics show that closely held companies in these three countries may be categorized under a model of concentrated ownership of capital and concentrated voting power, where the agency problems to be addressed are between the controlling shareholders and the minority. Belgium and Switzerland should be set apart from Finland, Norway, Spain and Sweden within the group where, as shown above, the ratio of widely-held to closely-held companies is higher. In 71.15% of firms that are not widely held in Belgium, no shareholder other than the controlling shareholder owns more than 10% of the voting rights. In Switzerland, this percentage is 68.39%. When it comes to the concentration of voting power, both countries therefore belong to the first group. The same results appear for the family-member-in-management test, as in Belgium and Switzerland the controlling shareholder is in management in respectively 80 and 70% of family-controlled firms. In view of these statistics, both countries belong within the model of concentrated ownership of capital and concentrated voting power, alongside France, Germany and Italy, where the agency problems to be addressed arise primarily between the controlling shareholder and the minority.

Other countries of the second group, *i.e.* Finland, Norway, Spain and Sweden, have in common the fact that companies having a single controlling shareholder make up around 40% of all closely held companies¹⁰², below the average of 53.99%. The same trend can be found in the UK and Ireland where only 43% and 42.31% respectively of closely held companies have a single controlling shareholder. Ownership in closely held companies in these countries is therefore less concentrated than in the first group. However, these countries, *i.e.* Finland, Ireland Norway, Spain, Sweden and the UK, are in line with the average for the panel of 3,300 companies studied across Europe when it comes to the proportion of family members of the largest shareholder active in management, which ranges from 62.50% to 73.47%. It follows that a majority of closely held companies within the second and third groups of

¹⁰² Finland: 41.30%; Norway: 38.78%; Spain: 44.30%; Sweden: 48.32% (Faccio M. and Lang L. H. P., *op. cit.*, 389).

countries belong to a model of dispersed ownership and concentrated voting power where the agency problem arises between the various controlling shareholders and minority shareholders.

The conclusions that can be drawn from the data analysed are threefold: (i) regarding the ownership structure of companies in Western European countries, these companies are most likely to be closely held (except in the UK and Ireland), (ii) regarding the concentration of voting power among closely held companies, it has been seen that in one group of countries, the majority of such companies are controlled by several shareholders, whereas in another group there is one single controlling shareholder, and (iii) in a majority of closely held companies controlled by a single shareholder in the countries surveyed, the concentration of power is further enhanced as at least one member of the family of the controller is in management.

1.1.b. Scale effects

Another angle from which the ownership structure and the concentration of control of companies can be considered is the effect of scale. The data put together by M. Faccio and L. H. P. Lang¹⁰³ in their above-mentioned study indicates that on average 59.66% of the 50 smallest companies of their sample are owned either by a family or by another unlisted firm, and this is also true of 48.82% of 50 mid-sized firms sampled. On the contrary, the majority of the 20 largest firms are widely-held¹⁰⁴. Differences between countries are especially significant among larger firms, for instance, in the UK, Sweden and Ireland, 90%, 80% and 70% respectively of the 20 largest firms are widely held, whereas the survey average is 45.24%. Companies controlled at the 20% threshold by a family or another unlisted company represent 59.55% of the smallest companies surveyed, 48.82% of mid-sized companies and 27.24% of the largest companies. This structure of company ownership is where the agency problems between the controlling shareholder(s) and the minority occur and these figures can therefore help define the range of companies in which agency problems could potentially arise.

1.1.c. Average percentage of equity needed to control a firm

This data shows that this study is particularly relevant with respect to the French corporate landscape due to the concentration of ownership and voting power, including in listed companies, which is one of the highest amongst the Western economies. Agency conflicts are indeed likely to arise in companies where, as reported, there is no significant second largest shareholder. In such cases, the largest shareholder is likely to maximize his own utility function, which may not necessarily be increasing the company's profits but could for instance involve fostering relations with the company's customers or

¹⁰³ Data relating to 5,232 companies throughout Austria, Belgium, Finland, France, Germany, Ireland, Italy, Norway, Portugal, Spain, Sweden, Switzerland and the UK was used to construct the concentration of control and firm size table.

¹⁰⁴ Faccio M. and Lang L. H. P., *op. cit.*, 382.

suppliers, as no counterbalancing power exists. One study did indeed find that the financial performance of a firm increases with the level of control held by the second largest shareholder¹⁰⁵. From one angle, however, France is better placed than some other countries with regard to potential agency conflicts between shareholders because of the average percentage of equity required to control 20% of the votes: in France, for 607 firms sampled, this percentage was found to be 19.93%. On average, for 5,232 publicly-traded firms sampled in Austria, Belgium, Germany, Finland, France, Ireland, Italy, Norway, Portugal, Spain, Sweden, Switzerland and the UK, the percentage is 18.74%. Among these countries, Sweden alone stands out where only 9.83% of the capital can buy 20% of the voting rights. Except for Sweden, these figures mean that controlling shareholders have a stronger incentive to maximize profits as they have substantial cash flow rights in addition to their voting power. This is not to say however that this will be enough either to bring the interests of all of the shareholders into line because other motives may in fact drive the controlling shareholders or to ensure that managers are closely monitored because, as we have already seen, the controlling shareholder is anyway more often than not involved in management.

The risk of agency issues is increased by the recourse to “pyramiding” which is widely used in Sweden in particular and also in developing countries. Pyramiding, *i.e.* building up pyramids of companies, is used as a method to benefit from controlling rights within a company that are disproportionate in comparison with share capital ownership. This is done by controlling a holding company which in turn controls the companies belonging to the lower tier of the pyramid through a cascade of intermediate, controlled companies. Control can therefore be exercised with relatively little ownership and therefore with little financial risk¹⁰⁶. The agency problem in this case results from the fact that the interests of the controlling shareholder are not aligned with those of the other shareholders of the companies in the lower tiers of the pyramid, because the controlling rights of this particular shareholder are superior to the cash flow rights. In this context, the incentive to exploit minority shareholders is considerable. A common agency issue in pyramids is the transfer of wealth between companies within the pyramid, known as “tunnelling”^{107 108}. “Tunnelling [is] an agency problem where the controlling

¹⁰⁵ Crama Y., Leruth L., Renneboog L. and Urbain J.-P., *op. cit.* See on the value of control-block votes themselves, Nenova T., *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, *Journal of Financial Economics*, 68 (2003), 325-351.

¹⁰⁶ R. Morck and B. Yeung have calculated that “a million dollar hit on the value of Firm F ultimately translates into a fall of USD 17,596 in the value of the family firm at the apex of the pyramid. Thus, the ultimate controllers of firm F have a real financial stake of only 1.76% in that firm”; with Firm F being at the sixth level in a pyramid where each company holds 51% of the following one, (See Morck R. and Yeung B., September 2004, *op. cit.*, 5).

¹⁰⁷ Johnson S., La Porta R., Lopez-de-Silanes F. and Shleifer A. (2000) *Tunnelling*, *American Economic Review* 90, 22-27.

¹⁰⁸ Referring to the example of R. Morck and B. Yeung *supra*, tunneling implies that if the value of a Firm F rises by USD 1,000,000, the cash flow for the family firm at the top of the pyramid will be USD 17,596. Now, as the family controls all the companies down to Firm F, it controls Firm F and may order that the asset be sold to a company at its old price higher up in the pyramid, say Firm A. It follows that the additional USD 1,000,000 value will generate a cash flow of USD 510,000, instead of USD 17,596, for the family firm as 51% of Firm A is held by the holding company of the family (Morck R. and Yeung B., (September 2004) *op. cit.*, 7.). For a study on tunneling in Indian pyramids of companies, see Bertrand M., Mehta P. and Mullainathan S. (2002) *Ferretting Out Tunneling: An application to Indian Business Groups*, *Quarterly Journal of Economics*, February, vol. 117, 121-148; and regarding South Korea: Bae Kee-Hong, Jun-Koo Kang and Jin-Mo Kim (2002) *Evidence from Mergers by Korean Business Groups: Tunnelling or Value Added?* *Journal of Finance*, December, vol. 57, 2695-2740. These studies conclude that tunneling is

(cont'd)

shareholder moves wealth out of firms whose cash flows mainly go to public shareholders and into firms whose cash flows accrue mainly to the controlling shareholder”¹⁰⁹.

In terms of stewardship theory also, pyramids can be a problem as the controller of the holding company at the apex of the pyramid is more remote from the companies at the lower end and the psychological bond, necessary in order for stewardship effects to be beneficial, might be lacking. For these reasons, various studies have demonstrated that companies belonging to pyramids underperform in comparison with their industry peers¹¹⁰.

Institutional factors, such as the quality of public education, the efficiency of the enforcement of rules by the justice system, and corruption, explain the popularity of pyramids in developing economies. However, many Western countries continue to embrace the model of the single-controlled company. R. Morck has demonstrated that in these countries the reason for the prevalence of pyramids is often tax-related¹¹¹. In many countries (with the notable exception of the United States), dividends are taxed only once when paid by a company to an individual. In the United States, dividends are subject to double-taxation, that is to say that taxes are payable at each level where the dividend is paid and finally by the entity at the receiving end of the pyramid, so that by the time the dividend reaches the individuals at the apex of the pyramid, a large number of different taxes may be owed. Pyramids of companies therefore disappeared in the United States following the enactment of this tax regime was in the 1930s¹¹². Another life or death issue for pyramids of family firms is inheritance tax. This is particularly high in the United States whereas in Canada it has been reduced which certainly has an influence on the fact that “about half of Canada’s great corporations belong to family pyramids now (...) [where] in the 1960s, most Canadian firms were widely held”¹¹³. Also dwelling on institutional factors, Mark Roe has developed the idea that pyramids of family firms tend to flourish in social democracies while widely held companies are more common in countries that are more economically liberal¹¹⁴.

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important in the jurisdiction considered. On the contrary, M. Faccio and H. P. L. Lang ((2002) The Separation of Ownership and Control: An Analysis of Ultimate Ownership in Western European Companies, *Journal of Financial Economics*, vol. 65, 365-395) conclude that due to the legal environment, tunneling is not a widespread phenomenon in Western European companies.

¹⁰⁹ Morck R. and Yeung B. (September 2004) *op. cit.*, 7.

¹¹⁰ For a study of pyramids of companies in Canada, see Morck R., Stangeland D. and Yeung B. (2000) *op. cit.*; For a study of pyramids of Asian firms, see Claessens S., Djankov S., Fan J. and Lang H. P. L. (2002) Disentangling the Incentive and Entrenchment Effects of Large Shareholdings, *Journal of Finance*, vol. 57, no. 6, December, 2741-2771; For a study of pyramids of companies in emerging economies, see Lins K. (2003) Equity Ownership and Firm Value in Emerging Markets, *Journal of Financial and Quantitative Analysis*, March 2003, 159-184.

¹¹¹ Morck R., Why Some Double Taxation Might Make Sense: The Special Case of Inter-corporate Dividends, National Bureau of Economic Research, Paper 9651.

¹¹² In addition, pyramiding was expressly banned for public utilities. See Becht M. and DeLong B., Why Has There Been so Little Blockholding in America? National Bureau of Economic Research, June 2003.

¹¹³ Morck R. and Yeung B. (September 2004) *op. cit.*, 7.

¹¹⁴ See Roe M. (2003) *Political Determinants of Corporate Governance*, Oxford University Press.

1.1.d. Corporate governance and financial returns

Interestingly, widely held companies are more likely to be found in countries with good investor protection and conversely closely held companies in countries with poor investor protection, as if concentration of ownership and voting power was nurturing itself from poor investor protection and vice versa. One explanation could be that controlling shareholders lack incentives to sell out to dispersed shareholders because poor investor protection fails to generate attractive share prices. The link between corporate governance and financial performance, reflected in share prices, has indeed now been well established. A recent study, based on the assumption of the superiority of the U.S./UK corporate governance model, found that “companies in countries with a legal system of English origin earn returns on investment that are at least as large as their costs of capital. Companies in all countries with civil-law systems earn on average returns on investment below their costs of capital”¹¹⁵. One should however be wary of findings regarding the supposed superiority of the Anglo-American legal regime over its French equivalent. With respect to the nineteenth century, Profs. Lamoreaux and Rosenthal have thus demonstrated that traditional ideas about the greater flexibility of common law were in fact a misconception¹¹⁶.

One way of showing the relation between corporate governance and financial returns is to compare dividend payments, a good sign of the absence of agency problems between managers and shareholders or owners-managers and minority shareholders¹¹⁷, with Tobin’s q , *i.e.* the ratio of return on a company’s total capital to its cost of capital. Admittedly, this measure can be flawed as the optimal dividend payout will vary with the amount of cash flow at hand and the number of investment opportunities, which themselves depend on various factors. This is why the findings mentioned above rely on the ratio of a company’s returns on investment to its cost of capital (qm), which “identifies overinvestment whatever a firm’s investment opportunities and cash flows are”¹¹⁸. Under this model, for a firm that maximizes shareholder wealth, we have $qm \geq 1$ since the average return on investment should be equal to or greater than the marginal return. Tellingly, the authors found for example that for France, rated as a poor corporate governance country, qm is 0.57¹¹⁹. For the UK and the U.S., qm is 0.85 and 1.05 respectively¹²⁰. When firms are categorized by capital structure, the same study found that family

¹¹⁵ Gugler K., Mueller D. C. and Burcin Yurtoglu B., Corporate Governance and the Returns on Investment, *Journal of Law and Economics*, vol. XLVII, October 2004, 589-633.

¹¹⁶ Lamoreaux N. R. and Rosenthal J.-L., Legal Regime and Contractual Flexibility: A Comparison of Business’s Organizational Choices in France and the United States during the Era of Industrialisation (2005) 7 *American Law and Economics Review* 28-61. See also Guinnane T., Harris R., Lamoreaux N., Rosenthal J.-L. Ownership and Control in the Entrepreneurial Firm: An International History of Private Limited Companies, Center Discussion Paper n° 959, Economic Growth Center, Yale University, December 2007.

¹¹⁷ It is assumed that the growth-oriented agents will overinvest and thus pay out fewer dividends to principals, as developed in the managerial literature. See for example, Stultz R., Managerial Discretion and Optimal Financing Policies, 26 *Journal of Financial Economics*, 1990, 3.

¹¹⁸ Gugler K., Mueller D. C. and Burcin Yurtoglu B. *op. cit.*, 591.

¹¹⁹ Based on 495 firms sampled.

¹²⁰ Based on respectively 1,331 and 8,591 firms sampled.

firms in countries with an Anglo-American legal system had a *qm* of 1.082 and countries with a French-inspired legal system had a *qm* of 0.569¹²¹.

The fact that the model of corporate governance is a determinant of financial performance is also illustrated by the higher valuation of companies around the world that cross-list their shares in the U.S. This is because controlling shareholders of these firms are faced with greater limitations on their use of the private benefits of control¹²².

1.1.e. Agency costs of debt in private companies

The data analysed above paints a different picture to the model studied by Berle and Means in "The Modern Corporation and Corporate Property" which focused on the separation between shareholders and management due to the widely dispersed nature of the companies on which they based their work. However, in the majority of companies, whether listed or unlisted and in particular if family run, that have no significant second largest shareholder and with family members in management, we have seen that agency conflicts arise not between shareholders and management but between majority shareholders and minority shareholders. We will now verify if the observations made so far with regard to agency conflicts in family firms from the point of view of equity investors also apply to debt investors¹²³, which is an important factor given that in the absence of funding from the public equity markets, debt is the main source of finance for closely held companies.

Tapping private debt markets, essentially through bank loans, entails the monitoring of management or the majority shareholder by the lenders¹²⁴. In France, financing for small and medium companies is often split equally between equity, bank lending and financing through suppliers¹²⁵. The main advantage of debt in most jurisdictions is that the financial interest is tax deductible and provides financing to the company without diluting value for existing shareholders. Heavily indebted companies are more likely to generate larger sales volumes and higher net income and gross profit than companies having raised money with an external shareholder, which reflects the fact that indebted companies

¹²¹ Gugler K., Mueller D. C. and Burcin Yurtoglu B. op. cit., 608.

¹²² See Doidge C., Andres Krolyi G. and Stulz R. M., Why Are Foreign Firms Listed in the U.S. Worth More? *Journal of Financial Economics* 71, 2004, 205-238.

¹²³ Anderson R. C. et al., Founding Family Ownership and the Agency Cost of Debt, *Journal of Financial Economics* 68 (2003) 263-285.

¹²⁴ See for instance Diamond D. (1984) Financial Intermediation and Delegated Monitoring, *Review of Economic Studies*, 51, 393-414; Myers S. (1977) Determinants of Corporate Borrowing, *Journal of Financial Economics*, 147-175; Garcia-Marco T. and Ocana C. (1999) The Effect of Banking Monitoring on Investment Behavior of Spanish Firms, *Journal of Banking and Finance*, 23, 1579-1603.

¹²⁵ See Duchéneaut B., (1995) *Enquête sur les PME françaises. Identités, Contextes, Chiffres*, ed. Maxima, 480. See also for data on other countries: Berger A. and Udell G. (1995) Relationship Lending and Lines of Credit in Small Firm Finance, *Journal of Business* 68, 351-382; Bittler M., Robb A. and Wolken J. (2001) Financial Services Used by Small Businesses: Evidence from the 1998 Survey of the Small Business Finances, *Federal Reserve Bulletin*, 183-205; Cole R., Wolken J. and Woodburn L. (2001) Bank and Non-bank Competition for Small Business credit: evidence from the 1987 and 1993 National surveys of small business finances, *Federal Reserve Bulletin* 82, 983-995.

conquer greater market shares using better quality products¹²⁶. These operational performances show that debt puts pressure on management to maximise the company's wealth, thereby aligning management's interests with the interests of the owners. Managers are indeed under pressure to pay off debt, which means generating sufficient cash flows, and thus reduces agency costs. The pressure on management or on the owner-manager resulting from debt is twofold: firstly, there is the risk of bankruptcy which would have a direct impact upon the personal situation of managers or the owner-manager¹²⁷, and secondly, paying off debt reduces the available cash flow which could be diverted to satisfy their own utility function¹²⁸. Reducing the amount of cash flow within the company therefore limits potential opportunism by managers and owner-managers. Empirical studies have shown a common trend among managers to engage in strategies financed by available cash flow which increase the size of the company beyond its optimal size with respect to maximization of shareholder value¹²⁹. This empire-building argument concerns managers of large and listed companies more than managers of closely held companies. In closely held companies, the agency costs of free cash flows are more likely to take the form of these funds being diverted into extra remuneration for a majority owner-manager instead of being used to pay dividends to all shareholders. Legal statutes providing for the disclosure of remuneration paid in the company are one control mechanism for this agency issue¹³⁰. On financial markets, a similar pressure is exercised by investors encouraging managers to use available cash flows to pay dividends, which is perceived as an incentive to raise further funds on equity markets. Without public equity markets to be tapped for closely held companies, debt thus functions as an incentive and therefore as an agency control mechanism. In family firms in particular it seems that the cost of debt is lower because the interests of the family are said to be aligned with those of the bondholders¹³¹. One reason is that family owners are likely to have invested a large part of their wealth in their company. In addition, the reputation

¹²⁶ See Stephany E. (1998) *Analyse de l'Impact d'un Financement par Capital Risque sur l'Organisation et le Management de la PME*, in *PME, de Nouvelles Approches*, Coordination O. Torrès, Economica, coll. *Recherches en gestion*, 112.

¹²⁷ See for instance Grossmann S. and Hart O. (1982) *Corporate financial structure and managerial incentives*, in *The economics of information and uncertainty*, J. Mc Call ed., University of Chicago Press.

¹²⁸ See Jensen M. C. (1986) *op. cit.* 323.

¹²⁹ See Donaldson G. (1984) *Managing corporate growth*, Praeger. See also Jensen M. C. (1989) *The Takeover Controversy: Analysis and Evidence* in Stern J. M., Stewart G. B., Chew D. H., eds. *Corporate Restructuring and Executive Compensation*, The Institutional Investor Series in Finance, Ballinger, Cambridge, 1989, 13.

¹³⁰ See Art. L. 225-102-1 of the French Commercial Code: "The report referred to in Art. L. 225-102 gives details of the total remuneration and benefits of all kinds paid to each executive during the financial year, including allotments of capital securities, debt instruments or shares giving access to the capital or giving entitlement to an allotment of debt instruments of the company or companies referred to in Articles L. 228-13 and L. 228-93.

It also indicates the amount of the remuneration and benefits of all kinds that each of those executives received during the financial year from controlled companies within the meaning of Art. L. 233-16 or from the company which, within the meaning of that same article, controls the company in which they performed their functions.

It also includes a list of all the duties and functions performed by each of those executives in any company during the financial year.

It also includes information, as stipulated in a *Conseil d'Etat* decree, on the manner in which the company takes account of the social and environmental consequences of its activities. The present paragraph does not apply to companies whose securities are not admitted to trading on a regulated market.

The provisions of the first and second paragraphs do not apply to companies whose securities are not admitted to trading on a regulated market and which are not controlled, within the meaning of Art. L. 233-16, by a company whose securities are admitted to trading on a regulated market. Nor do they apply to executives who do not hold any remit in a company whose securities are admitted to trading on a regulated market".

¹³¹ On the contrary, when the chief executive officer of the firm is a member of the founding family, the study found that the cost of debt financing increases because of agency problems.

of the company exercises a major effect and these owners are supposed to want to pass the company on to their descendants in good condition. On the contrary, shareholders in widely-held firms have incentives to expropriate the bondholders by investing in risky ventures because if such ventures prove successful, the shareholders reap the rewards, and if they fail, the bondholders bear the costs.

One advantage of private debt such as bank lending over tapping public debt markets is that there is no collective action problem when the lenders are banks. Collective action problems are found in public placements of bonds when the lenders are a group of investors with no personal incentive to monitor the management of the issuer, a phenomenon similar to that encountered by shareholders of widely held companies where no shareholder owns enough of the company to make the monitoring of costs profitable¹³². In this respect, lending banks can in fact be compared to controlling shareholders. If the loan is syndicated, this monitoring role will fall to one of the banks, which will take a certain percentage of the loan and receive an additional fee for monitoring the covenants of the borrower on behalf of the other banks to which the rest of the debt has been syndicated. Moreover, just as shareholders who invest more than the other shareholders in a company therefore take on more of the risk and are rewarded with a greater share of the internal decision-making power, lenders can end up taking over the management of the borrower if the investment goes beyond a certain risk threshold. This was for instance the case for the Eurotunnel Group, where secured lenders often threatened to take over the company's management if no agreement was reached regarding the restructuring of the company.

Providers of private debt such as commercial banks can only act as an efficient agency control mechanism if they monitor the solvency and liquidity of the borrower and control their own value at risk, rather than simply seek to develop commercial relations. If commercial banks were to compromise on liquidity and solvency ratios in favour of borrowers in order to attract new business or develop existing commercial relations with them, these commercial banks would be on the side of the person choosing the banks, *i.e.* the managers¹³³. These circumstances can potentially trigger opportunistic behaviour by managers who enter into lending agreements with commercial banks, which help them in their entrenchment strategies. Before the credit crisis, the legal terms and conditions of loan facilities offered a way for bankers to differentiate their bids to provide finance, especially acquisition finance. Such legal terms were favourable to the borrower in that the solvency and liquidity ratios were less demanding, meaning for instance that a lower EBITDA in the EBITDA/net debt or EBITDA/financial interest ratios did not trigger the facility's early-repayment provision. A broader definition of EBITDA could also be accepted which again was favourable to management because it made it easier to meet the target ratios. We see that on a borrower's market, such as up until mid-2007, the borrowing company benefited from

¹³² See for instance on the agency costs of debt: Anderson C. and Kakhija A. (1999) Deregulation, Disintermediation and Agency Costs of Debt: Evidence from Japan, *Journal of Financial Economics* 51, 309-339.

¹³³ See Cole R. (1998) The Importance of Relationships to the Availability of Credit, *Journal of Banking and Finance*, 22, 959-977; Petersen M. and Rajan R. (1994) The Benefits of Lending Relationships: Evidence from Small Business Data, *Journal of Finance*, 49, 3-38.

aggressive financial terms, *i.e.* lower interest rates, which is good for the shareholders as free cash flow is calculated after payment of financial interest. However, other terms resulting from a borrower's market usually included provisions that were favourable only to management because they were less demanding with regard to the company's future financial performance (measured by the amount of EBITDA in the examples above). This situation therefore generates an agency problem as the interests of management and shareholders are not aligned and, on such terms, debt does not work as an agency control mechanism. This could make commercial sense for lenders because even if they accepted a less favourable risk/reward ratio, commercial bankers could mutualise their risks on the syndication market. However, the borrower's minority shareholders have no such ways to mitigate risks and they stand to lose out when monitoring of the borrower's financial performance by the banks is less stringent as they are then lacking one external agency control mechanism. One particular study was based on the terms of facilities on data collected from Form S-4 documents filed with the SEC under Rule 144A¹³⁴ between 1 January 2002 and 31 December 2004 regarding loans to privately held businesses in the context of a leveraged buy out. One such legal provision aimed at protecting lenders against an outside event adversely affecting the financial condition of the borrower is the material adverse clause (known in financial parlance as a MAC clause) which has generally been particularly weakened in recent years. Material adverse change events usually include an event or matter which is, or is reasonably likely to be, materially adverse to (i) the business, assets, financial or legal condition or prospects of the borrower or its group taken as a whole and (ii) the ability of the borrower to perform any of its payment obligations or comply with the financial ratios under the facility agreement. According to the survey, 85% of material adverse change provisions included carve outs, *i.e.* a provision destined to describe what lenders can and cannot legally claim should a material adverse change in the company's performance occur. This amounts to mitigating the consequences of a breach of the material adverse change clause by the borrower. Consequently, this gave the managers the wrong signal from an agency-cost point of view. More specifically, it appears that in 75% of the deals surveyed, the lenders conceded that an event affecting the general economic or business conditions of the borrower would not be a material adverse change. This does not bode well for the monitoring of the actions of the management. However, in the event of a change in accounting methods, one area in which management opportunism can arise, only 21% of the loans tracked by the survey carved out "changes in GAAP" within their material adverse change clauses.

Debt can therefore be an efficient agency control mechanism because it limits the freedom of action of managers and controlling shareholders. However, collective action problems and, in times of credit boom, the existence of captive lenders may affect the potential benefits from debt expected by principals.

¹³⁴ "What's market?" survey conducted by New-York law firm Kaye Scholer, cited in Why Legal Terms have Become a More Potent Ingredient in Buyout Bids (January 2006) Capital Eyes, Bank of America.

1.2 The situation in France

1.2.a. Peculiarities in the capital structure of French listed firms

It is worthwhile taking a closer look, from a quantitative standpoint, at the situation in France, to which we will often refer for examples because of the concentration in company shareholding and voting power found there. France is indeed a good example because conflicts of interest between shareholders and between shareholders and managers, which are agency problems, still persist despite a statutory provision in the French Civil Code (*Code civil*) providing that companies must be run in the interest of all shareholders, this interest being the maximisation of their wealth. An in-depth study by Laurence Bloch and Elizabeth Kremp of ownership and voting power in French companies¹³⁵ confirms and provides details in support of the results mentioned above concerning France.

One interesting finding is that, as previously indicated, the level of ownership by the largest shareholders is high even in companies which could be expected to be widely held because listed. Regarding companies listed on Euronext Paris and quoted on the CAC 40 index, the authors found that the average holding of the largest shareholder is 29.4% and, more importantly, that the second largest shareholder lags far behind with an average holding representing only 6.4% of the voting power, the third largest holds on average 3% and from the sixth to tenth largest shareholders hold an aggregate of 3.2%. Among the companies making up the CAC 40, one single shareholder holds one half or more of the voting rights in 25% of companies, while in 40% of these, this stake is in excess of one third¹³⁶. The average ownership stake of the largest shareholder in CAC 40 companies ranges between 27% and 52%.

These figures show that concentration of ownership and voting power is therefore not specific to closely held companies in France. This observation is surprising because the liquidity of a market requires an atomicity of players, which means that concentration can impair its operation. It was also not expected that listed companies could have agency problems resulting from the concentration of ownership and voting power rather than from the separation of ownership and management, which again inspires most of the thinking on corporate governance. For example, just before it was bought out by AS Watson, Marionnaud, a company listed on Euronext Paris' first market, had members of the family of the founder and, at that time, largest shareholder occupying four seats on the board and three of the four top executive posts. In such a case, the parties to potential agency conflicts are likely to be small shareholders versus large shareholder(s) rather than shareholders versus management. One illustration of such potential problems is the € 97 m. "accounting error" disclosed by Marionnaud in December 2004.

¹³⁵ Bloch L. and Kremp E., Ownership and Voting Power in France, July 1999.

¹³⁶ Ibid. p. 9.

Even though concentration of ownership and voting power can also be found in listed companies in France, the market for shares as well as the statutory protection of minority shareholders provide answers to any potential expropriation of the minority. It is therefore less of a cause for concern than in private companies and, again, as it constitutes the primary domain of thinking on corporate governance, has already been extensively dealt with.

Another recent example is Ubisoft, a Paris-listed firm in which the founding family was until recently the largest shareholder with 15% of the shares and 22% of the voting rights and where the founder is both chairman and chief executive, whilst his brothers occupy four seats on the board. After another major player in the computer games sector acquired a 20%-stake thereby becoming the largest shareholder, the business press reported that the founding family had called this move “hostile” and was examining a possible shareholder agreement with other Ubisoft shareholders, including a French State-owned bank. This illustrates how, because of the perpetuation of large ownership and voting rights stakes, the behaviour of large shareholders of unlisted companies, such as a reluctance to relinquish control, can continue even after a flotation.

1.2.b. Categories of main shareholders in French companies

When it comes to the ownership of French privately held companies, the survey by Bloch and Kremp confirms the high degree of concentration. On average, the largest shareholder of a privately held company owns 66% of the share capital and this already high figure increases in direct proportion to the size of the company. The figure is 63% for companies with fewer than 20 employees and 88% for those with 500 to 2,000 employees and over 2,000 employees. Further data shows that “65% of French [unlisted] companies have individuals as owners of their capital and on average these individuals hold half of the capital”¹³⁷. Non-financial firms and holdings are respectively the second and third largest shareholders with on average 28% and 9% of the share capital.

The type of main shareholder can teach us something with respect to potential agency problems. For instance, studies have shown that in listed companies institutional investors usually take little action against management that does not have their approval. Agency problems are therefore not likely to be solved through corrective actions by such shareholders. This is because they have the opportunity to vote with their feet by selling their stake. More significantly however, private equity firms investing in a position in an unlisted company, be it a majority or a minority position, usually take an active role in monitoring management, for instance by occupying seats on the board of directors. This difference has to do with the fact that private equity investors have no obvious exit strategy options apart from selling to the management through an LMBO or to an industrial buyer, by way of an LBO or otherwise, or seeking

¹³⁷ Ibid. p. 13.

an initial public offering. Consequently, those firms cannot act as sleeping partners as institutional investors have until recently tended to do in listed companies, especially in Continental Europe. For private equity funds, no matter the stage of their investment (*i.e.* when investing seed capital or when targeting large, mature companies), the close monitoring of management is deemed essential. It can thus be expected that such investors will try to solve agency conflicts arising with another large shareholder, typically the founder's family, and management, often itself made up of family members. To avoid insoluble problems, they will have put in place contractual measures concerning the illiquidity of their investment, for example by concluding tag along agreements.

The situation is different for individuals, making up the vast majority of the largest shareholders in French unlisted companies, who can have a variety of motives for running a company. Profitability may be one of them, but enjoying the private benefits of control for another end may be another. The same goes for companies, be they non-financial companies or holdings, which make up the second largest shareholder group in French unlisted companies¹³⁸. The minority is particularly at risk in groups of companies where the interests of the parent company could potentially interfere with those of the subsidiary. For instance, a subsidiary may buy a business from its parent company by issuing new shares at a large discount, causing a greater than necessary dilution of the minority. Ways to prevent such conflicts of interest exist in the legal systems of major economies but they rely in the last resort on the approval of the transaction by the shareholders, which limits the efficiency of such devices when the party involved is the majority shareholder. It should however be noted that, under French law, the protection resulting from such devices has improved since the enactment in 2003 of a law providing the application of procedures to prevent conflicts of interest including for transactions involving the company and any of its shareholders holding more than 10% of the voting rights (related party agreements)¹³⁹. Previously, only transactions conducted between a company and a member of its management or board, as well as between two companies having managers or board members in common, were subject to this monitoring procedure.

It should also be noted that the concentration of ownership in French unlisted companies is further confirmed by the figures relating to foreign ownership. Although foreign firms own only 3% of the total capital of such companies, they own next to 80% of the capital of each such company¹⁴⁰.

As the figures above show, the capital and voting structure of French companies are amongst the most concentrated in Western economies. This is a context in which agency conflicts can potentially be the most severe and this is why we will make frequent reference here to French law. A second reason for referring to French law is less factual and has more to do with the company law system itself: as opposed

¹³⁸ Ibid, p. 13

¹³⁹ Art. L. 225-38 of the Commercial Code modified by law 2003-706 dated 1 August 2003.

¹⁴⁰ Bloch L. and Kremp E. (1999), *op. cit.*, p. 15.

to U.S. and UK company law, there is no statutorily organised exit route for shareholders under French law which we would argue to be the most efficient protection against agency conflicts between majority and minority shareholders. Existing legal devices used to prevent and solve agency problems will therefore be assessed before reaching the conclusion that an exit option is the most efficient remedy in closely held companies. French law stands out among legal systems lacking such a mechanism because of the existence of a statutory provision explicitly stating that shareholders share a common interest and defining what this common interest is, thus ruling out, in theory, any conflict of interest. It provides that the company should be run in the interest of the shareholders and that this interest is to share out corporate profits¹⁴¹. This rule looks like an efficient tool to mitigate adverse consequences of conflicts of interest in court. Despite this, it has proved to be disappointing in practice as judges have not consistently relied on this article 1833 when considering actions which were harmful either to the minority or the majority. Our analysis will start from this provision epitomizing the unity of shareholders' goals and the conflicting interpretations to which this has given rise.

With article 1833 of the French Civil Code (*Code civil*), French law provides an essential safeguard against the hubris of the majority in companies with no market for their shares. This provision is applicable to public and private companies alike as defined by both company and securities law and to every form of company under French law. It provides that a company must be formed in the common interest of its shareholders. Combined with article 1832 of the same code which states that the company is formed in order to share corporate profits among shareholders, article 1833 gives a clear view of what the interest of the shareholder is, *i.e.* seeking to generate and distribute profits.

The common interest of the shareholders is an important concept as decisions and actions by shareholders, management and the company itself need to be monitored against this standard. However, despite the clarity of both of the aforementioned provisions, the French courts rely on other notions such as the corporate interest (*intérêt social*) or the interest of the firm (*intérêt d'entreprise*) which remain undefined by either statute law or case law. For this reason, it is hard to know with any degree of precision what these notions amount to. In the mind of their proponents, the corporate interest and the interest of the firm constitute something more than the shareholders' common interest of wealth maximisation. It encompasses the interest of the various stakeholders (namely employees, customers, suppliers and society at large) that the company encounters in the normal course of its business. Such corporate interest is sometimes called "corporate social responsibility" in public companies.

¹⁴¹ The common interest of the shareholders is a requirement which is laid down by Art. 1833 of the French Civil Code (*Code civil*): "*Toute société doit avoir un objet licite et être constitué dans l'intérêt commun des associés*". (Every company must have a lawful purpose and be formed in the common interest of the members). On the importance of the notion of common interest, see Schmidt D., *De l'Intérêt Commun des Associés*, JCP 1994, Ed. G, I, no. 41, p. 440. See also the development regarding the notion of shareholders value maximisation in the introduction.

Even though much of the debate surrounding “corporate social responsibility” has flourished in public companies, identifying the goal of a company also has practical consequences in private companies. In private companies, when minority shareholders have no means to object to the policies followed by the majority and no means of exit from the company, it is of particular importance that the majority adheres to the goal of the company as the distribution of corporate profits to shareholders, as set out in articles 1832 and 1833. Indeed, with no market or external public scrutiny, the controlling shareholder of a private company needs to be constrained not to run the company in his sole interest and to the detriment of other members, for instance by voting reserved capital increases, thereby further diluting the minority.

As opposed to public companies, the risk in private companies, because of the lack of external safeguards, is related more to a diversion of the company’s profits or business by the majority than to the use of the corporate assets to “do good” instead of generating profits in a socially responsible company. At this point, article 1844-1 of the French Civil Code (*Code civil*) proves useful because it provides that members share in corporate profits according to their share in the capital of the company, except if provided otherwise in the articles of association. Any limits imposed via contractual adjustments to this principle, which would exclude a member from sharing in the profits (or contributing to losses), are prohibited as being unconscionable provisions¹⁴².

This framework of statutory provisions, consisting of articles 1832, 1833¹⁴³ and 1844-1, is a sound starting point from which to solve conflicts of interest. This is most useful, in theory at least if not in practice, in private companies where there is no investor protection based on stock market regulations. A distinction can indeed be made between listed companies and private companies with regard to the protection of minority shareholders and this is not specific to French companies. Listing on a stock market gives a specific rationale for protecting minority investors in addition to the grounds provided by company law. In listed companies, the prime rationale for such protection, for instance on the occasion of a transfer of control, is not to benefit minority investors as such, but to ensure the correct operation of the market through improved transparency and liquidity. The same is true of competition law and consumer protection on the market for goods and services: consumer protection is not a goal in itself for competition law (as opposed to consumer law), but is a by-product of the atomicity of players made possible by the regulation. The importance of securities regulation and its own rationale within the larger body of rules governing listed companies means that such companies are best described via an institutional rather than a contractual analysis. The fact that the listed company operates more as an

¹⁴² Art. 1844-1, para. 2, French Civil Code (*Code civil*).

¹⁴³ The common interest of the shareholders is a requirement which is laid down by Art. 1833 of the French Civil Code (*Code civil*): “*Toute société doit avoir un objet licite et être constitué dans l'intérêt commun des associés*”. (Every company must have a lawful purpose and be formed in the common interest of the members). On the importance of the notion of common interest, see Schmidt D., *De l'Intérêt Commun des Associés*, JCP 1994, Ed. G, I, no. 41, p. 440. See also the development regarding the notion of shareholders value maximisation in the introduction.

institution than as a nexus of contracts gives a higher degree of autonomy to its management in its relations with the shareholders' general meeting. This raises various agency problems that the corporate governance literature concentrating on large companies has sought to address. However, this corporate governance thinking has not paid much attention to private companies because the contract remains the analytical framework and it is assumed that with owner-managers in charge, there is no separation between the ownership of the company and its control and that specific measures mitigating agency conflicts are therefore not needed. However, as we have already seen, specific agency problems do affect closely held companies. In this context, French law, with shareholder wealth maximisation enshrined in the statutes, provides, at least theoretically, an efficient safeguard.

Yet even the questions raised by the separation of ownership and control are not completely solved, as shown by the corporate scandals of recent years involving the management of listed companies in the U.S. and France. The reaction has been the enactment of new statutes aimed at strengthening internal control procedures, such as the Sarbanes-Oxley Act in the U.S. and the *Loi de Sécurité Financière* dated 1 August 2003 and *Loi pour la Confiance et la Modernisation de l'Economie* of 26 July 2005 in France¹⁴⁴. Nevertheless, the rationale behind such regulations, as well as the political pressure to enact them, is to tackle agency problems resulting from the separation of ownership and control in large public companies and not those resulting from the concentration of ownership and voting power. Yet private companies also suffer from the governance problems identified so far by us on the basis of data on the ownership and control of private companies. In addition, a structural flaw affects the organisation of private companies as shareholders, through a combination of the majority rule with the absence of a market for the shares, cannot be ousted from control and may thus freely depart from the principle of shareholder wealth maximisation. In private companies, concentration of ownership and voting power generates principal-agent relationships between minority and majority shareholders. We will see below that this phenomenon is widespread, even in listed companies where it is less expected. This is because the rules governing initial public offerings only allow the sale of a small proportion of the company's share capital. It follows that it is not uncommon for these companies to remain controlled by their founders. Consequently, smaller Paris-listed companies still encounter issues relating to boardroom representation and independent directorships¹⁴⁵. Even on a major stock market, a founder and his family who own a minority stake after a flotation may be reluctant to give up control. The risk for the minority is even greater in private companies where no battle for corporate control is likely to take place.

Despite the fact that the distribution of corporate profits is enshrined in statute law, the debate over the goal of the company is still rife in French case law as one recent decision by the *Cour de cassation*, the French supreme court, has demonstrated. This ruling held that a manufacturer had

¹⁴⁴ As modified by the statute no. 2006-387 of 31 March 2006 and the statute no. 2006-1770 of 30 December 2006.

¹⁴⁵ See for policy implications for companies of a study of closed-end funds board, D. Del Guercio et al., *Governance and Boards of Directors in Closed-end Investment Companies*, *Journal of Financial Economics* 69 (2003) 111-152.

abused its power to unilaterally set prices with its exclusive distributors, thereby bringing them into financial hardship because, in the context of a deterioration in market conditions, this manufacturer had not borne enough of the consequences of the downturn and had instead chosen to raise prices while at the same time distributing dividends to its shareholders for an amount which would have been sufficient to alleviate the distributors' financial difficulties¹⁴⁶. In this case, the judges decided that the corporate profits should have been used to relieve the contracting parties' financial hardship rather than for dividends, despite a vote by the general shareholders' meeting to that end. This is therefore a rationale that is very different from shareholder wealth maximisation.

Another French case held that, despite articles 1832, 1833 and 1842-1 of the French Civil Code (*Code civil*), management decisions should be assessed not in the light of the shareholders' interests but in the light of another interest, namely that of the company, distinct from that of the shareholders¹⁴⁷. The Paris Court of Appeal endorsed a decision by majority shareholders to sell a block of the company's shares held by the company itself to a party having agreed to act in concert so as to restore the voting rights attached to those shares and thus further dilute the minority. By doing so, corporate assets are used to the benefit of the majority only and to the detriment of the minority. The Court of Appeal approved the majority's decision and held that "the interests of the shareholders are not superior to those of the company"¹⁴⁸, which is a statement that avoids addressing the issue of the use of the corporate assets for the benefit of the majority.

¹⁴⁶ Com. 15 January 2002, "l'arrêt retient que le concédant ne s'est pas imposé la même rigueur bien qu'il disposât des moyens lui permettant d'assumer lui-même une part plus importante des aménagements requis par la détérioration du marché puisque, dans le même temps, il a distribué à ses actionnaires des dividendes prélevés sur les bénéfices pour un montant qui, à lui seul, s'il avait été conservé, lui aurait permis de contribuer aux mesures salvatrices nécessaires en soulageant substantiellement chacun de ses concessionnaires".

¹⁴⁷ Paris Court of Appeal, 5 April 2002, JCP E 2002, p. 1796.

¹⁴⁸ "Les intérêts des actionnaires ne sont pas supérieurs à ceux de la société".

Similar patterns in the structure of share capital and voting rights have been identified in companies across Continental Europe. Concentration of ownership and voting power and having at least one member of the founding family in management appear to be characteristic of the majority of private companies in France, Germany, Italy, Belgium and Switzerland. This concentration of ownership and power is also true of the majority of public companies in France. In Finland, Norway, Spain and Sweden, the situation is more nuanced, and it is even more so in the UK, Ireland and the U.S., because the share capital of private companies is more dispersed. However, in this latter group of countries, corporate governance problems are still likely to arise since, despite the dispersal of the capital, voting power remains concentrated. In both groups of countries, the companies characterised by a concentrated or dispersed share capital and a concentration of voting rights are likely to be affected by agency problems.

It results from these patterns that the controlling shareholder, *i.e.* the agent, lacks the incentive to act in the best interest of the other shareholders, *i.e.* the principals. This is because the agent, whether an individual or a holding company, benefits from an asymmetry of information and remedying this situation generates costs for the principals and also for the agent. One way to mitigate these costs is to try to align as closely as possible the respective interests of the agent and the principal by finding the right incentives for the agent. We will see in the following chapters what these concepts of information asymmetry, agency costs and agents' incentives mean and into what equivalent legal notions they can be translated. We will then observe that one response, in legal terms, to agency conflicts is the development of fiduciary duties. However, these are not enough to mitigate agency problems and, in the last resort, an exit right must be granted to the principals if the agent is to be kept in check. This will result in a new model of governance for private companies where agency problems are the most acute. This new model will perhaps appear counter-intuitive as corporate law applicable to private companies tends nowadays to be becoming more flexible, with an emphasis on freedom of contract, whereas the model we propose requires strengthening the institutional framework by imposing an exit right for minority shareholders in certain circumstances. Nevertheless, as shown above, better – *i.e.* more balanced - corporate governance generates improved financial returns.

CHAPTER 2 ANALYSIS OF AGENCY THEORY FOUNDATIONS FOR MINORITY SHAREHOLDERS' RIGHTS

Pursuant to the theory of the firm, the firm is made up of a set of contracts which are incomplete because of the unpredictability of the states of nature. Among these contracts, we will focus on the relationships taking the form of incomplete contracts between shareholders and between shareholders and managers. These relationships reflect the factual situation resulting from the empirical data reviewed earlier in this work, which showed that agency problems arise in private companies between majority and minority shareholders and between owner-managers and minority shareholders. We exclude from the scope of our analysis the whole set of contracts with the various suppliers of the means of production and with the clients to which the operation of the company gives rise. As a consequence of the impossibility of foreseeing future states of nature, it results from the incomplete nature of contracts between members of management and/or controlling shareholders on one side and the other shareholders as residual claimants on the other side, that these relationships are understood in the form of fiduciary relationships. Fiduciary relationships amount to standards, thereby avoiding the drafting of numerous and detailed contracts. Under U.S. corporate law, fiduciary relationships and the obligations that they imply for those involved in the decision-making process, *i.e.* managers, controlling shareholders and sometimes minority shareholders, are dealt with explicitly. Therefore, a coherent body of law exists with regard to the fiduciary duties of the aforementioned parties. Fiduciary relationships are also identifiable in English company law but they are still in the process of formation in French law and they are currently rarely enforced by the courts. For all their usefulness, fiduciary duties are not sufficient to mitigate agency problems between agents and principals in private companies, firstly, because they apply more often to managers than to majority shareholders and this is not adapted to the model of concentration of ownership and control of private companies, and secondly because the sanction attached to the breach of such duties, usually the award of damages, is not sufficient to constitute a powerful incentive to act in favour of all shareholders. As a consequence, we will argue that, pursuant to the sell-out right model that we propose here, a court may consider that the breach of a fiduciary duty constitutes a subjective, *i.e.* intentional, event, thereby triggering the minority shareholders' right to sell out.

In their seminal work "The Modern Corporation and Private Property", Adolf Berle and Gardiner Means highlighted the fact that owners no longer monitor the management of large companies¹⁴⁹. It became clear that in these companies, managers were pursuing their own objectives, for instance the growth and the size of the company which have a direct relation to their income and the scope of their power. As empire-builders, their interests were conflicting with those of shareholders seeking the highest return on equity in accordance with the shareholder value maximization approach. The separation

¹⁴⁹ Means A. A. and Means G. C., *The Modern Corporation and Private Property*, New York, Macmillan, 1932.

between ownership and control, giving rise to an agency relationship between management and shareholders, illustrates the general situation in which one person, the principal, entrusts another person, the agent, with the conduct of his affairs, through a delegation of power in exchange for a payment. Agency theory provides solutions to the issue of finding the right incentives to act in favour of one party while subordinating one's own interests to those of the beneficiary, whereas the interest of both parties may diverge. It is indeed to be feared that the principal will be subjected to the opportunism of his agent, *i.e.* "the deliberate contractual conduct by one party contrary to the other party's reasonable expectations based on the parties' agreement, contractual norms, or conventional morality"¹⁵⁰.

In this chapter, we shall examine information asymmetry between shareholders and how it generates costs which an incentive system should aim to reduce. We shall then go on to consider how this observation provides a rationale for the existence of fiduciary duties before seeing how a breach of such duties may, subject to supervision by the courts, constitute a triggering event for a sell-out right. This sell-out right would thus work as a strong incentive for agents to abide by their fiduciary duties.

2.1 Information asymmetry in private companies

Moral hazard and adverse selection are two causes of opportunistic behaviour. Moral hazard arises from the impossibility for the principal to have detailed knowledge of what the agent is doing as well as the nature of the interests pursued by such agent. It was demonstrated in the field of insurance that this phenomenon regarding the behaviour of agents affects the level of risk of damage unobservable by insurers. Two sets of circumstances give rise to moral hazard: the principal-agent relationship with either hidden action or hidden information¹⁵¹. The first model refers to the principal's incapacity to observe the actions of the agent. Consequently, the agent might see an incentive to pursue his own interests and justify the neglect of the principal's interests by external circumstances unverifiable by the principal. The principal-agent relationship with hidden information differs from the previous model in that the agent's actions are observable, but the principal ignores whether or not the agent is acting for his benefit. In both cases, there is a problem resulting from information asymmetry between the principal and the agent. Both kinds of moral hazard can be split according to the ownership structure of the company. Moral hazard with hidden action is more likely to be found in a public company between shareholders and managers because of the complexities of the operation of a large company. Moral hazard with hidden information illustrates the use of power in private companies where, even if the behaviour of the management and/or majority shareholder can be observed, their goals cannot¹⁵². This is how moral hazard gives rise to conflicts of interest between the principal and the agent. Solving this problem

¹⁵⁰ Cohen G. M., Implied Terms and Interpretation in Contract Law, Encyclopedia of Law & Economics, p. 91.

¹⁵¹ On the distinction between hidden action and hidden information models, see Arrow K. J., The Economics of Agency, in Pratt J. W. and Zeckhauser R. J., Principals and Agents: The Structure of Business, Boston, Harvard Business School, 1985.

¹⁵² However, depending on factual circumstances, both models can be found at the same time in private and public companies.

affecting the principal requires procedures to ensure that the agent will act in the interest of the principal. These organisational considerations are instructive for corporate law in so far as they constitute a theoretical basis for the shareholder's right to information and the rules governing the disclosure of conflicts of interests.

Among fiduciary duties, the obligation for majority shareholders or managers not to compete with the company, for instance, is a mechanism aimed at solving moral hazard issues via hidden action. In the same way, the obligation for managers, directors or major shareholders to disclose the nature of their interests when contracting with the company to avoid conflicts of interest addresses a moral hazard problem arising from a principal-agent relationship involving hidden information.

Information asymmetry between the principal and the agent, which is at the origin of potential conflicts of interest between both parties, causes adverse selection in addition to moral hazard. This notion refers to the incomplete nature of the principal's information as to the expectations of his agent. As a consequence, the principal-shareholder is unable to define accurately the terms of his relationship with the agent-manager-cum-controlling shareholder. G. Akerlof used the second-hand car market to demonstrate the characteristics of adverse selection¹⁵³. He showed that when a buyer is ignorant of the quality of the product he wishes to buy, the seller will exaggerate the quality in order to increase the price. Therefore, the buyer cannot trust the seller and cannot deduce the quality of the product from its price.

Moral hazard and adverse selection require operational measures so as to ensure the proper supervision of the agents by the principals. One traditional way to place managers under the control of the shareholders is to devise a remuneration system giving managers the incentives to pursue the owners' interest, *i.e.* the shareholder value maximisation. In theory, stock options aim at aligning the interests of managers with those of shareholders. In practice, however, it is well known that when the only measurement of the managers' performance is the share price, then adverse effects ensue. In private companies, where the empirical data on ownership and control analysed above show that management is most likely to be in the hands of the controlling shareholder, remuneration is not the right monitoring device because it is determined on the basis of a majority decision. How then can the controlling shareholder, who benefits from the information asymmetry, be encouraged to act on behalf of all the shareholders? As a controlling shareholder in a private company, his powers are nearly unlimited. After showing that current legal strategies to counter majority opportunism are insufficient, we will argue that ultimately, the means to put pressure on the controlling shareholder is to compel him to buy out the minority in the event of a breach of a fiduciary obligation, whose content will be defined below, and under the supervision of the courts. The fiduciary obligation results from the expectation of those who *de facto* entrust the controlling shareholder with the management of some of their assets that a return will be

¹⁵³ Akerlof G., 1970, *op. cit.* p. 488-500.

obtained. Strict limitations are imposed on the use of the sell-out right, a model of which we propose in Part 3, so as not to compromise share capital stability, defined by a set of triggering events under the control of the courts. This sell-out right would therefore coexist with other sanctions imposed for the breach of fiduciary obligations, for instance the award of damages and the voidance of the wrongful decision.

2.2 Specific agency costs in private companies

The various strategies reviewed in Part 2, designed to solve the conflicts of interest resulting from information asymmetry and information inadequacy, themselves give rise to agency costs. The importance of the concept of cost is such that it justifies the very existence of the firm according to the theory of the firm. According to Ronald Coase, a transaction will occur in a company rather than on a market as long as management costs remain inferior to transaction costs¹⁵⁴. M. Jensen and W. Meckling defined the costs inherent in an agency relationship as being monitoring expenditures by the principal, bonding expenditures by the agent and finally residual expenditures by the principal¹⁵⁵. In the shareholder/manager and minority/majority shareholders agency relationships, one example of monitoring expenditures – through which the principal seeks to ensure that the agent pursues the principal's interest – is the cost of auditors' fees. Auditors' reports to annual shareholders' meetings contribute to shareholders' information¹⁵⁶ about the operation of the company. This is an illustration of the fact that "the function of the law is to reduce those agency costs"¹⁵⁷. As to the agents, as manager and/or controlling shareholder, they will be inclined to justify their actions in an attempt to reduce the fears that their powers awaken among the principals, and this generates bonding expenditures. An illustration in legal terms is the management report submitted by the board of directors and the chairman of the board at the end of each financial year¹⁵⁸, whose content has recently been strengthened by the Sarbanes-Oxley Act in the U.S. and the *Loi de sécurité financière* in France of 1 August 2003. In France, pursuant to this law, the chairman of the board of a listed company must now produce a report on the workings of the board as well as an assessment of the company's internal control procedures¹⁵⁹. In addition, the

¹⁵⁴ See for example, Coase R. H., *The Nature of the Firm*, in *Firms, Organizations and Contracts*, Ed. P. J. Buckley & J. Michiel, Oxford University Press, 1996, p. 45: "We may sum up this section of the argument by saying that the operation of a market costs something and by forming an organization and allowing some authority (an 'entrepreneur') to direct the resources, certain marketing costs are saved".

¹⁵⁵ See Jensen M. C. and Meckling W. H., *Theory of the Firm, Agency Costs, and Ownership Structure*, 3 *Journal of Financial Economics*, 1976, 305-360.

¹⁵⁶ See for example under French law, Art. L. 225-100 and L. 234-1, French Commercial Code (*Code de commerce*). See also Art. L. 225-237 on the 'warning duty' of the auditor (*devoir d'alerte*).

¹⁵⁷ Couret A., *Les Apports de la Théorie Micro-économique Moderne à l'Analyse du Droit des Sociétés*, *Rev. Soc.*, 1984, p. 251. Other provisions of the French Commercial Code (*Code de commerce*) partake of the monitoring of the managers and thus reduce agency costs: the right to know the total amount of the remunerations of the top management

(Art. L. 225-115, 4°, C. com.), the registration of securities, the court-ordered audit report on the request of minority shareholders of Art. L. 225-231, the right to ask questions twice a year to the management (Art. 225-32). More generally, the existence of the entirety of the powers at the disposal of the minority can be justified from this standpoint.

¹⁵⁸ In French law, see Art. L. 232-1, Commercial Code (*Code de commerce*).

¹⁵⁹ Art. L. 225-37, para. 6: "The chairman of the board of directors attaches to the report referred to in L. 225-100, L. 225-102, L. 225-102-1 and L. 233-26 a report on the manner in which the board's work has been prepared and organised and on the internal
(cont'd)

statutory auditors must themselves comment on the chairman's report on the internal control procedures and the treatment of financial and accounting information. Another difference between listed and unlisted companies in France is that in a private company, the chairman's report does not have to include an assessment of the internal control procedures¹⁶⁰, a simple description is sufficient. This difference illustrates that the adverse effects of the agency relationship in private companies are underestimated.

More generally, monitoring and bonding expenditures result from the fact that, to quote the French Commercial Code, shareholders must be in a position to "give an informed opinion and to pass an informed judgement on the management and the operation of the company's affairs"¹⁶¹. On this condition, the principals can monitor how their interests are pursued. Chances are that the management of the company will diverge from the goal of shareholder wealth maximisation because of moral hazard and adverse selection. Again, according to Jensen and Meckling, "The dollar equivalent of the reduction in welfare experienced by the principal due to this divergence is also a cost of the agency relationship, and we refer to this latter cost as the residual loss"¹⁶². Such an additional cost at the expense of shareholders results for instance from the fact that it may be in the managers' interest to run the company excessively prudently, so as to limit risks and entrench their position and such behaviour harms the potential for increasing the corporate and, consequently, the shareholder value. At first glance, this argument may seem to account for the situation of managers more than for controlling shareholders. One reason is that managers are in general more reluctant than shareholders to take risks since, unlike the latter, they do not have the option of diversifying their investment and therefore spreading their risks. However, controlling shareholders exercising power in a private company usually have a proportionally larger part of their own wealth tied up in the company compared to the minority shareholders. This is especially true of family firms which account for a large proportion of all private firms, as shown by the statistical data. Consequently, controlling shareholders may be more risk averse, which in itself constitutes a cost to other shareholders.

2.3 Specific agents incentives in private companies

The agency relationship between the shareholders exercising power and the others may result either from the separation of ownership and control, as traditionally addressed in corporate governance literature, or from its concentration, situation considered here and previously illustrated with figures. The relationship is based on the idea that when a party pursues its own interest, this party works at the same

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control procedures put in place by the company. Without prejudice to the provisions of Art. L. 225-56, the report also indicates any limitations which the board of directors has applied to the powers of the general manager".

¹⁶⁰ Rép. Pélissard: A.N. 15 June 2004, p. 4716, no. 37190.

¹⁶¹ "...de se prononcer en connaissance de cause et de porter un jugement informé sur la gestion et la marche des affaires de la société", in Art. L. 225-108 al. 1, Commercial Code (*Code de commerce*).

¹⁶² Jensen M. C. and Meckling W. H., *Theory of the Firm, Agency Costs, and Ownership Structure*, in *Foundations of Corporate Law*, Oxford University Press, Ed. R. Romano, 1993, p. 7.

time in the interest of the other. This is the very general notion of the “invisible hand” of Adam Smith and it underlies the reference to the idea that shareholders share a common interest in the maximisation of shareholder value. “Common interest” is the expression used in French law to describe the goal, the ultimate objective, of the company under articles 1832 and 1833 of the French Civil Code (*Code civil*). It follows that the monitoring, when exercised by minority shareholders, benefits all members of the company and not just those shareholders. Prof. Dominique Schmidt therefore notes “the rights of the minority are not destined to the protection of the few against controlling capitalists (...) they ensure on the contrary the intervention to corporate ends, in order to contribute to the better operation of the company”¹⁶³. Indeed, the economics of proprietary rights show how the exercise of individual prerogatives can be a source of general utility. This is why one condition for the company’s efficiency and for the reduction of agency costs is that its owners have the will and the power to monitor the use of their “ownership”.

The agency relationship pursuant to which the owner puts his interests in the hands of a manager¹⁶⁴ is ultimately based on trust¹⁶⁵. The collective utility resulting from the satisfaction of individual interests implies that the shareholder can trust the manager/controlling shareholder as long as the latter, while honouring his commitments to the agent, pursues his own goals. This is why remuneration systems aimed at aligning the interests of principals and agents are central to finding the right incentives. Incentives through remuneration are certainly more efficient with managers than with owner-managers who, as shareholders, have residual claims to the company’s profits, which is why as stated above remuneration-based incentives are less well adapted to the ownership structure of private companies than public companies. Moreover, because of the majority principle, owner-managers have little incentive to take decisions representing the common optimum interest because their decision-making power is in excess of the risks they incur: they decide on behalf of every member of the firm whereas their liability is limited to their personal contribution. This is the problem with the majority principle that we dealt with above.

When seeking incentives for owner-managers to act for the benefit of all shareholders, one is faced with the problem of finding how to put pressure on the owner-manager as, because of the majority principle, the firm will structurally operate to his benefit. In effect, on the one hand, the owner-manager has structurally unlimited powers to run the company but, on the other hand, his liability, and therefore the risk incurred, is limited to the level of his contribution. The first of these attributes, power, is limitless because other shareholders are in effect prevented from freely selling their shares in the company.

¹⁶³ “Les droits de la minorité ne sont pas destinés à la protection de quelques-uns contre le capital dirigeant (...) ils garantissent au contraire l’intervention à des fins sociales pour contribuer au meilleur fonctionnement de la société”, D. Schmidt in *Les droits de la Minorité dans les Sociétés Anonymes*, *Bibl. dr. com.*, t. 21, Sirey, 1970, no. 305, p. 229.

¹⁶⁴ The term “manager” includes, as before, all those whose decision-making power exceeds the risk they incur. In this way, the controlling shareholder exercising the power himself in a private company is called here a manager.

¹⁶⁵ See for example, *A Matter of Trust*, *Economic Focus*, *The Economist*, 17 February 2001, p. 92.

Therefore, an efficient means of exercising pressure on the controlling shareholder would be to introduce a sell-out right for the minority under certain limited circumstances to be assessed by the courts. With the sell-out right, the incentive to pursue the common interest of the shareholders is therefore twofold: it is related to the economic function of the shareholders as contributors of capital. The withdrawal of capital may indeed adversely affect the company's prospects. In addition, the incentive to pursue the common interest of the shareholders under the pressure of a sell-out right results from the fact that the controlling shareholder would have to pay for it personally. A second aspect of the majority shareholder's influence is the fact that his liability is limited to the amount of his contribution. Introducing a sell-out right to be paid for by the controlling shareholder at the origin of a triggering event would amount to extending his financial liability in cases where his own interest prevails over the common interest of the shareholders.

Using this mechanism, the courts could therefore be instrumental in reducing the transaction costs resulting from the monitoring of opportunistic behaviour, which make it impossible to write exhaustive contracts. As we have seen above, an agent with bounded rationality¹⁶⁶ cannot anticipate and protect himself from an infinite number of circumstances, which will give rise to the other party acting opportunistically. This idea is conveyed in the approach to the company as being a nexus of incomplete contracts designed to limit conflicts of interest between the parties. The objectives of the parties are therefore to avoid the costs attached to the drafting of complex contracts or to the negotiation of series of short-term agreements, and this in turn is why fiduciary duties are required.

2.4 The specific purpose of fiduciary duties in private companies

The mandatory buy-out of the minority shareholder under certain circumstances to be assessed in court would be the legal embodiment of an implicit agreement between majority and minority shareholders, pursuant to which major expressions of opportunism, on the one hand, and legitimate major alterations of the corporate contract, on the other hand, will lead to the withdrawal of the "victim" from any common future activity¹⁶⁷. The majority would thus have an implicit obligation, justified by the difficulty for the shareholders, as has been stated, to anticipate and to protect themselves contractually against divergences of interests that could occur. By granting the courts the ultimate decision-making power over this right of the minority shareholder, they would be able to resolve conflicts of interest that could not have been explicitly tackled in the contract between the parties because of bounded rationality or because of a disadvantageous bargaining position. In fact, the completion of the contracts between shareholders would be delegated by the parties to the courts. This analysis fully adopts the contractual - as opposed to institutional - approach to the company. The contractual approach makes a realistic

¹⁶⁶ See Simon H. A., A Formal Theory of the Employment Relationship, 19 *Econometrica*, 1951, p. 293.

¹⁶⁷ "...on implicit contracts (...) each party lives up to the other party's (reasonable) expectations from a fear of retaliation and breakdown of cooperation.", Foss N. J., Lando H. and Thomsen S., *The Theory of the Firm*, Encyclopedia of Law & Economics, p. 642.

description of the company according to which it is an inherently incomplete contractual structure, made up of company law, the articles of association and fiduciary obligations. In addition to these three sources, relationships between shareholders and between shareholders and managers are also affected by voting rights. The incomplete contracts therefore include resolutions voted during general shareholders' meetings and by the board of directors¹⁶⁸.

Potential future conflicts of interest are hard to predict when drafting contracts. If the principal does not have sufficient information in order to monitor the efforts of his agent (moral hazard situation), he will not be able to make provision for future adverse situations through detailed contracts. Consequently, the opportunism inherent in the agency relationship entails the drafting of incomplete contracts which themselves generate opportunistic behaviour. This is why fiduciary duties are only part of the solution for solving agency problems and why, in the last resort, only a right to sell can break this deadlock. Uncertainties resulting from the risk of opportunism and the ignorance of the states of the world due to the bounded rationality hypothesis weigh more heavily on shareholders than on other stakeholders¹⁶⁹, hence the necessity of fiduciary obligations and the need for a sell-out right. The reason is that shareholders, as residual claimants to the corporate profits, bear the risks inherent in the operation of the company, in contrast with bondholders, employees or suppliers whose rights are explicitly determined in fixed income, salary or price. Despite the need for a protective framework for shareholders, surprisingly, under French law, the only explicit statutory obligation imposed upon directors is that of confidentiality¹⁷⁰. It was only recently that the French courts "discovered", in a landmark case, that in certain circumstances board members in private companies have a fiduciary duty to their shareholders¹⁷¹.

Fiduciary duties fall in the category of relational contracts¹⁷². "A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangement to the well-defined obligations"¹⁷³. Relational contract theory formalises situations in which interaction between the parties shows behaviour that is consistent with predetermined norms. In this context, it seeks to avoid opportunism likely to arise where managers are assigned a task with an unspecified content in accordance with the bounded rationality hypothesis. For example under French law, the *directeur général* is "vested with the widest possible powers to act in the name of the company under all circumstances"¹⁷⁴. It is then in the nature of the relational contract, entered into between the

¹⁶⁸ See Easterbrook F. H. and Fischel D. R., Voting in Corporate Law, 26 Journal of Law and Economics 395, also in Foundations of Corporate Law, Oxford University Press, Ed. R. Romano, 1993, p. 195.

¹⁶⁹ See Easterbrook F. H. and Fischel D. H. (1991) op. cit., in particular the chapter 4: The Fiduciary Principle, the Business Judgement Rule, and the Derivative Suit, p. 90.

¹⁷⁰ Art. L. 225-37, Commercial Code (*Code de commerce*).

¹⁷¹ Com. 27 February 1996.

¹⁷² See for example, Hviid M., Long-Term Contracts and Relational Contracts 2000, in Encyclopedia of Law & Economics, p. 46-72.

¹⁷³ Goetz C. J. and Scott R. E., Principles of Relational Contracts, 67 Virginia Law Review, 1089-1150, cited in Hviid M., op. cit., p. 53.

¹⁷⁴ "...le directeur general est investi des pouvoirs les plus étendus pour agir en toute circonstance au nom de la société", Art. L. 225-56, Commercial Code.

shareholders and the managers and between the minority and majority shareholders, to include a fiduciary obligation¹⁷⁵. This kind of relational contract, such as the assignment of the *directeur général*, with broadly defined prerogatives, needs to be counterbalanced by fiduciary obligations on the part of the agent.

How does this translate into legal terms? Under French law, there is an answer dating back to the nineteenth century: in the 1867 Companies Act, managers were explicitly considered as the agents (*mandataires*)¹⁷⁶ of the shareholders¹⁷⁷. Little remains of the notion of *mandat* in the current Commercial Code, but for the use of the term in a few provisions¹⁷⁸. In French corporate law, power is indeed allocated in a formal way through the various corporate organs, *i.e.* the general assembly and the board of directors, and not through contracts. This is consistent with the “personification” of the firm – the management acts in the name and on behalf of a legal entity, the company, and not the shareholders – and with the fact that, having no personal will, the company is unable to contract a *mandate*, an agency agreement, with its representatives. This is why the company’s powers are not defined by contracts but by statutory law. Yet if powers hidden behind the veil of the corporate personality are to be correctly understood, the analysis should focus on the relationships between the shareholders and between shareholders and managers, depending on the shareholding structure of the company. In listed companies, the French legal notion of the *mandat* can be identified in the form of the implicit investment contract concluded between the shareholders outside the group of controlling shareholders and the market on one side and the management of the company and the controlling shareholder on the other side. According to the notion of the investment contract to which the *Commission des Opérations de Bourse* (predecessor of the *AMF*) has explicitly referred, the market gives a mandate to management to run the company in order to generate a financial return. The practical application of this is that when the expectations, *i.e.* the shareholder value maximisation that motivated the parties to enter into the contract of mandate, are no longer met, the investor has the right under certain conditions to be bought out by the controlling shareholder, pursuant to the sell-out right of article 236-2 of the *AMF* General Regulations.

So as to reflect closely in enforceable legal provisions the findings of the agency theory, legal concepts must be found to mirror these economic principles. Under French law, the legal notion of the “mandate” therefore makes it possible to account for the *mandat* is defined as “an act through

¹⁷⁵ “Task uncertainty implies relational contracts between management and investors, where these parties do not agree on specific actions and benchmarks for performance, but in procedures for joint monitoring and decision-making.”, Gonenc R., *Corporate Governance: What Do We Learn from New Investment Vehicles?*.

¹⁷⁶ The closest notion under UK law is that of trustee.

¹⁷⁷ Prof. Paul le Cannu thus writes: “One can (...) reconstruct the bases of French law around the corporate practice prior to 1867, where the structure remained standing thanks to the *mandat*”. (“*On peut (...) reconstruire les bases du droit français autour de la pratique des sociétés anonymes avant 1867, où l’édifice tenait grâce au mandat*”), in *Légitimité du Pouvoir et Efficacité du Contrôle dans les Sociétés par Actions*, Bull. Joly, 1995, chr., p. 643.

¹⁷⁸ The word *mandat* is mentioned in Art. L. 223-22 para. 5 and L. 225-253 para. 2 concerning *gérants*’ and directors’ liability when at fault; in Art. L. 225-21, L. 225-67, and L. 225-77 concerning the maximum number of positions as a director, chairman and member of the *directoire* and *conseil de surveillance*, and lastly in Art. L. 225-54-1 relating to the *directeur général*.

which one person gives another the power to do something for the principal (*mandant*) and in its name”¹⁷⁹. The *mandat* thus accounts for the decision-making power given to the agent in the relationship between shareholders and managers. The company is indeed run by the management (“...the power to do something...”) on behalf of the shareholders (“...for the principal and in its name”) and therefore in their interest.

Using the notion of *mandat* makes it possible to characterise in legal terms the relationship between those in power and the other shareholders of the company, *i.e.* between the managers and the shareholders, or between the majority and the minority, depending on the capital ownership structure. It is therefore possible to give a legal foundation to the duties implied by the relational contracts we referred to earlier. Subsuming pure relations of power in the company in the form of contractual mandates is consistent with the analysis of the firm as a nexus of contracts. Internal controls, through the enforcement of fiduciary obligations and the general principle under the French law that the agent can be dismissed without cause¹⁸⁰ are coherent with the view that the company functions as a kind of marketplace, bringing together various parties with diverging interests. These controls make possible the maintenance of an equilibrium between the parties, which would otherwise be constantly under threat because of information asymmetry. This information asymmetry is duly taken into account in the *mandat* as article 1993 of the French Civil Code (*Code civil*) provides that the agent must account for his own conduct¹⁸¹. For the same reason, the board of directors must produce a report to be presented to the general shareholders’ meeting¹⁸². The idea of the dismissal of board members without just cause under French law appears to have been directly inspired by the same provision as article 2004 of the French Civil Code (*Code civil*) dealing with the *mandat*. Pursuant to this article, the principal may revoke the powers given to the agent at any time. This is why, for instance, the share price of a listed company whose management systematically opposes potential takeover bids, resulting in their *de facto* irremovability, will usually fall. As Prof. Paul Didier concludes, using a reference to the *mandat*: “the relationships of the shareholders with their managers are relationships between a *mandant* and a *mandataire*, the latter taking responsibility to conduct and to get a return on the funds that the former entrusts him”¹⁸³.

¹⁷⁹ Art. 1984, French Civil Code (*Code Civil*): “*Le mandat ou procuration est un acte par lequel une personne donne à une autre le pouvoir de faire quelque chose pour le mandant et en son nom*” (An agency or power of attorney is a transaction by which a person gives to another the authority to do something for the principal and in his name).

¹⁸⁰ Art. 2003, French Civil Code (*Code civil*): “*Le mandat finit, par la révocation du mandataire...*” (An agency comes to an end by the revocation of the agent ...) and 2004: “*Le mandant peut révoquer sa procuration quand bon lui semble...*” (A principal may revoke his power of attorney when he pleases...).

¹⁸¹ Art. 1993, French Civil Code (*Code civil*): “*Tout mandataire est tenu de rendre compte de sa gestion, et de faire raison au mandant de tout ce qu’il a reçu en vertu de sa procuration, quand même ce qu’il aurait reçu n’eût point été dû au mandant*” (Every agent is bound to account for his management, and to return to the principal all that he received by virtue of his power of attorney, even where what he received was not owed to the principal).

¹⁸² Under French law: Art. L. 232-1, Commercial Code (*Code de commerce*).

¹⁸³ Didier P. (1997) *op. cit.*, p. 236. Prof. Alain Couret also writes: “The contract uniting the shareholders with the managers is basically a contract of *mandat*”, in *Le Gouvernement d’Entreprise, la Corporate Governance*, D. 1995, chr., p. 165.

However, the mandate that the shareholders give to their agents has a specificity that distinguishes it from the *mandat* of civil law: the powers of the agent are unlimited. Indeed, with respect to third parties, the chief executive officer (*directeur général*) has under French law the most extensive powers to act under all circumstances in the name of the company¹⁸⁴. In addition, the agent's acts are binding upon the company *ultra vires*¹⁸⁵. This considerable degree of latitude granted to agents under company law is another illustration of the incompleteness of the contract. It is because of the common inability to predict future circumstances and the expenses that the drafting of an exhaustive contract accounting for the latter would cost, that the powers in the shareholder-agent contract are broadly defined and the corresponding duties imprecise.

These powers vested in the managers and by extension the powers of the controlling shareholders who appoint them are greatly increased when an allocation of votes frozen by the majority principle has in practice made the managers' appointments irrevocable, as is the case in private companies. This places a limit on the efficiency of fiduciary duties in solving agency problems. The contractual approach that we use as an analytical framework leads to the conclusion that in a company, no one party should remain bound against its will if the corporate contract is breached or profoundly altered. To determine the conditions triggering a sell-out right in private companies as a sanction of the alteration, intentional or incidental, of the initial expectations embedded in the corporate contract, it is now necessary to identify the content of the various duties incumbent upon those in power.

Fiduciary duties work as agreements that would be reached by the parties if the contracts were to be negotiated and applied without costs and in a perfectly rational manner. In terms of transaction costs, the existence of fiduciary duties is justified by their cost saving capacity: "these structures [...] are implemented in so far as they are rapidly paid off"¹⁸⁶. Transaction costs result, on the one hand, from the human deficiencies mentioned above, such as bounded rationality and opportunism, and, on the other hand, from specificities attached to the transactions themselves. These specificities, brought to light by Oliver Williamson, are asset specificity, uncertainty and the frequency of those transactions¹⁸⁷. These notions must be briefly referred to as they provide a basis for the need to have recourse to fiduciary obligations in private companies in order to mitigate agency costs.

The notion of asset specificity shows how a party comes to have a hold-up power over his contracting partner. This situation is manifest for the minority shareholder in the private company. The power of the controlling shareholder, resulting from the majority principle coupled with the absence of any market for the shares, which would ensure an effective transferability of the securities, puts the minority

¹⁸⁴ Art. L. 225-56, I, Commercial Code (*Code de commerce*).

¹⁸⁵ Art. L. 225-56, I, Commercial Code (*Code de commerce*).

¹⁸⁶ "Ces structures (...) sont mises en place dans la mesure où elles sont rapidement amorties", Kreps D. M., *Leçons de Théorie Microéconomique*, coll. Finance, PUF, 1996, ed. orig. 1990, p. 736.

¹⁸⁷ See in particular on these questions, Williamson O. E., *The Economic Institutions of Capitalism*, New-York, Free Press, 1985.

shareholder at the mercy of the controlling shareholder. The minority is subject to the decisions of the majority and cannot avoid them by selling when, objectively or wrongfully, the majority shareholder departs from the enforcement of the corporate contract¹⁸⁸. These circumstances are particularly likely to cause opportunism and to lead to majority abuses and also to potentially minority abuses when the minority has a hold-up power. The parties can anticipate the hold-up power over minority shareholders as it is a direct consequence of the structural combination of the majority principle and the absence of any market for shares, which are two characteristics of the private company. This anticipation would require the parties involved to reach an agreement before the mandate is carried out. More precisely, the foreseeable future hold-up power ought to intervene in the *ex ante* negotiation of their relationship because the minority puts its specific assets at risk as it has no other contracting partner to turn to. For this reason, “the exchange [is] asymmetrical in the sense that one of the participants takes a higher risk than the other”¹⁸⁹. The minority must therefore take precautions against the risks of exploitation thereby incurred. To this end, it should negotiate a fiduciary mandate with the controlling shareholder but in most cases, given the balance of power, the minority will not be in a position to obtain much in terms of protection from opportunism. This is where enforceable fiduciary duties, and in the last resort a sell-out right, are needed.

Before we turn to the notion of uncertainty which constitutes the second source of transaction costs, we will consider in greater detail the consequences of the minority’s asset specificity on the controlling shareholder’s exercise of power. The power resulting from the position of controlling shareholder gives the latter particular responsibilities. The legal concept of mandate as a contract suffices to express the shareholder-manager relationship. However, it is the notion of “power, detached from a contract”¹⁹⁰ which makes the role of the controlling shareholder comprehensible with regard to the other shareholders. Power enables its holder to let his personal interest prevail. Therefore, the necessity to respect the common interests of all shareholders is essential, whether such power results from the law, as is the case with managers, or results *de facto* from the majority principle, as is the case with controlling shareholders. When personal interest prevails over the common interest of the shareholders, *i.e.* the shareholder value maximisation, various legal mechanisms, such as legal sanctioning of abuse of power or misappropriation of corporate funds, come into action. However, under French law, when the acts of the managers or controlling shareholders are detrimental to certain of the shareholders only and are not contrary to the interest of the company as such, as a legal entity, these sanctions cannot be enforced and the shareholder protection will result from the enforcement of fiduciary duties.

The enforcement of the duty of loyalty makes it possible to sanction any violation of the shareholders’ interest as a consequence of the fact that “if the manager is, as is often the case, the

¹⁸⁸ See *infra* Part 3.

¹⁸⁹ Kreps D. M. *op. cit.*, p. 735.

¹⁹⁰ Le Nabasque H., *Le Développement du Devoir de Loyauté en Droit des Sociétés*, RTD com, avril-juin 1999, p. 282.

emanation of a majority in shareholders meeting, he is nonetheless the depositary of the interest of all"¹⁹¹. The same can obviously be said of controlling shareholders. Under French law, this solution derives from article 1833 of the French Civil Code (*Code civil*), according to which the company must be formed in the common interest of the shareholders. As one of the report on corporate governance having authority in France also puts it: "when a company is controlled by a majority shareholder (or a group of shareholders acting in concert), this majority shareholder assumes a particular responsibility towards the other shareholders, direct and distinct from that of the board of directors"¹⁹².

In order to pursue the foundation of the need to rely on fiduciary obligations, we must consider the notion of uncertainty, which is the second source of costs. As opposed to asset specificity, these costs are attached to the transaction itself and not to the parties. The uncertainty refers to the forecasting ability of one party prior to entering into a transaction, and thus to the hypothesis of the bounded rationality and the information asymmetry, both sources of opportunism. The uncertainty is therefore a source of potential conflicts that the parties' contractual relationship aims to limit. It confirms the idea, mentioned above, that the company is a set of incomplete contracts whose function is to limit conflicts between the diverging interests of the parties, thereby giving rise to transaction costs.

Finally, the frequency of certain transactions, such as those between minority shareholders and the majority and managers, makes it possible for inherent costs to be shared. To prosper, these relationships require that conflicts of interest and the associated costs should be limited. A standard agreement is therefore needed and it should include obligations of good faith and loyalty. How does this relate to the various forms of control of the management?

The institutional organisation of management supervision is sometimes seen as a failure. This view stems from the observation that corporate decisions are taken during shareholder meetings, often with a low turnout, and that boards of directors lack the independence from the management needed to exercise an efficient control. It does not mean however that members of management escape every form of control, as one may suppose that those who keep their shares are generally content with the way the company is being run whereas those who sell their shares are effectively voting with their feet. The supervision of the management therefore works in the following way: the sale of a large block of shares by dissatisfied shareholders entails the collapse of the share price, making the company easy prey for a hostile bidder, which is naturally unfavourable to the incumbent managers since the bidder's aim is precisely to do better than they have done. In addition to this, there is the existence of a market for corporate managers which is fairly efficient when it comes to listed companies. Shareholders discontent does indeed affect the reputation of managers and consequently their value on the labour market, which

¹⁹¹ Le Nabasque H. op. cit., p. 285.

¹⁹² CNPF and AFEP, *Le conseil d'Administration des Sociétés Cotées*, Editions Techniques Professionnelles, Paris, 1995, p. 16.

in turn is supposed to influence their behaviour. This control system by markets, which includes credit markets, especially control by lenders, can be called "external control"¹⁹³.

When the markets are lacking in liquidity or even non-existent, the control of the use of power falls to existing corporate law procedures that are internal or, depending on the jurisdiction, on a *de lege lata* or *de lege ferenda* statutory sell-out right. This alternative to the external form of control is an internal control. In private companies, control¹⁹⁴ relies mainly on internal supervision procedures and partially on external forces if the company borrows on private debt markets, as we have already seen how debt can work as an agency control mechanism.

As we observed when analysing empirical data earlier in this work, ownership of share capital in private companies is very heavily concentrated, especially in Continental Europe. In addition to this concentration of capital, other than in private equity firms, shareholders are unlikely to be specialists in corporate finance, in the way that mutual funds investing on stock markets are, but are in most cases families and also holding companies or commercial banks. As we have demonstrated above, it therefore follows that the objectivity of their supervision is likely to be negatively affected because these shareholders may pursue individual strategic aims, whereas investment funds are driven by their members' collective interest to increase the value of their assets. The satisfaction of this shareholder value maximisation interest constitutes the standard against which corporate management is assessed¹⁹⁵. On the contrary, relationships between the management and commercial banks can be dependent on their commercial relationships and thus the banks may limit their scrutiny of the management so as to generate more business within them in the future. In this respect, they are no allies of minority shareholders. Moreover, a bank may sometimes have to choose between its best interests as shareholder in or as creditor of a particular company. The effectiveness of the control over executive power in a company belonging to a group of companies can also be questioned in so far as the shareholding of subsidiaries frequently forms part of crossed shareholdings and self-controlling share

¹⁹³ See for example, Plihon D., Ponssard J.-P. and Zarlowski P., Quel Scénario pour le Gouvernement d'Entreprise ? Une Hypothèse de Double Convergence, in *Les Investissements des Fonds Etrangers (fonds de pension et autres fonds institutionnels) dans les Entreprises Industrielles*, Rapport au Ministère de l'économie, des finances et de l'industrie, dir. Ponssard J.-P., 2000, p.174.

¹⁹⁴ See for example, Mottis N. and Ponssard J.-P., L'Impact des FIE sur les Firmes Françaises et Allemandes: Epiphénomène ou Influence Réelle? and Gehrke I., Evolution de la Gestion de Création de Valeur Actionnariale dans le Contexte Industriel Allemand, dir. Ponssard J.-P., 2000, op. cit. p. 155. On the consequences for German firms of the development of the control by financial markets, see for example *The Wall Street Journal Europe*, Bayer Meeting to Signal Future, 27-28 April 2001, p. 1. A fund manager asks the shareholders to vote in favour of his resolution proposing the dismantling of the company.

¹⁹⁵ See *loi no. 97-277*, 25 March 1997, Art. 13, I: "Retirement savings funds are bound to exercise effectively in the sole interest of the members, the voting rights attached to the securities...", ("*Les organismes de placement collectif en valeurs mobilières, le dépositaire et la société de gestion doivent agir au bénéfice exclusif des souscripteurs*") and Art. 24 para 2, *loi no. 88-1201* 23 December 1988: "Mutual funds [*OPCVM*], ...and the investment management company must act on behalf of subscribers only", ("*Les organismes de placement collectif en valeurs mobilières, le dépositaire et la société de gestion doivent agir au bénéfice exclusif des souscripteurs*"). See on the question of the exercise of the voting right by mutual funds, Couret A., *Première Traduction Législative de la Corporate Governance: la Loi sur les Fonds de Pension (libres propos autour de la loi n° 97-277 du 25 mars 1997)*, D., 1997, chron., p. 241.

interests¹⁹⁶ may sometimes exist, where permitted by law. In companies having shareholders and *a fortiori* directors in common, there is a risk of mutual agreements aimed at exercising control in one of the companies, thereby compromising the efficiency of such control.

This monitoring model accounts for the situation prevailing in private companies for several reasons. Firstly, power is concentrated in the hands of a controlling shareholder who, as the statistics discussed above show, exercises such power either personally or through a manager whose appointment and dismissal is decided by him. Secondly, the limitations on the free transferability of shares freeze the allocation of the shareholding and thus the allocation of power resulting from the majority principle. The company's management is thus free to indulge in entrenchment strategies. Thirdly, private as opposed to public companies are less susceptible to experiencing competition between the interests of various stakeholders, except maybe those of the employees. The pursuit of shareholder wealth maximisation as the company's goal is nevertheless not guaranteed. The absence of a sell-out right for minority shareholders to counterbalance the majority principle encourages opportunistic behaviour and conflicts of interest on the part of the controlling shareholder that cannot be mitigated by fiduciary duties alone.

The disclosure of information acts as a powerful internal control mechanism. In terms of agency costs, we have seen that the moral hazard resulting from the asymmetry of information between the principal and the agent can be mitigated through a system of disclosure of information. For a controlling shareholder, disclosing information relating to his relationships with other shareholders, including members of his family¹⁹⁷, is not something he would naturally do since alliances, be they strategic or purely financial, are the sources of his power. Secrecy is how the balance of power is maintained but also the reason why conflicts of interest flourish. This is why the main strategy of corporate law in tackling agency problems is to give shareholders the right to gather information on the operation of the company, some of it prior to general shareholders' meetings only and some of it on a permanent basis. Not all corporate information is available to shareholders because undue involvement of the shareholders in the management of the company must legitimately be prevented and too much information would almost certainly miss its goal anyway. In addition to such disclosure, shareholders are usually granted the right to put questions to the management during general meetings, thereby completing their knowledge of the company. However, shareholder agreements, unless attached to the articles of association, do not form part of the body of information produced by the company and are therefore not disclosed with the rest of the information. Shareholder agreements are nonetheless a key element in the operation of a company as they are, for instance, a typical way of organising voting and the exit of certain shareholders from the company.

¹⁹⁶ It justifies the regulation of crossed shareholdings in French law by Art. L. 233-29 et seq. of the Commercial Code and the criminal sanction defined by Art. L. 247-3. For an illustration of a public company where the management obeying a controlling minority thanks to a cascade of crossed shareholdings is *de facto* irremovable, see for example: The Wall Street Journal Europe, 27-28 April 2001, Breakingviews, p. 21. This company's share price is for this reason 40% below the value of its net assets.

¹⁹⁷ In the frequent case where a family is the majority shareholder of the company.

There are two ways to extract more information from controlling shareholders or shareholders seeking control. One way is obviously to constrain them, through legislation, to disclose more when dealing with shareholders, for instance when given a mandate to sell the shares of other shareholders in a situation where there might be a conflict of interest, or when one shareholder enters into an agreement with another shareholder either for the purpose of taking control of the company or, once this has been achieved, to decide on the future orientation of the company. Another way is for a judge to enforce the duty of loyalty incumbent upon shareholders. The obvious drawback of the judicial, as opposed to the legislative, approach is that one must wait for the case to come before the courts. This is what happens in France where the behaviour of shareholders is sometimes challenged in court on the basis of more general civil law concepts such as fraud or wilful misrepresentation. A comparison can be made here with consumer law where transparency has been imposed through legislation. It is often argued in this field that overloading consumers with information, for instance regarding the composition of certain products or insurance policy terms and conditions, has had an adverse effect as most people end up not reading the information provided and suppliers may subsequently counter claims from consumers by arguing that the compulsory information had been disclosed. Such adverse effects can be prevented because a general duty of loyalty exists under civil law but there is a significant difference between consumers and shareholders in private companies in that, except when under duress, consumers are not obliged to purchase goods or services. However, unless they can benefit from a provision similar to section 994 Companies Act 2006 under English law, shareholders of private companies have no way of escaping the company. Providing information is therefore crucial but it should be seen as a means and not as an end in itself, the end being the right to exit under certain circumstances assessed by the courts.

We will address successively both issues in the next part, *i.e.* how disclosure helps mitigate agency costs by preventing potential abuses but does not solve the structural problem affecting the governance of private companies, which results from the majority principle.

CHAPTER 3 STRUCTURAL DEFECTS AFFECTING MINORITY SHAREHOLDERS IN PRIVATE COMPANIES

The majority rule makes the running of complex organisations, like companies, easier because it deprives members of their power of veto and thus transfers the bargaining power to the majority. It is inherent in the majority rule that certain persons will have choices imposed upon them that are not of their making, which implies that their preferences expressed through votes will not be taken in consideration. However, in the marketplace, the optimal allocation of resources results from preferences expressed by persons among several alternatives. In this regard, the majority rule and the market are on opposing sides. It therefore follows that, for the market, the objective of the company is the sum of the objectives of its shareholders. On the other hand, if a vote is taken pursuant to the majority rule, the collective choice will result from a division among the objectives of the voters.

3.1 The problem with the majority principle

The inefficiency in the allocation of resources resulting from the majority vote is mitigated by voting agreements when the ballot is divided into several votes: in general shareholders' meetings there are thus as many polls as proposed resolutions. Any voting agreements to which these give rise should theoretically be disclosed to other voters so that the result of the vote still expresses a collective choice representing the sum of individual preferences. Voter X will therefore vote in favour of resolution (a) representing a benefit for voter Y but not for X if he knows that Y will vote in favour of resolution (b) benefiting X but not Y.

The formulation of individual preferences is not identical in the marketplace and pursuant to the majority principle. In the marketplace, the preferences of agents are indicated by a price: the higher the price, the higher the level of interest in the product or service. When a vote takes place, preferences are expressed in the form of a vote "for" or "against" and the intensity of preference cannot therefore be expressed, which means that votes do not represent the nature of preferences with precision. The collective choice stemming from the ballot will not reflect adequately what the group values. This is what happens in the private company where, because of a *de facto* monopoly on ownership of information and the absence of a liquid market for the shares, the share price cannot reflect the preferences of the shareholders. The absence of such a price is an indication of a market failure which justifies the establishment of a sell-out right.

It is therefore possible to say that the sell-out right would be compensation for the usage, even legitimate, made of the majority rule when this results in an objective breach, *i.e.* a non-faulty breach, of the corporate contract. In a listed company, this option to exit the company results from the possibility for

the shareholder to sell his shares if there is a liquid market, even if the price may reflect the loss suffered, or mandatory bids or sell-out rights triggered when the liquidity of the market is missing. In the private company, the effects of the majority rule call for the same rights in favour of non-controlling shareholders. As this prerogative will not result from the existence of a market or the possibility of a mandatory takeover bid, it is in the notion of breach of the corporate contract that a basis for action can be found. The corporate contract entered into in private companies between controlling and non-controlling shareholders is in a state of permanent potential breach since the governing majority can at any time give an advantage to a member of the controlling alliance, with disregard for the common interest, or profoundly modify the corporate contract for legitimate reasons.

These observations underline the contractual nature of the company in which majority rule threatens permanently and structurally the unanimous consent which prevailed at the time of the formation of the company and at the time of the purchase of the company's shares. Shareholders are nevertheless united by the common objective of seeking to maximise shareholder value. The sell-out right would constitute the logical consequence of majority rule, necessary to the operation of the company, coupled with the unanimity principle at the origin of the corporate contract.

Two inefficiencies affect the private company because its shares are unlisted: an inefficient provision of information¹⁹⁸ and a voting procedure which does not allow for an expression of the intensity of preferences of shareholders since, as described above, there is no share price reflecting the value of the shares, as a consequence of the illiquidity of the market for such shares. Also, the market for corporate control in the private company is different from an efficient conventional market on which, in the absence of externalities, the purchaser and the seller alone are affected by their transaction.

The market for corporate control reflects the majority rule and is thereby comparable with political markets which are the subject of the analyses of public choice theory. When corporate control is transferred, third parties who were not consulted are affected, exactly as in the political sphere. Choices by the majority group have a coercive effect on those who voted differently, *i.e.* the minority, or who abstained. This outcome leads to an inefficient allocation of resources if compared with the Pareto test, which fails when the satisfaction of one agent cannot be improved without decreasing that of at least one other agent. The same effect is shown through a less constraining criterion, the Kaldor-Hicks test of efficiency. This test concludes that a transaction is efficient as long as the profit generated by some agents is either higher than or equal to the losses caused to the others. This criterion justifies the existence of compensation granted at the time of ballots by means of exchanges of votes or alliances between voters, resolutions after resolutions, necessary to obtain the majority. This is why, as will be explained in the next chapter, information relating to the organisation of power, such as the existence and

¹⁹⁸ See *supra* Part 1, Chapter 2.

content of shareholder agreements and actions in concert, is important, both in listed companies where this importance has already been widely acknowledged and in private companies where the consensus is less clear.

It is within the context of listed companies that the asymmetry of information between the principal and its agent as well as one of its consequences, moral hazard, were acknowledged, regarding more specifically the relationship between managers and shareholders. The result is that the right to monitor and dismiss managers, which is conferred in return for their power, is granted to the community of shareholders organised pursuant to the majority principle. This is coherent with the dividing line resulting from the observation of the exercise of power in large companies, which differentiates between the managers, on the one hand, and the shareholders as a whole, on the other hand. In the private company however, because of the concentration of share capital, we have seen that this distinction is not the most relevant and that it is necessary to replace it with the agency relationship between controlling shareholders and non-controlling shareholders. However, the empirical data on the ownership of private companies studied above has shown that this power structure is not uniform: ownership of capital is more diversified in the UK and the U.S. where there are large private companies. Private companies with such a shareholding structure are less problematic from the minority standpoint. Indeed, it is possible that the board of directors will have some independence from the shareholders if the latter are not united and there is no clear-cut majority and minority. In this case, agency conflicts are less acute and individual shareholders have less need to fear that the majority rule will be used to their detriment by other shareholders. As for the board, if its interests are in conflict with those of the shareholders, the general shareholders' meeting has the power to get rid of its members. If following such a conflict no majority can be reached against the board, it will mean that it has the support of a *de facto* majority. However, this is not the most widespread situation especially in private companies in Continental Europe because of the concentration of their share capital, which is why the separation between the controlling shareholder and the non-controlling shareholder will remain our working hypothesis.

Company law usually confers the power to monitor management on the community of the shareholders and not on particular given shareholders individually. As a consequence, in accordance with the majority principle, decisions taken in this regard by the majority of shareholders are imposed on those who did not consent thereto. However, if we come back to the basis of the right to monitor directors and the management conferred on the community of the shareholders, *i.e.* the fact that the agent is better informed than the principal, we observe that the majority principle is the cause of a hiatus. Indeed, by definition, the majority principle makes a distinction between shareholders while, on the contrary, the sanctioning of the moral hazard ought to benefit the shareholders as a whole. Nevertheless, it is true that company law usually grants specific prerogatives to minority shareholders in order to monitor the managers, the directors but also the majority shareholders, for instance the right to petition in court for the appointment of a third party expert in management. This minority control over the majority is based on

the same idea as that underlying the control by the community of shareholders over the managers and the directors. This is because a specific agency relationship exists between the majority and the minority shareholders. It is within this theoretical framework that an obligation to purchase the shares of the non-controlling shareholders, in certain circumstances that we will discuss in Part 3 and under the supervision of courts, should weigh on the controlling shareholders.

Where sell-out rights exist in listed companies in favour of minority shareholders, paid for, according to the circumstances, by the controlling shareholders or by those holding more than 66% or 95% of the share capital of the company, these provisions come on top of the permanent option to sell the shares on a liquid stock market. A liquid stock market provides an exit, albeit at a price reflecting the nature of the behaviour of the majority towards the minority shareholders. It is well known that buy or sell orders, be they voluntary or mandatory, as in the context of mandatory bids, are the means by which shareholders express their confidence or their distrust in management or the board of directors. The transfer of listed shares and, as a consequence, the movement of the share price constitute a control and sanction mechanism over the agent/manager or director by the principal/shareholder. The reason is that one function of the stock market is to have companies compete for capital. However, since investors seek the companies generating the highest return on investment, company management is pressured into pursuing the maximisation of the shareholder value. If there are no permanent takeover defences and no one single majority shareholder, unlike in Continental Europe, maintaining a high share price will keep potential bidders away and is in the interest of the managers and directors who will therefore be able to keep their positions. In the context of the stock market, provided that enough of a company's share capital is floated, the utility of the managers, directors and shareholders therefore tend to converge. On the contrary, in the private company where no market forces act in support of voting rights, such voting rights therefore remain ineffective.

We will argue first that the exercise of the voting right according to the majority principle is structurally inefficient, before concluding that a sell-out right therefore needs to be introduced into the private company as a remedy to this inefficiency. One possible regime, inspired by the characteristics of the various sell-out rights existing in listed companies, will be put forward in Part 3, taking into account a factor common to listed and unlisted companies, the agency relationship.

In the absence of any market for their shares, shareholders in private companies are directly affected by the failings of the majority rule. These shareholders cannot efficiently express their preferences since voting entails a separation between the exercise of power and the taking of risks. In this regard, the introduction of a sell-out right would provide a remedy for the inefficiency of the market for votes, while remaining consistent with a contractual approach to the firm because it would, subject to court approval, be triggered by a breach of the corporate contract, the implicit pact underlying the shareholders' relationships, for the benefit of the minority shareholders.

In accordance with the contractual approach to the firm, the function of the vote is to achieve the common objective of shareholder value maximisation¹⁹⁹. This objective is implicitly agreed between the shareholders at the time of the choice of the type of company (for-profit). The basis of the voting right granted to shareholders in a company is that they are the “owners” of the firm which means that they hold the residual claim to the net assets of the company although they are not personally liable, as proper owners would be. It is to be noted that another difference between a shareholder and an owner, according to standard definitions of ownership, results from the purpose of the corporate form which is to prevent shareholders from prematurely withdrawing capital from the company²⁰⁰ and also shareholders do not have the owner’s absolute right to dispose of his property with complete freedom²⁰¹. Only management or the board of directors can dispose of corporate assets, not in their own interest as if they were real owners but in the shareholders’ interest. The right to vote, which is the right to decide, is therefore the consequence of the risk borne by the shareholder, in particular the risk that the corporate net assets could be negative and cause him a loss. However, the amount of information at the disposal of the non-controlling shareholder does not make it possible for him to cast an informed vote. Moreover, it results from the majority principle governing voting procedures that a shareholder cannot individually hope to influence the outcome. Also, the benefit of a positive decision, contributing for example to better management, will be all the more limited in that its stake in the share capital is small. All this shows why resolutions adopted via voting do not reflect the preferences of shareholders with the same degree of accuracy as a share price would.

In order to allocate resources as efficiently as possible, markets require that agents express not only their preferences, but also the intensity of such preferences. However, the lack of liquidity or the outright absence of a market for non-listed shares do not provide the necessary conditions for the emergence of a price whose economic function is precisely to reflect the intensity of the respective preferences of a purchaser and a seller. Contrary to listed companies in which the share price expresses the level of interest in the shares, the market for corporate control in the private company is affected by a market failure which prevents the shareholders from expressing the intensity of their preferences. This is why it is frequently noted that the selling price of an unlisted share does not give an accurate idea of its value because of the minority discount. There are reliable intrinsic valuation methods for unlisted shares but, in relative terms, with regard to preferences, these remain less accurate than the price resulting from the matching of a buy order and a sell order on a liquid market. In this regard also, the valuation of the shares on the occasion of a sell-out right will be useful to the private company shareholders.

¹⁹⁹ See Easterbrook F. H. and Fischel D. R., *Voting in Corporate Law*, in *Foundations of Corporate Law*, Oxford University Press, Ed. R. Romano, 1993, p. 195.

²⁰⁰ See M. Blair, *Locking In Capital: What Corporate Law Achieved for Business organizers in the Nineteenth Century*, 51 *UCLA Law Review* 387 (2003), 392.

²⁰¹ See Didier P., *Le Droit Commercial au Tournant du Siècle*, Université Panthéon - Assas / Paris II, Dalloz, 2000, p. 465. See also Didier P., *Théorie Économique et Droit des Sociétés*, in *Mélanges Sayag*, 1997, p. 227.

We have seen that in a private company, the voting procedure governed by the majority principle results in a separation between the decision-making power and the notion of risk with regard to the shareholder as a residual claimant. Risk is an important notion in the contractual approach to the company which tends to be hidden by the concept of legal personality. The nexus of explicit and implicit contracts making up the company, which expresses the common interest of the shareholders, is indeed in their eyes the optimal arrangement with regard, on the one hand, to the level of risk which they agree to take and, on the other hand, to the opportunities that they expect. The company thus appears as an organisation in which participation is voluntary and this is confirmed by the initial unanimous agreement to the corporate contract including constitutional documents, fiduciary duties and disclosed shareholder agreements. However, after the time of the formation of the company when the consents given were unanimous, corporate life requires the substitution of the majority principle for the unanimity voting rule, otherwise corporate decision-making would be brought to a stand-still. The consequence is the severance of the proportional equality which, at the time of the company's creation, linked the risk incurred with the power to make decisions. Minority shareholders will have to follow the decisions of the majority and will thus incur a proportionate loss of decision-making power whereas they will continue to assume a share of the risk proportional to their contribution of capital.

Another way to look at the contrast between the approaches to the firm as a nexus of contracts or as a legal person is to consider that the first approach limits team-specific investments because "each of the participants would probably be reluctant to extend himself or herself very far" and to emphasise that it is necessary to incorporate and invest through a separate entity in order to make the commitments of the partners credible and to elicit the investment of human and financial capital. The obvious advantage of the institutional aspect of the corporate form is that it enables the building of a basis for the various stakeholders in a business enterprise which is more reliable than a partnership-like relationship²⁰². In this respect, the separation of ownership from control can be said to be "one of the most important benefits of the corporate form"²⁰³.

Returning to the contractual approach, basing the sell-out right on the breach of the implicit corporate contract raises the question of whether this contract is a fiction or a reality. The answer requires a distinction to be made according to the ownership structure of companies. At first sight, a corporate contract is identifiable as a reality only where the number of shareholders is limited. Consequently, it would be in "quasi-partnerships" only, that is in very small incorporated companies having a much greater resemblance in fact to a partnership, that a contract between the members would be enforceable as shown by the 'legitimate expectations' doctrine under section 994 of the 2006 UK

²⁰² N. Lamoreaux and J.-P. Rosenthal note the potential of "incorporation [to solve] some of the agency problems associated with partnerships" in *Legal Regime and Contractual Flexibility: A Comparison of Business's Organizational Choices in France and the United States during the Era of Industrialisation (2005)* 7 *American Law and Economics Review* 28-61.

²⁰³ See for example M. Blair, *Locking In Capital: What Corporate Law Achieved for Business organizers in the Nineteenth Century*, op. cit., p. 402, 427 and 433.

Companies Act (formerly section 459 of the 1985 Companies Act). Conversely, with regard to private companies with a more widely dispersed share capital as well as with public companies, this doctrine would assume that the constitutional documents are exhaustive arrangements between shareholders and that no other terms of any kind are to be enforced outside it. It would therefore make the notion of the corporate contract at best a fiction if not an illusion. However, this approach seems too formalistic. An example taken from court decisions rendered under section 459 shows that the notion of corporate contract should be understood more widely and could consequently be enforced in every limited liability company. Courts have indeed enforced the right of a minority shareholder to take a seat on the board of a company after it was demonstrated that a shareholder agreement existed on the matter. Prof. P. L. Davies concludes that "section 459 may qualify, not only the formal articles, but also the statutory powers of the majority". It therefore follows that statutory provisions and contractual provisions are placed on the same level, as indeed they should be. The contractual nature of these provisions is demonstrated by the fact that they were accepted on a voluntary basis and that they were eventually priced. The regulation of the powers of the majority and its inherent prevention of any potential abuse therefore forms a part of every implicit corporate contract.

However, before we go on to examine the consequences of the breach of the corporate pact, let us look briefly at how parties to different types of contract can or cannot withdraw their capital.

3.2 No exit routes

If two parties organise their relationship in the form of an implicit team, that is to say when neither party makes a team-specific investment as no party produces something that no one else has the ability to provide on similar terms, then the withdrawal of its capital by one of the parties will not trigger any sort of legal penalty. This is because, in the absence of team-specific investments, there is no information asymmetry to foster opportunism. Even if team-specific investments (and with them potential opportunism) were to develop between the parties, it would still be possible for one of them to withdraw opportunistically and yet pay no compensation. Organising in the form of an implicit team therefore implies that each party assumes the risk that future developments may encourage a party to withdraw from the relationship if it is in its interest to do so. Therefore, this does not provide the necessary permanence required by a company. For this allocation of risk to be attractive, the parties must have the opportunity to diversify their investments against these risks. This seems far removed from the situation of the average non-controlling shareholder who may have a large proportion of his wealth invested in a closed corporation.

One organisation process that is halfway between the implicit team and the firm is long-term contracting. To what extents are the parties free, *i.e.* not obliged to pay any penalties to withdraw their financial or human capital in long-term contracting? The long-term contracting organisation process is

closer to the firm in that it brings together parties who make team-specific investments, that is, investments that are most profitable when used in conjunction with the activities of the team. This is characterised by the fact that, contrary to the implicit team, it provides *ex ante* for *ex post* contingencies by allocating specific rights and duties to parties. This leads to another difference from the implicit team in that the withdrawal by one party makes it liable to pay damages to the other party for breach of contract. This cost operates as a deterrent to opportunistic threats to withdraw. However, another type of risk stems from the attempt to draw up a fully contingent contract: that of erroneous specification when the contractual clause designed to adjust for changed circumstances later proves to be maladaptive. This risk can be alleviated via a mechanism that does not go as far as setting an automatic adjustment every time but that provides for a renegotiation option at a party's request. This cooperative stance is exposed to the risk that one party may opportunistically refuse to renegotiate however, in terms of withdrawal power, the risk of loss from the opportunistic threat to withdraw is lowered as legal penalties would apply. It is therefore the trade-off between opportunism and adaptability to future changes and thus the conditions governing the severance of ties between parties that is at the origin of the choice of a model of organisation²⁰⁴.

If we now turn to the private company, we see that the private company contract is a set of standard form rules resulting from corporate law, supplemented by a particular company's constitutional documents and shareholder agreements, but that it usually includes no details with regard to responses to future contingencies. We see that here, contrary to long-term contracts, gap-filling problems are dealt with *ex post*.

Gap-filling authority rests mainly with majority shareholders and to a lesser extent with the courts. To complain, the minority needs to show that it suffered oppression by the majority, that a fiduciary duty has been breached or, under a restrictive set of circumstances, that reasonable expectations have not been met. Then, the courts may grant equitable relief. However litigating is costly and the outcome is uncertain and this is why the majority gap-filling process is favoured.

Under this "would-have-wanted" gap-filling theory, *i.e.* the combination of adaptability to changed circumstances and risk of opportunism attached to the parties' chosen business form, it can be argued that the relations between majority and minority should be governed by partnership law rather than company law when decisions can no longer be reached by consensus²⁰⁵. In such a case, opportunism and adaptability are combined by inserting partnerships' liquidity provisions into the private company

²⁰⁴ "Central to my theory is an understanding of the dichotomy between opportunism and adaptability", O'Kelley Jr., C. R., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 *Northwestern U. L. R.*, 218 (1992).

²⁰⁵ This is why "Many SMEs worried about the threat of minority oppression in the corporation to such an extent that they were willing to bear the partnership's substantial risk of untimely dissolution" (Guinnane T., Harris R., Lamoreaux N., Rosenthal J.-L. *Ownership and Control in the Entrepreneurial Firm: An International History of Private Limited Companies*, Center Discussion Paper n° 959, Economic Growth Center, Yale University, December 2007, p.53.)

contract. Profs. Hetherington and Dooley thus argue that these corporations should have rules making the shares redeemable upon request by the dissatisfied shareholder²⁰⁶. This would obviously have an adverse effect on the stability which is precisely the aim of the establishment of the company. This is why certain authors see the "private limited liability companies", *i.e.* the private limited company in the UK, the *SARL* as opposed to the *SA*, viewed as a corporation, in France or the *GmbH* as opposed to the *AG* in Germany, as a kind of middle ground between the partnership's inability to lock in capital and the costs associated with dominant shareholders in corporations²⁰⁷. It may be that this interesting approach gives too much weight to the power of contractual flexibility to differentiate the regime of private limited liability companies from that of corporations and annihilate the risk of minority oppression inherent in the corporation²⁰⁸.

One alternative interpretation of the "would-have-wanted" gap-filling theory is found in the work of Profs. Easterbrook and Fischel who argue that, when faced with gaps, courts should seek to identify what the parties "would have bargained for had they anticipated the problems and been able to transact costlessly in advance"²⁰⁹, as the parties would not necessarily have transacted for partnership-like rules.

3.3 Possible remedies

Resolving shareholder relationship problems through partnership-like rules is to give pre-eminence to the adaptability of the corporate contract. Pursuant to this approach, each shareholder can thus withdraw his capital at will, but it is at the risk of a greater degree of opportunism - in this case, minority opportunism. On the other hand, in companies, the withdrawal of capital by the shareholder can depend on the majority since a minority position is more easily sold alongside the majority than on its own, and this potentially gives rise to majority opportunism. When devising an opt-out rule, one should therefore bear in mind the relative majority/minority opportunism implied by the shareholders' investment characteristics. This is why the sell-out right model that we propose in Part 3 is not triggered automatically but further to a court decision only, and the majority has the opportunity to oppose valid reasons to the sell-out right.

When there is no way to remove a shareholder from power, as is the case when a member holds a stake giving him an absolute majority in a company and the shares are not in practice freely

²⁰⁶ Hetherington J. A. C. and Dooley M. P., *Illiquidity and Exploitation: A Proposed Statutory Solution in the Remaining Close Corporation Problem*, 63 Va. L. Rev. 6 (1977)

²⁰⁷ Guinnane T., Harris R., Lamoreaux N., Rosenthal J.-L. *Ownership and Control in the Entrepreneurial Firm, op. cit.* See for instance p.32 where, to illustrate that the *SARL* has been a useful tool against minority oppression, the authors "Consider the case of a *SARL* with no dominant shareholder", a situation where the case for the contractual flexibility may be relevant but which fails to address the context of choice of minority oppression which is the agency relationship between majority and minority shareholders. In other instances, the authors draw on the fact that minority shareholders acting as managers of a *SARL* who were specifically named in the articles of association could not be removed without serious cause. This is no longer the case since the *gérant* of a *SARL* can be dismissed by a majority of the shareholders (article L.223-25 of the French Commercial Code).

²⁰⁸ See *infra*, p. 130.

²⁰⁹ Easterbrook F. H. and Fischel D. R., *The Economic Structure of Corporate Law*, 34, 1991.

transferable, there is little chance that the minority will be able to secure a commitment from the majority, for example, an undertaking to set aside a seat on the board for such minority shareholder. An analogy with society at large can be made in this regard. John Rawls showed that one condition for political liberalism is that those currently in power fear the day when they will no longer be in power and so govern wisely for the time being. The consequence is that the social contract requires the holding of regular elections so that the minority has a chance to become the majority and the balance of power can be shifted. No such thing happens in a private company governed by an entrenched majority as mentioned above. It is therefore necessary to base the solution, *i.e.* the sell-out right, on an implicit corporate contract which takes this risk into account. In order to do so, drawing on applicable laws, constitutional documents and the management/controlling shareholder's duties is sufficient. These all refer to the various allocations (of votes, or profits and losses) to which a shareholder is entitled and provide for a principle of proportional equality which prevents, or at least limits, conflicts of interest.

Since the separation between power and risk increases potential conflicts of interest, several consequences are triggered in most legal systems when a majority decision results in the reorientation of the initial implicit corporate contract. It is interesting to note that both shareholders and bondholders are in a similar situation in this respect²¹⁰. This confirms that it is as a residual claimant that the shareholder is granted the right to vote and that consequently, when this right is systematically deprived of effect, the shareholder should be allowed to reconsider his investment decision, *i.e.* to sell his shares at fair value. The consequences which can be attached to the alteration of the contract between the company and either the bondholders or the shareholders are, in ascending order of seriousness and relating to the first category, the attribution of an intervention right in corporate operations, with regard to the second category, the restoration of unlimited liability and finally, in common to both groups, the obligation to purchase the shares of the minority shareholders or to repay the bondholders. To take an example from French law, when the company is involved in projects "tending to the amendment of the bond-issuing contract"²¹¹, which in practice will or could potentially increase the bondholders' exposure to risk, article

²¹⁰ "...suppliers of finance [stockholders and debtholders] bear a unique relationship to the firm: the whole of their investment in the firm is potentially placed at hazard.", Williamson O. E., *Corporate Governance*, in *Foundations of Corporate Law*, Oxford University Press, Ed. R. Romano, 1993, p. 158. More generally, this is a sign of an increasing proximity of the status of the shareholder and the bondholder in the context of the market.

²¹¹ Art. L. 228-65, French Commercial Code: " I. - *L'assemblée générale délibère sur toutes mesures ayant pour objet d'assurer la défense des obligataires et l'exécution du contrat d'emprunt ainsi que sur toute proposition tendant à la modification du contrat et notamment:*

1° *Sur toute proposition relative à la modification de l'objet ou de la forme de la société ;*

2° *Sur toute proposition, soit de compromis, soit de transaction sur des droits litigieux ou ayant fait l'objet de décisions judiciaires ;*

3° *Sur les propositions de fusion ou de scission de la société dans les cas prévus aux articles L. 236-13 et L. 236-18 ;*

4° *Sur toute proposition relative à l'émission d'obligations comportant un droit de préférence par rapport à la créance des obligataires composant la masse ;*

5° *Sur toute proposition relative à l'abandon total ou partiel des garanties conférées aux obligataires, au report de l'échéance du paiement des intérêts et à la modification des modalités d'amortissement ou du taux des intérêts. (...)*

II. - *L'assemblée générale délibère dans les conditions de quorum prévues au deuxième alinéa de l'article L. 225-98. Elle statue à la majorité des deux tiers des voix dont disposent les porteurs présents ou représentés".*

(I.- The general meeting shall deliberate on all measures intended to ensure the defence of the bondholders and the fulfilment of the loan agreement and on any proposal aimed at amending the agreement and in particular:

(cont'd)

L. 228-65 of the French Commercial Code (*Code de commerce*) provides that they have a right to have a say on the project, which amounts, depending on factual circumstances, to a right of veto. Indeed, the most serious modifications of the initial pact, such as a change in the form or purpose of the company or the issuance of bonds for priority repayment, trigger the obligation to refund the bondholders upon request²¹². This may constitute such an onerous financial burden that it leads the majority to give up its plans. This example confirms the idea that the right to decide is conferred on whoever assumes the financial risk of the company in the last resort: it can be either a shareholder or a bondholder.

In the same way, it would seem logical to ignore the limitation of the liability of owner-managers or majority shareholders whenever they exposed the creditors to excessive or unnecessary risks. The shareholders' and the managers' limited liabilities determine the level of risk which they have chosen to accept. Their decision-making power as a manager or a majority shareholder is, as has already been stated, proportionally more important than their liability. It would thus seem logical to consider the extension of their liability when they increase the power/risk ratio on the occasion of a decision, adopted by means of the majority principle, involving risks from which they are exempt, because of the limitation of their financial liability. The same rationale would command the same solution against majority shareholders who do not abide by the wealth-maximization goal common to the community of shareholders. This logic is confirmed in practice, for example banks making a loan to smaller companies will often ask the managers and/or majority shareholders to grant a personal guarantee. So as to avoid producing an overly risk-averse environment for corporate controllers, the extension of the financial liability of managers and majority shareholders in case of intentional breach of the corporate contract should not be automatic and should require a court decision. Another idea would be to make them subject to sanctions for misuse of the company's assets, which can be a criminal offence, when they let their personal interest or the interest of another company in which they have a stake prevail. It would also amount to ignoring the limitation of their financial commitment to the company. There is an alternative to this potential criminal risk which would also result in the extension of the limitation of their liability: this would be to compel them to issue in favour of the minority shareholders a guarantee of profits or to

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1° On any proposal relating to the alteration of the object or form of the company;
2° On any compromise proposal relating to rights in dispute or which are subject to court decisions;
3° On company merger or division proposals in the cases specified in Articles L.236-13 and L.236-18;
4° On any proposal relating to the issue of bonds including a preferential right in respect of the claim of bondholders forming the body;

5° On any proposal relating to the total or partial abandonment of the guarantees granted to bondholders, on the extension of the due date for payment of the interest and on the alteration of the terms of repayment or the interest rate. (...)

II.- The general meeting shall deliberate in accordance with the quorum and majority conditions specified in the second and third paragraphs of Art. L. 225-98.)

²¹² See Art. L. 228-72, French Commercial Code and D. 234, D. 23 March 1967. Art. L. 228-72: "A défaut d'approbation par l'assemblée générale des propositions visées aux 1° et 4° de l'article 313, le conseil d'administration, le directoire ou les gérants de la société débitrice peuvent passer outre, en offrant de rembourser les obligations dans le délai fixé par décret".

(Failing approval by the general meeting of the proposals referred to in 1° and 4° of I of Art. L. 228-65, the board of directors, management or managers of the debtor company may carry on regardless by offering to redeem the bonds within the period fixed by a *Conseil d'Etat* decree. The decision of the board of directors, management or managers to carry on regardless shall be published in accordance with the conditions fixed by a *Conseil d'Etat* decree which shall also determine the period during which the redemption must be requested.)

commit to purchase their shares²¹³. The latter solution will be preferred when, in spite of a financial compensation, the conflict of interests has permanently altered the initial corporate pact. Offering the minority shareholders a right to sell out also makes it possible to avoid restricting the notion of the breach of the initial corporate contract to the facts referred to by a criminal offence, such as misuse of company assets²¹⁴, *i.e.* the intentional and wrongful behaviour of the shareholders resulting from a majority decision made during the operation of the company²¹⁵.

As the preceding illustrations have shown, the concept of risk links the majority principle with its correlative, *i.e.* the limitation of liability, and links the unanimity principle with unlimited liability. The first pair implies that the shareholders agree not to take part in practice in the decision-making process of their company on a double condition: on the one hand, that corporate decisions remain within the limits of the corporate contract initially concluded, under the control of courts, and on the other hand, that their financial commitments be limited to the amount of their contributions. Consequently, if the corporate contract is significantly altered, a unanimously voted decision should in theory be taken. This refers to the second term of the alternative: the unlimited liability-unanimity pairing which is in force in partnerships. In limited liability companies, it is precisely in case of an increase in the risks incurred by the shareholders that the majority principle makes way for unanimity. If it were otherwise, the voting right would be disconnected from the level of risk incurred.

Prof. Paul Didier sums up this idea as follows: "The voting right is measured by the risk incurred"²¹⁶. In French corporate law, this principle of proportionality results from article L. 225-122 of the Commercial Code (*Code de commerce*) and it underlies the prohibition on acquiring voting rights without acquiring the corresponding shares²¹⁷. Despite this provision, shares with double voting rights continue to exist, as well as voting right certificates, which violate the principle of proportionality between ownership and control. This principle entails the idea that anybody who enjoys power greater than the risks incurred will not receive a share of the residual profit or loss resulting from the resolution in favour of which he

²¹³ Didier P. (1997) *op. cit.*, p. 240.

²¹⁴ See *infra* in this chapter.

²¹⁵ See *infra* Part 3.

²¹⁶ ("... *le droit de vote se mesure au risque assumé*."), in Didier P., *Le consentement sans l'échange*, *Rev. Jur. Com.*, Novembre 1995, n° spécial, p. 86.

²¹⁷ Art. L. 225-122: "*I. - Sous réserve des dispositions des articles L. 225-10, L. 225-123, L. 225-124, L. 225-125 et L. 225-126, le droit de vote attaché aux actions de capital ou de jouissance est proportionnel à la quotité de capital qu'elles représentent et chaque action donne droit à une voix au moins. Toute clause contraire est réputée non écrite.*

II. - Dans les sociétés par actions dont le capital est, pour un motif d'intérêt général, en partie propriété de l'Etat, de départements, de communes ou d'établissements publics, et dans celles ayant pour objet des exploitations concédées par les autorités administratives compétentes, hors de la France métropolitaine, le droit de vote est réglé par les statuts en vigueur le 1er avril 1967.

(I.- Subject to the provisions of Articles L.225-10, L.225-123, L.225-124, L.225-125 and L.225-126, voting rights attached to capital or dividend shares shall be in proportion to the share of the capital they represent and each share shall entitle the holder to at least one vote. Any clause to the contrary shall be considered non-existent.

II.- In limited partnerships with shares, whose capital is partly owned by the State, departments, municipalities or public institutions as a matter of public policy, and those whose object is to operate services under licence from the competent Government authorities, outside mainland France, voting rights shall be governed by the memorandum and articles of association in force at 1 April 1967.)

voted, proportionate to its power. In these circumstances, this person is not able to make an optimal decision. One could in the same way question the rationale underlying the special majorities required to approve major corporate decisions, such as the alteration of constitutional documents. The requirement for a two thirds majority in extraordinary general shareholders' meetings results leads to greater weight being given to certain shares, thus breaking the principle of proportionality. Moreover, it provides the corporate management with an indirect support by depriving the shareholders of a tool for lobbying in favour of compliance with the shareholders' common interest of wealth maximisation. Special majorities could therefore be replaced by an arrangement that would combine a relative majority voting procedure with a sell-out right in favour of minority shareholders.

To take another example from French law, this connection between voting and risk is also implicitly laid down in article 225-96 of the Commercial Code which provides that the extraordinary general meeting ruling with a majority of two thirds cannot "increase the commitments of the shareholders". Similarly, article 225-245²¹⁸ explicitly requires a unanimous vote in the event of the conversion of a limited liability company into a partnership in which the partners are indefinitely and jointly liable with respect to corporate debts. These three events in the life of a corporation, which each illustrate a major alteration of the contract entered into by the shareholders' community at the time of their investment, cannot happen via a simple majority vote. Moreover, it is significant that in listed companies a factual situation very similar to that of article 225-245 entails the obligation for the majority to make an offer to purchase the minority shares²¹⁹. The right to exit the company constitutes the third term of the alternative between the unanimity, often ineffective, and the majority principle, which can be iniquitous. Also, a sell-out right would make it possible for the minority shareholder to have a new occasion²²⁰, after the time of its initial investment, to express his preferences through the price which will emerge from the interplay of supply and demand for his shares or from their valuation by a third party.

²¹⁸ Art. 225-245: "La transformation en société en nom collectif nécessite l'accord de tous les associés. En ce cas, les conditions prévues aux articles L. 225-243 et au premier alinéa de l'article L. 225-244 ne sont pas exigées. La transformation en société en commandite simple ou par actions est décidée dans les conditions prévues pour la modification des statuts et avec l'accord de tous les associés qui acceptent d'être associés commandités. La transformation en société à responsabilité limitée est décidée dans les conditions prévues pour la modification des statuts des sociétés de cette forme".

(Conversion into a general partnership shall require the agreement of all the partners. If such agreement is obtained, the conditions laid down in Articles L.225-243 and the first sub-paragraph of Art. L. 225-244 shall not be required.)

Conversion into a limited partnership, with or without shares, shall be decided in accordance with the conditions laid down for the amendment of the memorandum and articles of association and subject to the agreement of all the partners who agree to be active partners.

Conversion into a limited liability company shall be decided in accordance with the conditions laid down for the amendment of the memorandum and articles of association for companies incorporated in that legal form.)

²¹⁹ Art. 236-5, AMF General Regulations, see infra.

²²⁰ The other occasion for a shareholder to express the intensity of his preferences is the price he paid for his shares at the time of his joining in the company.

PART 2. AVAILABLE STRATEGIES

CHAPTER 1 INFORMATION SUPPLY IN PRIVATE COMPANIES

In this chapter, we will consider the disclosure of information as a strategy for dealing with some of the policy issues identified in Part 1 arising from empirical data on the ownership of private companies. We will follow a comparative path between listed and unlisted companies and deal with disclosure rules of listed companies, which would efficiently counterbalance the asymmetry of information between principals and agents in private companies and thus limit opportunism.

1.1 The disclosure of information on and outside the stock market

Signal theory applied to the analysis of information on capital markets shows that the law is grasped as a piece of information and at the same time is a producer of information on the stock market. That is why investors assess listed companies through their ability to transmit information. In this regard, the organisation of the listed company is more influenced from a theoretical point of view by the financial markets, with the emphasis being placed on information in the theory of efficient capital markets, than by the theories of the firm. This is particularly clear when assessing the rationale behind the sanctioning of insider trading in listed companies.

Just to expand briefly on this example, which we will deal with extensively in the developments regarding the disclosure obligation resulting from the enforcement of a duty of loyalty in the next subsection, the sanctioning of the use of inside information in the context of sales of unlisted shares is currently under development²²¹. However, in the absence of a market for shares, the basis put forward cannot be that it harms the operation of such market and another rationale for the disclosure of information in private companies and for sanctioning the use of private information must therefore be found. This is in fact that it amounts to a breach of a disclosure obligation resulting from a duty of loyalty²²².

The study of information in organisations has progressively developed into a branch of economics in its own right²²³. So great is the influence of the notion of information that “organisation theory has

²²¹ See in French law, Com. 27 Feb. 1996 and more recently Com. 12 May 2004, RTD Civ. 2004. 500, observations by Mestre J. and Fages B.

²²² See infra Part 2, 2.3.a.

²²³ See for example, *L'Economie de l'Information*, under the direction of Pascal Petit, Coll. Recherches, Ed. La Découverte, 1998.

mainly become an information theory²²⁴. In the context of information economics, information is a resource of the company in the same way as work and capital and it is thus understood as a competitiveness factor. In listed companies, information needs to be regulated because information is what financial markets are all about. In private companies however, information will be regulated in the same way as other resources such as workforce and capital. Out of the context of the financial markets, regulation is also needed because within the company, described as a nexus of contracts, specific information problems arise leading to agency problems and market failures. Listed and unlisted companies thus have in common the fact that "information shapes the organisation which produces it"²²⁵, even if it does so for different reasons. The regulation of information is currently more efficient (*i.e.* its net benefits are higher) in listed companies where the financial market proves to be a powerful influence, since to operate efficiently the market needs to extract as much information as it can from companies. Prof. Christian de Boissieu underlines the importance of information in all types of companies, listed or unlisted, embodied by agency issues as follows: "information is at the root of all conflicts and litigation relating to power and may justify a reinterpretation of all modern economic theory; I think that it is the same in the legal field"²²⁶. An effective information allocation system is therefore necessary in private companies, for the benefit of minority shareholders, in the context of asymmetry of information. Moreover, it is of interest to note that the economics of contracts, which aim at seeking ways to encourage agents to disclose the information they hold, applies indifferently to listed and unlisted companies.

On stock markets, where information is constantly being processed and where the control of companies is permanently up for grabs, depending on the amount of capital floated, the mandatory disclosure of actions in concert and shareholder agreements in accordance with stock exchange regulations illustrates the link that exists between information and power. The rationale for such disclosure is that if these signals relating to the exercise of power were not made public, certain investors aware of the existence of alliances would benefit from additional power. It is in the light of this information that investors on the stock market will decide whether to buy, keep or sell their shares. The sharing of information therefore contributes to balancing the distribution of power amongst shareholders and between shareholders and managers. The spread of information should therefore be improved in the private company and reflect stock market practices in order to act as a counterbalance to the power of the

²²⁴ Crémer, J. Information dans la Théorie des Organisations, in L'Economie de l'Information, op. cit., p.277.

²²⁵ In L'Economie de l'Information, op. cit. Directed at the idea of a theory of the firm constructed on the base of the notion of information: "...all the theories of the firm most commonly used (agency theory, transactional approach, teams' theory, etc.) are based on the hypothesis that the firm is conceived as an "information processor". According to these theories, the firm's behaviour may be inferred from informational signals detected in its environment, so that, even though the nature of the informational problem differs from a theory to the other (existence of information asymmetry, existence of information gathering costs, unequal spread of information between the members of a "team", etc.), the focal point remains the same", Cohendet P., Information, Connaissance et Théorie Evolutionniste de la Firme, in L'Economie de l'Information, op. cit., p. 253.

²²⁶ Boissieu C. de, Comparabilité Economique entre Système Concurrentiel de Biens et Services et Système Boursier et Financier, in Droit Boursier et Droit de la Concurrence, Seminar of 7 April 1999, Dir. Frison-Roche M.-A. and Cohen-Tanugi L., Petites Affiches, 21 July 1999, no. 144, p. 6-7.

controlling shareholder. Granting better access to information, which constitutes a public good, is therefore a necessary precondition for the protection of minority shareholders.

The general idea that the holder of private information has an advantage in terms of power over other agents in an organisation has been extensively analyzed by sociologists, including French sociologist Michel Crozier²²⁷, who demonstrates that the withholding of information is closely linked to the development of a hierarchical model of allocation of power. In a hierarchy, power and its legitimacy result from the concentration of information²²⁸. The concentration of information therefore contributes to the concentration of power. On the other hand, an efficient market is a model in complete contrast to an organisation characterized by its concentration of power and indeed such market model is considered to be the complete opposite of the hierarchical principle. If companies are considered as the nexus of many markets, it then makes sense to work out in the private company “a neutralization of powers by attributing rights to minority shareholders as compensation for the power which the majority principle confers upon majority shareholders”²²⁹.

We will now address the issue of the disclosure of information from a cost perspective. The improvement of information disclosure should indeed be based on its cost-effectiveness. We will first highlight the costly nature of the production and acquisition of information in the context of the agency relationship because of the public good nature of information, before going on to illustrate the cost-saving function of disclosure regulation.

1.2 Information and agency costs

Information asymmetry gives rise to agency costs on two occasions: at the time of its production and at the time of its acquisition. The production of information by those who hold it, for instance the managers or the majority shareholders, can be considered as a bonding expenditure made by the latter in order to justify their actions to the shareholders. From the same perspective of agency costs, for shareholders, information acquisition costs amount to monitoring expenditures through which the shareholders as principals control the behaviour of their agents. In this context, the goal of the regulation of information is to lower the agency costs resulting from information asymmetry.

²²⁷ “...Any collective action structure gets organized as a power system. It is a phenomenon, an effect and an act of power. (...) Any reliable collective action analysis must consequently put the power at the centre of its reflections. Because collective action is finally nothing more than every day politics. Power is its “raw material”, Crozier M. and Friedberg E., *L'acteur et le système, Les Contraintes de l'Action Collective*, Seuil, Coll. Points Essais, 1992, 1st ed. 1977, p. 26; see also for example, Crozier M., *La Négociation et la Règle du Point de vue du Sociologue de l'Organisation*, in *Variations autour de la Régulation Sociale, Hommage à Jean Daniel Reynaud*, Presse de l'Ecole Normale Supérieure, 1994, p. 65. This idea is also at the centre of game theory analyses.

²²⁸ “Withholding information is at the centre of the organisation of the French company, since it [information] is the base of the authority justifying the hierarchy”, Crozier M., *MTF-L'AGEFI*, no. 102, November-December 1998, p. 32. On the legal personality in company law as model of the hierarchical approach, see *infra*.

²²⁹ See Frison-Roche M.-A., *Le Droit Financier entre Volontés et Informations*, in *Prospectives du Droit Economique, Dialogues avec Michel Jeantin*, Dalloz, 1999, p. 16.

This is best demonstrated within the context of listed companies where disclosure requirements prior to the flotation of the shares or to a public offering of securities illustrate how the costs generated by information asymmetry between insiders and the market, made up of current and potential shareholders, are lowered by mandatory requirements. The same reasoning is applicable to the private company if one considers the market for corporate control of those companies, even though there is no liquid market for the shares as such²³⁰. This illiquid market is plagued by information asymmetry, which entails costs that the market itself cannot eliminate, thereby leading to market failures that regulation can counterbalance by restoring efficiency.

In the context of the separation of ownership and control which differentiates the interests of shareholders and managers in listed companies, managers must prove that they are pursuing the interests of the principals, *i.e.* the shareholders, because their situation in a listed company can be threatened in the marketplace if the control of the company is up for grabs or if there is a statutory mandatory bid regulation. It is therefore in the interest of the managers of listed companies to voluntarily provide information to the financial markets, made up of current and potential shareholders, so that for instance subsequent placements of securities will be subscribed to and, more generally, the share price on the secondary market will remain steady. A low share price indeed acts as an incentive for a bidder to launch a takeover, which puts the managers' situation at risk. Consequently, this aspect of the agency theory coupled with the market for corporate control used as a sanction on the violation of the principal's interest, creates a voluntary source of information that is specific to listed companies. This specificity has led Profs. Easterbrook and Fischel to conclude that a legal system of information disclosure is superfluous in listed companies because this is already provided spontaneously by the financial markets²³¹. This voluntarily provided information, which convinces the market of the management's efficiency, is an illustration of the bonding costs which make up the agency costs, together with monitoring and residual expenditures.

Managers of listed companies have at their disposal several ways in which to convey information or signals to the market, some of which are organized by law. When management plans a major change in corporate strategy, the disclosure of this information to the market is usually subject to explicit statutory provisions. This is specific to listed companies where, pursuant to stock market regulations, any news likely to have an impact on the share price is subject to a disclosure obligation²³². Another bonding cost takes the form of recourse to third parties for the certification of the corporate accounts, which conveys to

²³⁰ Even though it is notable that the development of private equity transactions leads to the formation of a secondary market for the shares of certain companies.

²³¹ See Easterbrook F. H. and Fischel D. R., *Mandatory Disclosure and The Protection of Investors*, Virginia Law Review, vol. 70, 1984, p. 669.

²³² See under French law. Art. 223-2, *AMF General Regulations*: "Any issuer must, as soon as possible, take to the attention of the public any important fact likely, if it was known, to have a significant impact on the share price", "*Tout émetteur doit, le plus tôt possible, porter à la connaissance du public tout fait important susceptible, s'il était connu, d'avoir une incidence significative sur le cours...*".

the shareholders and the market at large the fact that an objective entity – the statutory auditors – have confirmed the financial statements established under the supervision of the management, all the more so because the status and the function of the statutory auditors are determined by law. The credibility of the management is thereby enhanced and this is particularly important on financial markets “where the criteria of the strength of the message is [...] in its capacity to convince”²³³. The same credibility argument applies to agreements entered into by a company with investment banks for the underwriting of public offerings of securities on primary or secondary markets. As part of these underwriting agreements, investment banks buy some of the shares floated. In this way, in terms of credibility for investors, the issuers benefit from the reputation of the investment banks acting as underwriters. More generally, having recourse to financial intermediaries for certain market transactions is usually required by law²³⁴, which contributes to the quality and makes the signal thus transmitted important. Finally, it is of interest to note that practices which were originally agents’ bonding expenditures have now become mandatory.

Reputation is of particular importance on financial markets because of their network structure. Reputational risk obliges agents to operate in the interest of shareholders and the market at large and therefore to provide them with the information they require. It is possible to see “a contradiction between the transparency [which is inherent in the financial market] and the club’s spirit”²³⁵, which is what gives reputation its importance. It is however because it is also a clubby world – the club of listed companies’ managers – that managers feel a duty to disclose the information they hold. The basic idea is that the value of a manager will decrease in the managerial marketplace if he is bad at disclosing information to the market. Theoretically, the loss incurred in terms of reputation as a repeat player on the market should in the long term be superior to the profit made on the basis of inaccurate disclosure or by withholding information. A comparable agency approach can be applied to the managers and majority shareholders of private companies in the context of private equity transactions where private equity firms take minority or majority stakes in those companies. If these managers or majority shareholders want respectively to remain employable and to be able to raise funds in the future, it is in their interest to maintain their reputation and therefore to act as a transparent management team in the eyes of the providers of capital and potential employers.

The legal mechanisms aimed at controlling those exercising power in the company by aligning the interests of the agents with those of the principal compensate for the information asymmetry existing in favour of managers and gained by them through their daily presence in the company. These

²³³ “le critère de la puissance du message est [...] dans sa capacité à convaincre”, Frison-Roche M.-A., Droit, Finance, Autorité (Les Modes de Régulation Juridique Propres aux Autorités de Marchés Financiers), Rapport Général, Convention Ministère de la Justice, Mission de Recherche Droit et Justice, 1999, p. 45.

²³⁴ See for instance, Art. N.3-1-1, avis SBF 15 January 1997 on the recourse “to one or several financial intermediaries responsible for the initial public offering” (“un ou plusieurs intermédiaires financiers responsables des opérations d’introduction”) and Art. N.3-1-11 of the same rule, on the certification of annual accounts of the last two financial years on the occasion of the listing on the premier marché. See Book II Euronext.

²³⁵ “...une contradiction [entre] la transparence et l’esprit de club”, Frison-Roche M.-A., Droit, Finance, Autorité, op. cit., p. 103.

instruments of control are in effect incentives to share information or to send signals to the market if the company is listed. One way to encourage managers to disclose the information in their possession is via a direct financial impact, for instance by granting stock options or shares to management²³⁶. In this way, when the share price is impacted by the lack of transparency of the management's practices, the manager-shareholder also incurs losses as investors subtract a risk premium from the profit forecasts.

The issue of debt also has a favourable effect in terms of disclosure of information. By increasing the default risk (default being a prejudicial event in the career of a manager that he will therefore want to avoid), an issue of debt amounts to a message aiming at signalling the quality of the issuer to investors. The signalling process works as follows: taking on debt is abnormally risky for any company in poor financial health, and indeed a company with limited cash flows would not manage to raise funds. Consequently, issuing debt is seen as a sign of quality of the issuer²³⁷. More generally, the provisions which ensure the prevalence of the shareholders' interests are interpreted as information or signals sent to either the market or the shareholders, whether the company is listed or not.

The various information channels described above are costly to shareholders. As was stated earlier, they represent agency costs: the costs resulting from the production of information are bonding expenditure and costs resulting from the acquisition of information are monitoring expenses. Statutory auditors and investment banks must indeed be remunerated. In the same way, shareholders have to pay managers higher salaries to compensate for the risks resulting from having a non-diversified portfolio of shares, *i.e.* shares mostly in the company they work for²³⁸. Moreover, this risk exposure may lead managers to behave as risk-averse agents and cause them to turn down risky but potentially profitable investment strategies. Finally, the issuance of debt is also a source of transaction costs.

The aim of a disclosure system should therefore be to reduce these costs. In a context where information is viewed as a signal and where the quality of goods is uncertain²³⁹, such as returns on shares, it must be noted that the sanctioning of the violation of disclosure obligations is a supplementary cost for an issuer of low quality shares if its intention is to pass for an issuer of high quality shares by disclosing false information. Conversely, for issuers of high quality securities, compliance with a disclosure regime entails costs resulting from the implementation of the disclosure requirements.

It must however be noted that the costs incurred by companies via the implementation of disclosure regulations can be high. For instance, this is especially true for small cap listed companies as

²³⁶ See for example for a criticism of such schemes for their alleged inefficiency, Jensen M. C. and Murphy K. J., *Performance Pay and Top Management Incentives*, in *Foundations of Organizational Strategy*, Harvard University Press, 1998.

²³⁷ See for example, Beaver W., *The Economic Basis for Disclosure Requirements*, in Posner R. and Scott K., eds., *Economics of Corporation Law and Securities Regulation*, 1980.

²³⁸ Easterbrook F. H. and Fischel D. R. *op. cit.* *Mandatory Disclosure and the Protection of Investors*, p. 677.

²³⁹ See the seminal article of Akerlof G., *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, *The Quarterly Journal of Economics*, vol. 1984, 1970, p. 488. G. Akerlof was awarded the Nobel Prize for economics jointly with Michael Spence and Joseph Stiglitz for their work on information economics. See www.emlab.berkeley.edu/users/akerlof/index.html

under French (but not UK) law, they are subject to the same disclosure requirements as mid-cap and large-cap listed companies. However, the EU Prospectus Directive²⁴⁰ does not provide for a “one-size fits all” regime and the technical regulations implementing this directive²⁴¹ therefore take into account the sizes and legal forms of issuers.

Another source of expenditure regarding disclosure in listed companies is the operating costs of the financial markets regulators. It must also be taken into account with regard to the production of rules, the monitoring of their implementation and the sanctioning of their violation. Finally, another source of costs for issuers is the possibility that potentially profitable projects may be abandoned because disclosure requirements would result in too much information being passed on to competitors for instance.

For investors, compliance with disclosure regulation saves on monitoring expenses and, for managers, it saves on bonding expenditures. The cost of issuing high quality shares therefore decreases, whereas the cost of issuing low quality shares increases. The legal regime governing information disclosure enables companies to stand out in the eyes of investors at less expense than private auditing. Prof. Ogus thus writes that, in the context of a company, “it is not unreasonable to assume that a public system of scrutiny and enforcement is more cost-effective than one in which reliance is placed entirely on private auditing and legal actions”²⁴². Therefore, the disclosure regime in listed companies makes it possible (i) to lower the agency costs generated by the production and the acquisition of information and thus to increase the volume of information provided and (ii) to contribute to the transparency of financial markets. In the same way, the disclosure regime in private companies must aim at lowering the agency costs resulting from the production and acquisition of information, which are borne by the shareholders so as to produce more and better focused information.

We have seen that the cost of information limits its diffusion amongst shareholders and market players. We will now see that part of the information existing in a company is by nature under-supplied because of its public good characteristics. This entails a market failure which calls for a regulatory intervention.

1.3 Mitigating the effects of the public good nature of information

Depending on its use, information may have the characteristics of a public good. A public good “combines two characteristics: first, consumption by one person does not leave less for others to consume; and, secondly, it is impossible or too costly for the supplier to exclude those who do not pay from the benefit”²⁴³, known respectively as “indivisibility” and “non-excludability”. The competition system

²⁴⁰ Directive 2003/71/EC, 4 Nov. 2003.

²⁴¹ Commission regulation (EC) 809/2004. 29 April 2004.

²⁴² Ogus A. I., Regulation, Legal Form and Economic Theory, Clarendon Law Series, Oxford University Press, 1996, p. 140.

²⁴³ Ogus A. I., (1996) op. cit., p. 33.

cannot ensure the production of such goods because of the lack of incentives for the producer. The producer cannot obtain a return on the production of the goods since third parties will have a free ride, as they will be able to benefit from the goods without having to pay for them. As a result, there is a serious risk of underproduction. A market failure therefore originates from this situation where property rights are made useless, and which calls for regulatory intervention to address the question of supply.

Sometimes, however, in the context of companies, information can be a private good. If the producer of a piece of information can make a profit on it by trading on the market before any impact is felt on the share price, then this piece of information has a private value and its producer therefore has sufficient encouragement to continue its production. In this hypothesis where information is used for trading only, information is a private good whose production is not affected by externalities such as the behaviour of third parties.

We will now consider a situation in which information will be under-produced because it constitutes just such a public good. This can be the case with information generated by financial analysts. When these analysts sell a research report to a client, the client will operate in the market in the light of the information (a share price forecast, for instance) contained therein. However, in order for the client to make a profit, it is necessary that the rest of the market reacts to this new information. If the client buys shares anticipating a rise in the share price, the market must actually rise in order for his profit to materialise, *i.e.* an upturn in the market is necessary. This will result from the fact that, at some point, the information initially conveyed to the client will be disclosed, in a way or another, to other market players. For instance, through the observation of volumes of shares traded or the evolution of share price, the information produced by an analyst is consumed free of charge by third parties. Because of these externalities and given that only one user pays for the product, there is a risk of an under-supply of such information. In theory, it therefore follows that the coverage of companies by financial analysts will not receive enough investment to satisfy the market's demand for information.

In practice, analysts keep on producing information for two reasons: firstly, up until the corporate scandals involving investment banks in the aftermath of the bursting of the stock market internet bubble in 2000, the remuneration of this research activity was integrated into a wider business context and profitability was guaranteed because investment banks, the analysts' employers, were remunerated through brokerage fees or mergers and acquisitions advisory fees. The arrival of discount brokers on the market, providing neither financial advice nor information and billing fees much lower than those of full service brokers, has shown that the latter received a premium amounting to the value of the information provided²⁴⁴. Secondly, the data used by analysts – the permanent and ad hoc information disclosed by companies – is not produced voluntarily by the market players but results mainly from a legal mandatory

²⁴⁴ See Coffee Jr, J. C., Market Failure and the Economic Case for a Mandatory Disclosure System, Virginia Law Review, vol. 70, 1984, p. 737.

disclosure regime. The regulation of information on the stock market is thus justified in economic terms, together with cost-saving, by the fact that in the presence of a market failure, a regulatory regime has been built up to substitute for the competition system and enhance the production of information so that in the last resort assets remain efficiently allocated.

Another illustration of the “public good” characteristic of information is the disclosure of data relating to the company’s business. For instance, regarding shareholder agreements, it is difficult to prevent third parties from benefiting from the knowledge of such agreements once they have been made public and what a party has “consumed” does not reduce what is available to others. This can explain why shareholder agreements are kept secret in the private company, as there is no incentive for their disclosure and their secrecy is an advantage for the parties involved. On the contrary, the transparency imperative requires the disclosure of such agreements in listed companies where, under French law for instance, any clause of a pact providing for preferential conditions for the acquisition or sale of at least 0.5% of the capital or voting rights must be disclosed to the *Autorité des Marchés Financiers* (the French Financial Markets Authority or “AMF”), which then discloses such information to the market²⁴⁵. If such a clause is not disclosed to the AMF, its effects are suspended and the parties are released from their obligations pursuant to this shareholder agreement in the event of any attempted takeover. The fact that such information is not disclosed in private companies shows that in an unregulated market for information, there will be a sub-optimal amount of voluntary disclosure. As far as better information can be a strategy for limiting strategy costs, we will therefore argue below in favour of an equivalent mandatory disclosure provision for private companies.

After examining the sources of the costs attached to the production and acquisition of information, we will now focus on illustrations of the cost-saving function of disclosure regulation.

1.4 The cost-saving function of disclosure regulation

Disclosure rules cannot effectively ensure the transparency of shareholders’ relationships when such rules are limited to the disclosure of the percentage of shareholding interests held and do not address the terms of shareholders agreements, as is the case in French private companies. One solution might be to apply the disclosure consequences attached to actions in concert on stock markets to private companies. In this way, in addition to the identification of shareholdings, shareholders would also gain knowledge of the factual nature of control, which relates to influence, and which cannot be grasped through a simple listing of shareholdings. Potential breaches of the common interest of the shareholders as a sell-out right triggering event would also be more easily identifiable. This requires a more comprehensive regime for the disclosure of financial links and alliances within the private company.

²⁴⁵ Art. L. 233-11 of the French Commercial Code.

The identification of the composition of the share capital of companies and of alliances aimed at controlling listed companies is usually disclosed in filings with financial market regulators. The financial market is fed with large amounts of information, disclosed as soon as possible, in order to work out the anticipations underlying investments. However, this information is not solely for the benefit of the market. Managers of companies subject to disclosure requirements are themselves informed of acquisitions of shares in their companies and of the evolution of strategic alliances. Managers can thus anticipate potential takeovers, which put their personal positions at risk. It is not only the market which needs information: regulators must also share in the information in order to be able to implement stock exchange regulations. Finally, since shareholders of listed companies are able to monitor the evolution of the composition of the share capital of their companies, they are able to anticipate any transactions which will have an impact on the control of these companies, as well as to identify the names of the parties involved. In this way, shareholders are in a position to assess the state of the implicit contract which binds them to the managers.

As we have already underlined, in the unlisted company, insufficient knowledge of the evolution of the composition of the share capital, on the one hand, and of the alliances dealing with corporate control, on the other hand, makes it impossible for minority shareholders to anticipate potential breaches of the corporate contract. Under French law for instance, the management of a company is under no obligation to inform the shareholders of the acquisition of a significant interest in the share capital. For this reason, we will give consideration below to the rules aimed at ensuring the disclosure of information relating to shareholders agreements within the private company.

The concentration and relative stability of the share capital in private companies, as opposed to the dispersion and free transferability of the capital in listed companies, renders a detailed knowledge of the composition of the share capital all the more necessary. However, it is usually in listed companies that the rules imposing the identification of any investors who are likely to exert an influence on the control of the company are to be found. Listed company laws usually provide for an obligation to disclose the acquisition or transfer of blocks of shares in excess of certain thresholds in terms of capital or voting rights. This disclosure obligation usually rests with the acquirer of the shares and any breaches can be punished by the deprivation of voting rights²⁴⁶.

Introducing the notion of action in concert into the legal regime of the unlisted company could be used to require an entity acting in concert to disclose the crossing of thresholds when acquiring shares²⁴⁷. To shed more light on the state of control in a company, it is indeed necessary to subject all persons sharing a common objective with regard to the exercise of the corporate control by acting in concert to the obligation to disclose their actions pertaining to the acquisition of the corporate control. The knowledge of

²⁴⁶ See Art. L. 233-14 of the French Commercial Code.

²⁴⁷ See Art. L. 233-7 of the French Commercial Code.

the allocation of power in the company is improved by the fact that, in listed companies, the shares and voting rights of senior management, intermediaries or subsidiaries, including any options owned by the latter, are put in the same category as shares and voting rights held by persons under the obligation to disclose the crossing of shareholder thresholds. The evolution of the structure of power in a company being a question of fact, it seems desirable that the private company should benefit from the realism demonstrated in the knowledge of transactions aimed at acquiring the corporate control of listed companies. This is the case under English company law which obliges investors in private companies to disclose the crossing of thresholds. However, Directive 2001/34/EC imposes disclosure requirements for the sole purpose of market transparency and is therefore applicable to listed companies only. As a consequence, in the UK the Companies Act 2006 proposes making the mandatory disclosure of shareholding structures applicable to listed companies only²⁴⁸. This is one example of an EU directive having a retrograde effect from the point of view of transparency in private companies.

Where there is no statutory provision requiring the disclosure of the acquisition of shares and if the knowledge of such acquisitions is not gained through rights of first refusal or pre-emption rights, it is possible to make contractual provision, either in a shareholder agreement or in the articles of association, for such a disclosure obligation. In order to be effective, the violation of this disclosure obligation must give rise to some form of sanction. In listed companies, it is also in the interest of managers that such information be disclosed since it serves the purpose of giving them warning of any potential takeovers. On the other hand, in the private company where changes of control are unlikely to occur without managers knowing the identity of the majority shareholders or those closely linked to them (although this is not always the case), the transparency of the composition of the share ownership structure is less obviously in their interest. This is one reason why it would be useful for the mandatory disclosure of additional information in private companies to be imposed by law.

Under French law, the *AMF* requires, in addition to notification when thresholds are crossed, that any investor holding a significant interest²⁴⁹ in the capital of a listed company must disclose his intentions. This mandatory statement of intent shows that the knowledge of the allocation of power provides information with regard to its “dynamics”²⁵⁰ and not only its distribution.

²⁴⁸ See http://www.opsi.gov.uk/acts/acts2006/ukpga_20060046_en.pdf

²⁴⁹ Art. 223-17, *AMF* General Regulations: “The *AMF* shall publicly disclose the information mentioned in Art. L. 233-7 to L. 233-9 of the Commercial Code. The *AMF* shall specify in an instruction how such information is to be transmitted to it. The *AMF* may request that companies whose registered office is outside France provide equivalent information”.

²⁵⁰ “Consequently, the regulation governing the identification of shareholdings resulting from current texts (...) is undoubtedly just the beginning of a much more fundamental evolution which concerns the disclosure of the geography and the dynamics of power in companies”, Bézard P., *Connaissance de l'Actionariat*, in *Rev. Jurisp. Com.*, n° spécial La Stabilité du Pouvoir et du Capital dans les Sociétés par Actions, Nov. 1990, p. 49.

More generally, the rationale behind the Transparency Directive²⁵¹ applicable to issuers whose securities are admitted to trading on regulated markets only is also relevant with regard to the shareholders of unlisted companies: "The public should be informed of changes to major holdings in issuers whose shares are traded on a regulated market situated or operating within the Community. This information should enable investors to acquire or dispose of shares in full knowledge of changes in the voting structure; it should also enhance effective control of share issuers and overall market transparency of important capital movements. Information about shares or financial instruments as determined by Article 13, lodged as collateral, should be provided in certain circumstances"²⁵².

The knowledge of the dynamics of power when the control of listed companies is being acquired is implemented by means of statements of intent and by the disclosure of shareholder agreements. Once shareholders and other holders of voting rights have been identified, shareholders will want to know the ultimate aim of the decisions taken within the company. As in listed companies, a shareholder in a private company ought to be informed of (i) any alliances formed between his co-shareholders as well as between any one of them and an outside investor, and (ii) the intentions underlying the acquisition of control of the company. Even more important than the mere identification of the composition of the share ownership structure at any given time, which has just been addressed, is the knowledge of the strategic means placed at the disposal of investors holding a significant share interest in the company. In this regard, the shareholders of these companies should know with whom these investors are potentially acting in concert, the number of voting rights held by them, the amount of their indirect share interests, the potential amount of share capital to which they have access and finally the various strategic alliances concluded by them. This plan of action is routine for investors in listed companies. In Continental Europe, rules on these issues were often developed in this type of company in response to pressure from the market, with the assistance of managers keeping in mind the protection of their own positions during takeovers²⁵³. So as to shed light on the reality of power, these solutions born in the context of the stock market should now be implemented in private companies, however this should be done not in the name of the protection of management but rather for the protection of the shareholders as a whole²⁵⁴.

The mandatory disclosure of intentions²⁵⁵ which can be required along with the disclosure of thresholds exceeding certain percentages of share ownership or voting rights within a listed company makes it possible to identify the aims of any investor acquiring or increasing his shareholding. Pierre

²⁵¹ Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.

²⁵² Directive 2004/109/EC, Whereas no. 18.

²⁵³ "...this evolution occurred with a large consensus in the world of finance, if not at its own request, in an effort to protect current managements", Bézard P. (1990) op. cit., p. 48.

²⁵⁴ "Cleaning up the market by compelling companies to transparency is a laudable goal and must be approved, but why is that that these provisions only affect listed companies, thus strengthening their specificity? Every joint stock company must be transparent, shareholders must be aware of agreements and formed coalitions. This difference is not justified", F. Cherchouly-Sicard, Rev. Jurisp. Com, no. 34, Febr. 1990; p. 53.

²⁵⁵ See in French law, Art. 223-17, AMF General Regulations.

Bézar, former presiding judge of the commercial section of the *Cour de cassation*, explains the purpose of the rule on the mandatory disclosure of intentions: "The question is not only to disclose the fact that an interest has been bought, but to specify if, by that, one intends to seize power in the company and to do so alone or with others"²⁵⁶. Such information is important and would prove most useful in the private company where minority shareholders have no statutory right to know the future plans of influential shareholders for the company.

The issue here is more generally that of the disclosure of the secret agreements used to seize power in a company. In France, stock market regulations currently deal with this question via provisions concerning the action in concert and the mandatory disclosure of shareholder agreements pursuant to article L. 233-11 of the Commercial Code and, during a takeover, under article 231-5 of the *AMF* General Regulations. Pursuant to the latter, agreements likely to have an effect on the outcome of a takeover bid must be disclosed, in addition to all agreements concluded in connection with the offer²⁵⁷.

The disclosure of shareholder agreements and of agreements entered into in the context of the buy-out of unlisted companies addresses the issue of the identity of those who share a common interest in a given allocation of power in the company. This implementation of a legal disclosure regime in the unlisted company is required so that the veil shrouding the allocation of power can be lifted, from the point of view of shareholders who have no strategic relations with the management of the company. "It [...] no longer seems possible to say: here is a company where a certain play is being performed for the small investors and shareholders in accordance with the law but actually, behind the scenes, a very different scenario is being followed"²⁵⁸. This other scenario could for instance lead to a permanent "freezing" of the allocation of power, itself resulting from a shareholders' agreement organizing the stability of ownership of the share capital and of the management²⁵⁹. It could also lead to a transfer of power without the knowledge of the non-controlling shareholders. In any case, these situations harm the principle of shareholder equality.

In private companies, in the absence of an equivalent to the market regulator which publishes information regarding shareholder agreements on its website, the disclosure of agreements between

²⁵⁶ Bézar P. (1990) op. cit., p. 49.

²⁵⁷ Art. 231-5, *AMF* General Regulations: "Any clause of an agreement that provides for preferential terms of sale or acquisition of shares admitted to trading on a regulated market, and has been transmitted to the *AMF*, shall be presented in the offer document(s).

Once a proposed tender offer has been filed, any other restrictive clause agreed by the parties concerned or their shareholders that could have an impact on the assessment of the tender offer or its outcome, subject to determination of its validity by the courts, must be disclosed to the parties concerned, the *AMF* and the public. If it was not possible to mention the clause in the offer document(s), because of the date on which it was agreed or for other reason, the signatories shall ensure that the content of the clause is disclosed to the public by means of a news release, as soon as the clause has been agreed".

²⁵⁸ Bézar P., Discussion, Colloque de Deauville (1990) op. cit., p. 52.

²⁵⁹ N. Lamoreaux and J.-P. Rosenthal note that "Such agreements could actually worsen the situation of minority shareholders by making it easier for a controlling group to solidify its power" in "Legal Regime and Contractual Flexibility: A Comparison of Business's Organizational Choices in France and the United States during the Era of Industrialisation" (2005) 7 *American Law and Economics Review* 28-61.

shareholders which are not referred to in the articles of association could be made in an official legal gazette, with the exact terms and conditions of the agreements being held available at the company's headquarters, on its website or via the office of the clerk to the local commercial court.

Though it is important to know the identity and aims of any persons having control, this is not enough to enable efficient monitoring by the non-controlling shareholders. Such monitoring also requires the *ex ante* supervision and *ex post* sanctioning of the use of private information to make a profit on the sale of shares. As we will see in the next chapter, a disclosure obligation resulting from the directors' and controlling shareholders' duty of loyalty can be an efficient way to deal with *ex post* insider trading²⁶⁰.

With respect to *ex ante* solutions, the prohibition of insider trading in unlisted companies could be made easier when the shares are registered shares²⁶¹ and not bearer shares. Under French law, registered shareholders can have access to the complete list of shareholders²⁶², which typically include the number of shares and votes held by each. The number of votes is information that can also be found using the attendance registers of shareholders' meetings, if such documents are made available to shareholders²⁶³. In this way, it is possible, in theory at least, to follow developments in transactions on the share capital. However, in practice, the information resulting from the registration of the shares usually remains in the hands of the managers because of their daily presence in the company and is therefore less useful than it might initially appear.

The regime of disclosure of directors' shareholdings and share transactions which used to exist until 2007 under English law²⁶⁴ was a preventive means of control that was subsequently introduced into French law. This regime applied in the UK and now applies France without distinction to both listed and unlisted companies. When an individual becomes a director, he must notify the company in writing of the number of securities he holds in the company²⁶⁵. During his mandate, a director must inform the company, and therefore the shareholders, of any agreement entered into to buy or sell the company's shares or bonds and of any share or debenture options granted by a company belonging to the same

²⁶⁰ See *infra* Part 2, Chapter 3, 2.1.a.

²⁶¹ In French law, Art. L. 212-3-1 French Monetary and Financial Code (*Code monétaire et financier*). This is why Art. L. 225-109 of the French Commercial Code (*Code de commerce*), provides for the mandatory registration of shares held by the executive officers of listed companies. This obligation is sanctioned by a criminal provision (Art. L. 247-4 of the Commercial Code (*Code de commerce*)).

²⁶² Art. L. 225-116 and D. 140 and 141, D. 23 March 1967.

²⁶³ See in French law, Art. L. 225-117 and D. 145.

²⁶⁴ See Davies P. L., *Gower's Principles of Modern Company Law*, 6th ed., Sweet & Maxwell, London, 1997, p. 448-453.

²⁶⁵ Under French law, the equivalent provision is Art. L. 225-109 of the French Commercial Code (*Code de commerce*): "The chairman, managing directors and directors of a company, and any natural persons or legal persons exercising the functions of a director or member of the supervisory board, and also permanent representatives of legal persons exercising the said functions, shall be required, upon conditions to be determined by an Order approved by the *Conseil d'Etat*, to register or deposit any shares belonging to themselves or their non-emancipated minor children that have been issued by the company itself, by its subsidiaries or parent company or by other subsidiaries of its parent company, where the said shares are admitted to trading on a regulated market.

Spouses of the persons mentioned in the preceding sub-paragraph shall (unless judicially separated) be subject to the same obligation".

group. In France, this is true for executive officers and directors of listed companies only²⁶⁶, which is unfortunate because it would also be an efficient agency control mechanism within private companies. Each of these disclosures must include the number of securities involved. However, above all, and this is also useful for the prevention of insider trading, the Companies Act 2006 stipulates that the price paid or received pursuant to any agreement to buy or sell the company's securities to which a director is a party must be disclosed²⁶⁷. If this price disclosure were applicable to majority shareholders transferring the control of a company, it would enable other shareholders to identify the existence of potential conflicts of interest, known only to the controlling shareholder, having an impact upon the value of the company. When buying shares from a fellow shareholder at a certain price in order to sell them subsequently to the acquirer of the control for a higher price, it would therefore be possible to know if the majority shareholder was withholding information that, if known, would have prevented his fellow shareholder from concluding the sale and purchase agreement. The existence of a control premium must of course be taken into consideration when assessing the difference between the two prices.

We have already emphasized that certain statutory provisions usually associated with the regulation of stock markets would improve the flow of information to shareholders in private companies with regard to the seizure of power within the company. This would tend to blur the distinction between listed companies and unlisted companies and would lead to a unification of their legal regimes on this issue.

In French law, a listed company-inspired disclosure regime is already in force in *sociétés par actions simplifiées* (SAS). These are private companies characterized by the fact that they are very lightly regulated, are governed almost exclusively by their articles of association as opposed to statutory provisions²⁶⁸ and cannot be listed. This is an illustration of the fact that in unlisted companies, the shareholders' freedom to contract regarding their relationships is greater than in listed companies where rules are less flexible due to the specific external requirements of the stock market. The regulation of listed companies implements the requirements necessary for the proper operation of the financial markets whereas unlisted companies are governed pursuant to internal requirements ensuring the protection of shareholders. Consequently, the legal framework of the latter can be more easily contracted around shareholders than that of the former, since the regulatory regime of listed companies must abide by financial principles. Restrictions on the transferability of shares are, for example, unpopular in listed companies because they contradict the financial requirement of liquidity.

For instance, the need to identify the end investors who control the legal entities holding shares in a company does not result from any financial rationale. In France, a rule providing for the provision of

²⁶⁶ See Recommendation COB 2002-01, Bull. COB Feb. 2002, 17.

²⁶⁷ Schedule 13, Part III.

²⁶⁸ This form of company is arguably not famous for the quality of the protection granted to minority shareholders but examples of such companies are few and far between.

such information forms part of the legal regime of one type of private company only, the *SAS*²⁶⁹. The articles of association of an *SAS* may provide (i) that the transfer of control of any legal entity which is a shareholder must be disclosed to the *SAS* and (ii) that, based on such information, a squeeze-out may then be imposed upon this shareholder. This provision is therefore protective of both the management and majority shareholders. It makes it possible for the shareholders of the *SAS* to take precautions “against situations where the change of control of [an indirect shareholder] of the company affects the *SAS* itself as it allows into the company shareholders with whom [the initial shareholders] may not wish to continue the business of the company”²⁷⁰.

In addition, one interesting aspect with respect to the protection of minority shareholders in the unlisted company in general is the information which is disclosed on the occasion of an indirect transfer of control. This “upward transparency”²⁷¹, to borrow the expression used by one French court, confirms, as stated earlier, how useful it would be to export the concept of action in concert (a concept usually belonging to financial market regulations) to the private company, as is already the case under English law. The transfer of control, *i.e.* the event triggering the disclosure, cannot indeed be dissociated from the concept of action in concert since the control is itself often held in concert.

This notion of “upward transparency” was first mentioned under French law in a case involving media companies before the aforementioned article L. 227-17 of the French Commercial Code had been enacted. This provision makes it possible for the minority shareholder to anticipate the evolution of the balance of power within the company. In particular, it gives the shareholder a better ability to anticipate shifts of power inside the group to which its company belongs. This is why we propose that this solution, which can usually only be negotiated if the minority shareholder is powerful enough to impose his volition, should become statutory in all private companies because not every shareholder can reach this solution by way of a contract.

In any case, when this solution results from a contract, it aims at protecting management since it is generally accompanied by a clause providing for a squeeze out in the event of the transfer of control of the legal entity which is a shareholder²⁷². In order to protect the minority, informing shareholders as a

²⁶⁹ Art. L. 227-17 of the French Commercial Code (*Code de commerce*): “The articles of association may specify that partner companies whose control is altered within the meaning of Art. L. 233-3 must, on this alteration, inform the simplified joint-stock company of this. The latter may decide, in accordance with the conditions fixed by the articles of association, to suspend the exercise of the non-financial rights of these partners and to exclude the latter.

The provisions of the above paragraph may be applied, in accordance with the same conditions, to partners who have acquired this capacity following a merger, division or dissolution operation”.

With respect to the *SAS*, see for example, Vidal D., *La Société par Actions Simplifiée*, Commentaire de la loi 94-1 du 3 janvier 1994, Montchrestien, 1994 ; Uetwiller J.-J. et Larrivé P., *Préface Parléani G., Guide de la Rédaction des Statuts de la SAS*, EFE, 1995.

²⁷⁰ French National Assembly Report, no. 258, 2 June 1993, p. 25.

²⁷¹ Court of Appeal, Montpellier, 17 December 1992, *RJDA* 3/93, no. 227.

²⁷² Case law endorses this type of clause, but one may wonder if it contributes to the information of shareholders as a whole or managers only. See, Com. 13 December 1994, *Midi Libre*, *JCP*, 1995, Ed. E, no. 30, p. 139 s., note Paclot Y.; *RJDA*, 3/95, no. 292, p. 230 s., note Le Nabasque H.; See also, Nancy, 28 July 1989, *Est Republicain*.

whole is more important than the squeeze-out provision which may lead to a freeze of the corporate governance balance between management and the shareholders. It is indeed not in the interests of the minority shareholders to perpetuate the balance of power in the company by leaving it up to the board of directors to decide on the identity of the new shareholders in the company. This is also the case when the articles of association include a provision for a veto right over new shareholders for the board of directors, as it is usually the case²⁷³.

Under French law, three provisions in force in private companies impose an obligation to disclose shareholding interests: article L. 233-6 of the Commercial Code (*Code de commerce*), subparagraph 1, and articles 248-12 and 293 of the decree of 23 March 1967²⁷⁴. These three provisions have in common the fact that they concern only shareholders of a company in the process of acquiring control of another company, and not the minority shareholders of the company whose control is transferred, whereas greater risks are generally incurred by the latter²⁷⁵.

The French Commercial Code²⁷⁶ provides that the mandatory report to be presented to the shareholders' meeting by the board of directors must mention all interests acquired representing more than one twentieth, one tenth, one fifth, one third or one half of the share capital of a company or giving the control of the company. It should be noted that this report excludes some important information as it does not refer to share interests held in companies registered abroad. Article 293 of the decree of 23 March 1967 provides that the portfolio of securities held by listed or unlisted companies having a turnover of over € 3,048,980.34 or with a portfolio of securities worth at least € 304,898.03 must be disclosed and this information is then published in a legal gazette²⁷⁷. Finally, companies which publish consolidated accounts must include in an appendix "the list of the principal companies making up the item "shareholdings" in the consolidated accounts"²⁷⁸. In addition to this list, further information regarding such companies, such as the percentage of capital held, the amount of any profits or losses and the net book value, must be disclosed.

However, the nature of the above-mentioned information resulting from the inventory of shares held by a company does not give shareholders the opportunity to anticipate potential changes of control of the company. Information resulting from the inventory is useful in that shareholders have a chance to gain knowledge about existing capital links²⁷⁹ between their company and another company and therefore

²⁷³ "The articles of association determine which company organ is entitled to rule on the request for the acceptance of transfers of shares. Generally, powers are given to the board of directors", Merle P., *Droit commercial, Les Sociétés Commerciales*, 4th ed., 1994, no. 322, p. 306.

²⁷⁴ The regulation on reciprocal share interests and reciprocal holding of control can be added.

²⁷⁵ It is also true that a transfer of control may also affect the allocation of power in the assignee company.

²⁷⁶ Art. L. 233-6, French Commercial Code (*Code de commerce*).

²⁷⁷ Art. 293-1, Decree of 23 March 1967.

²⁷⁸ Art. 248-12, 8°, Decree of 23 March 1967.

²⁷⁹ Knowledge of commercial and especially strategic alliances laid down in listed company law, is quite as useful for the prevention of conflicts of interests.

to draw conclusions regarding potential conflicts which could arise between the personal interest of the controlling shareholder and the common interest of the shareholders as a whole²⁸⁰. These conflicts of interest could then be mitigated by the proper enforcement of fiduciary duties²⁸¹. More generally, information disclosed by companies in a legal gazette can then be gathered and processed by specialized data banks, thereby providing useful information to shareholders on the composition of the capital of companies in which interests are acquired.

A detailed knowledge of the share capital structure and especially of the identity of the shareholders is an efficient tool in the hands of minority shareholders who want to ensure that their rights are being protected. Under the aforementioned provisions dealing with the disclosure of the identity of shareholders²⁸², within fifteen days before a general meeting of the shareholders, or six days in the event of a second convocation²⁸³, shareholders may obtain access to a list of their co-shareholders. However, the efficiency of this provision is diminished because of the restricted time frame. Moreover, only the managers have relevant information on share transfers. Shares in unlisted companies are registered securities and as such they are recorded in an account kept by the issuing company or by a financial intermediary acting on its behalf. In practice, this situation is advantageous to the managers²⁸⁴. Moreover, the mandatory disclosure of the crossing of thresholds in the capital of listed companies happens to be more effective at preventing conflicts of interest.

The amount of information at the disposal of shareholders in private companies is less likely to give an accurate image of the capital links than in listed companies and leaves shareholders unaware of agreements whose purpose is gaining or managing corporate control because these agreements do not necessarily entail a transfer of shares. The knowledge of such agreements would result from the application of the notion of action in concert in the unlisted company. Again, up until now, it is in the context of stock market regulations that mandatory disclosure rules have been laid down, including the disclosure of actions in concert, in order to identify relations of power, because this contributes to the transparency required by such markets. However, solving agency problems resulting in private companies from the concentration of ownership and control also requires that relations of power be brought to light. The disclosure of information is therefore more thorough in listed companies, especially with respect to relations of power, because the stock market is a market for corporate control. It provides a set of disclosure rules regarding 'political' alliances in addition to 'economic' alliances whose goal is essentially to organize the transfer of shares.

²⁸⁰ See Schmidt D., *Les Conflits d'Intérêts dans la Société Anonyme*, coll. *Pratiques des Affaires*, Joly Editions, 2004.

²⁸¹ See *infra* Part 2, Chapter 2, *The Enforcement Fiduciary Duties in Private Companies*.

²⁸² Art. L. 169, 24 July 1966 Act and Art. 140, 141 and 152, Decree of 23 March 1967.

²⁸³ Art. L. 225-116, French Commercial Code (*Code de commerce*) and Art. 140, D. 23/03/67.

²⁸⁴ Moreover, under French law, the regime of managed registered securities (*titres nominatifs administrés*) (Art. 4, Decree of 2 May 1983) does not require the holder of the account to update the information (including the name and address) included in this account. In the same way, intermediaries keeping books do not have to communicate updated information to the issuing company.

In private companies, the existence of agency problems between majority and minority shareholders should be fully acknowledged and the gap between listed and unlisted companies should be closed with respect to relations of power. The disclosure of information should be made sufficient to mitigate the information asymmetry between the controlling shareholder and the management, on the one hand, and the minority shareholders, on the other hand. This would be the first step towards an anticipated identification of conflicts of interest, which *ex post* will be mitigated if they can be characterized as breaches of fiduciary duties.

1.5 Relevant recent developments in disclosure regulations in France

In French law, two of the most recent company laws dated 11 May 2001 and 1 August 2003 have had significant consequences on the legal regime of information in companies, including private companies. We shall now give a brief overview of the new features introduced which somewhat reduce the information asymmetry, before examining how these rules nevertheless still fail to hit their target.

A new provision regarding the disclosure and authorisation by the board of directors of transactions entered into between a company and any one of its shareholders, directors or corporate officers (“related party agreements”) provides improved transparency²⁸⁵. The novelty is that shareholders must now be informed of such transactions even if these constitute standard transactions with standard terms, except if their purpose or financial consequences make them insignificant²⁸⁶. Under this regime, the reporting requirements relating to such transactions could therefore become overwhelming, especially in groups of companies. The notion of significance will therefore have to be appreciated by the courts with this risk in mind and it will certainly be useful to report only those transactions that are concluded with a person related to the company in consideration of the actual identity of this person. In this way, everyday transactions conducted in the capacity of a customer or client of the company would not have to be reported. It is in the interest of other shareholders to be aware of such transactions because even though they do not result in a conflict of interests, they do provide evidence concerning the inner workings of the company. Previously, such transactions were simply not disclosed to shareholders. It must however be noted that it is only the purpose of the transaction that is disclosed to the shareholders and not the terms and conditions of the transactions themselves.

Minority shareholders’ rights to information will also benefit from the lowering of the proportion of share capital that must be held in order for shareholders to put written questions to the management, twice yearly, on any fact likely to compromise the operation of the company. This threshold was previously set at 10% of the share capital but has now been lowered to 5%²⁸⁷. In addition, under the law

²⁸⁵ See also Part 2, Chapter 2, 2.2, Conflicts of interests when dealing with the company.

²⁸⁶ Art. L. 225-39 and L. 225-115-6°, Commercial Code (*Code de commerce*).

²⁸⁷ Art. L. 225-232, Commercial Code (*Code de commerce*).

of 1 August 2003, all resolutions proposed by shareholders now have to be disclosed to other shareholders²⁸⁸ whereas previously, shareholders had to undertake various steps and make formal requests in order to obtain such information. Also, a report on the number of stock options granted to and exercised by employees must now be submitted to the general meeting²⁸⁹.

Finally, a major advance in terms of shareholder information is the report which, under the law of 1 August 2003, the chairman is obliged to provide to the general shareholders' meeting concerning the organization of the board and the procedures governing the internal control of the company²⁹⁰, as well as the statutory auditors' report on this chairman's report. However, the law of 26 July 2005 went back on this issue and unfortunately stipulated that this report would be compulsory in listed companies only.

The prevention of potential conflicts of interest, this time on the part of statutory auditors, will also be improved by a provision obliging the management of a company to disclose to the shareholders the amount paid in fees to statutory auditors. Outside the realm of information regulation strictly speaking but regarding the prevention of conflicts of interest involving statutory auditors, it should be noted that the law of 1 August 2003 prohibits a statutory auditor from giving any advice or conducting any consulting mission that is not related to the review of the corporate accounts²⁹¹.

On the procedural side, one innovation is that any violation of the shareholders' right to information will now give rise to a court injunction ordering the chief executive officer to disclose the relevant information and, if applicable, imposing a fine for late disclosure²⁹². In such circumstances, the courts may also appoint an agent to obtain the disclosure of such information.

Less positively, the law of 1 August 2003 went back on a provision of the law of 15 May 2001 according to which the annual report must indicate all payments made and advantages granted by the company to each director and member of the management. Under the law of 1 August 2003, this obligation is no longer in force in unlisted companies unless these are a subsidiary of a listed company²⁹³. This change is unfortunate as the assessment of all amounts paid to management is a good indication of whether the company is run in the common interest of the shareholders or in the sole interest of those in power. The rationale behind this distinction between listed and unlisted companies is that such information is required in the context of listed companies because it contributes to the transparency of the market. According to this view, it is not necessary to disclose this information in unlisted companies.

²⁸⁸ Art. L. 225-105, para. 2, Commercial Code (*Code de commerce*).

²⁸⁹ Art. L. 225-184, Commercial Code (*Code de commerce*), inserted following law of 1 May 2001.

²⁹⁰ Art. L. 225-37, para. 6, and (for dual structure companies) L. 225-68, para. 7 Commercial Code (*Code de commerce*).

²⁹¹ Art. L. 822-11, II, Commercial Code (*Code de commerce*). Various other provisions leading to a better prevention of conflicts of interests on the part of statutory auditors have been introduced by the law of 1 August 2003, including the prohibition on taking any interest either in the company whose accounts they review, or in its parent company or subsidiary. Moreover, a code of professional ethics, which will go into more detail regarding the nature of interests that can be held by members of multidisciplinary firms, is currently being drafted.

²⁹² Art. L. 238-1, Commercial Code (*Code de commerce*).

²⁹³ Art. L. 225-102-1, para. 5, Commercial Code (*Code de commerce*).

However, this position does not address the fact that agency costs result from the concentrated nature of ownership and control in the private company and that such a rule would limit the information asymmetry at the origin of such costs.

Another unfortunate development of the recent reforms in French corporate law is the increase in the size of the shareholding required to trigger the procedure of control of conflicts of interest in transactions between a company and any party having a potential interest in this company. Previously, shareholders with at least 5% of the share capital had to disclose all such transactions and have them approved by the board of directors, but this threshold has now been raised to 10%²⁹⁴. The argument in favour of this change is that it reduces the burden resulting from having to monitor a large number of transactions, however this point may not be relevant in private companies where the concentration of capital means that there are usually not that many stakes smaller than 10%.

Despite disclosures, controlling shareholders keep a hold-up power over other shareholders. The majority principle and the absence of a market for shares impair the efficiency of disclosure systems and, for this reason, disclosing information turns out to be insufficient in order to prevent the controlling shareholders from abusing their position. The growing prominence of fiduciary duties that we develop in next chapter is therefore a welcome trend.

²⁹⁴ Art. L. 225-38, Commercial Code (*Code de commerce*).

CHAPTER 2 THE ENFORCEMENT OF FIDUCIARY DUTIES IN PRIVATE COMPANIES

Pursuant to the approach to the company as a nexus of contracts, fiduciary duties can be considered as the agreements that parties would reach if the contracts were negotiated and applied without costs by perfectly rational parties. As we have already seen, in terms of transaction costs, the existence of fiduciary duties is justified by their cost-saving capacity which rapidly leads to the related expense being recovered²⁹⁵. Transaction costs result, on the one hand, from human deficiencies, such as bounded rationality and opportunism, and, on the other hand, from particulars attached to the transactions themselves, including asset specificity, uncertainty and transaction frequency²⁹⁶. These notions, which have already been dealt with, explain the situation of the minority shareholder in the private company and, by extension, the need to have recourse to fiduciary obligations. Where there is little internal control due to concentration of the capital ownership, such as in private companies in Continental Europe, and therefore where fiduciary obligations are most needed, an extensive body of case law has yet to develop on the issue.

Fiduciary duties lower the agency costs of relationships between shareholders and between shareholders and managers. Pursuant to this contractual approach to the company, as opposed to an institutional approach based on the organs governing the company, it is possible to consider the firm as an instrument which balances diverging interests – *i.e.* those of the shareholders, the managers, the employees and the suppliers - through contracts in order to maximise profits. In the private company, this is a way to achieve an objective goal which is usually better implemented in listed companies as part of stock market regulations, by which we mean the effective protection of minority shareholders. Under French law, pursuant to this contractual approach, a statutory legal basis for the factual fiduciary relationship can be found in general contract law, notably articles 1134, paragraph 3, and 1135 of the French Civil Code (*Code civil*)²⁹⁷.

As we saw earlier, the closest legal concept comparable to the factual relationships between controlling and non-controlling shareholders or between shareholders and managers is the French notion of the *mandat*, which is a contract by which one person gives another person the power to do something for him and in his name²⁹⁸. However, the law of agency or *mandat* does not apply to relationships within a company since these parties are contractually committed not to each other but to the company. A *mandat* can therefore be identified between the parties on a de facto basis but not from a legal point of

²⁹⁵ See the criticism of Mashonaland (1891) *infra* 3.3 Competing with the company.

²⁹⁶ See in particular on these questions, Williamson O. E. (1985).

²⁹⁷ Art. 1134 of the French Civil Code (*Code civil*): Agreements lawfully entered into take the place of the law for those who have made them. They may be revoked only by mutual consent, or for causes authorized by law. They must be performed in good faith.

Art. 1135 of the French Civil Code (*Code civil*): Agreements are binding not only as to what is therein expressed, but also as to all the consequences which equity, usage or statutes give to the obligation according to its nature.

²⁹⁸ Art. 1984 of the French Civil Code (*Code civil*): An agency or power of attorney is a transaction by which a person gives to another the authority to do something for the principal and in his name. An agency is formed only through acceptance of the agent.

view. However, when a shareholder enters into an agreement with a director or a controlling shareholder, the statutory obligation of good faith set out by article 1134 of the French Civil Code (*Code civil*) and the loyalty obligation derived from article 1135 of the French Civil Code (*Code civil*) do apply. These obligations are even more demanding for the director or the controlling shareholder because in this capacity they receive the trust of the shareholders who mandate the former to represent each of them on the board and entrust the latter to act in their best interest. French courts are now progressively starting to acknowledge this situation and to adopt an approach to relationships of power within the company in which they identify fiduciary duties without referring to any specific provisions of general contract law.

In this discussion of the basis for a fiduciary duty, it must be noted that the French courts have in the past already identified such a duty without referring to any “concrete” basis, *i.e.* without citing any statutory provision or judicial precedent. Rather, with regard to the duty owed by the chairman of the board of directors to inform the directors, the courts have inferred this duty from the nature of the factual relationship between these parties.

The obligation for the chairman of the board of directors to provide each director with all of the information necessary to make informed decisions as a board member first resulted from a ruling by the commercial section of the *Cour de cassation* which justified this interpretation in a case dated 2 July 1985²⁹⁹ by linking the supply of information to the considerable extent of the board’s powers³⁰⁰. The underlying idea was that such powers can only be exercised with a sufficient amount of information. The judges also based their decision on the *de facto* fiduciary relationship between the chairman of the board and the directors.

It should be noted that this right to information is counterbalanced by the director’s duty to make all necessary inquiries before casting his vote. As a consequence, any director who fails to make such inquiries can be found liable³⁰¹. The *de facto* agency relationship underlying these rights and obligations can be identified: the chief executive officer has an obligation to provide information to each director

²⁹⁹ Com. 2 juillet 1985, note Y. Loussouarn, D. 1986, p. 351. See also com. 8 October 2002, no. 1558, RJDA, 7/03, no. 735.

³⁰⁰ Art. L. 225-35, French Commercial Code (*Code de commerce*): “The board of directors determines the broad lines of the company’s business activities and ensures their implementation. Without prejudice to the powers expressly invested in meetings of the shareholders, and in so far as the memorandum and articles of association permit, *it deals with all matters relating to the conduct of the company’s business and decides all pertinent issues through its deliberations.*”

In its dealings with third parties, the company is bound even by acts of its board of directors which do not come within the purview of the company’s corporate mission, unless it can prove that the third party knew that a specific action was extraneous to that mission or, given the circumstances, could not have been ignorant of that fact, and mere publication of the memorandum and articles of association does not suffice to constitute such proof.

The board of directors shall carry out the inspections and verifications which it considers appropriate. The company’s chairman or general manager is required to send all the documents and information necessary to perform this task to each director.

Undertakings, avals and guarantees given by companies other than banks or other financial institutions must be authorised by the board of directors as prescribed in a *Conseil d’Etat* decree. That decree also determines the conditions under which any transaction which exceeds that authorisation can be raised against third parties. “

³⁰¹ CA Aix-en-Provence, 3 février 1966, J.C.P. 1966.11.14861, note Percerou R., see also, Paris, 4 février 1994, Bull. Joly, avr. 1994, 121: The directors are liable “when they exercised no monitoring of the books of the firm... consequently the faulty abstention of the directors partook of the carrying out of the damage suffered by the victim”. (*la responsabilité des administrateurs peut être recherchée lorsqu’ils n’ont exercé aucune surveillance sur la tenue des comptes sociaux... de sorte que l’abstention fautive des administrateurs avait participé à la réalisation du préjudice subi par la société.*)

because (and this is particularly true with regard to the minority directors) he benefits from an asymmetry of information over those who elected him³⁰². As for the director himself, he has the obligation to inquire into the corporate affairs, within the scope of the statutory mission under his directorship, even though there may be limits to this obligation. In France for instance, a director could not raise issues directly with the employees of the company³⁰³.

The information obligation owed by the chairman therefore results from the power derived from the relationship between him and the directors and shareholders. As the asymmetry of information in favour of the chairman fosters opportunistic behaviour and consequently potential conflicts of interest, a corrective measure must therefore be found, which should be part of this relationship. This corrective measure is a general duty of loyalty, and it includes an obligation to provide information. What is at stake here is how to make all the various interests which the company has to reconcile on a permanent basis work together efficiently. The true nature of these interests cannot always be grasped for the simple reason that they are hidden behind the company's decision-making organs, *i.e.* the general shareholders' meeting and the board of directors, as well as the status of chairman of the board. The development of a duty of loyalty, which establishes an analysis in terms of interests rather than organs, therefore increases the factual (as opposed to formal) nature of corporate law. It is therefore not surprising that the 2 July 1985 and the 8 October 2002 cases referred to above, establishing the duty to pass information to directors under French law, do not refer to a specific corporate law provision and are based not on statutory provisions but on a broad standard that generates this implicit information obligation³⁰⁴. It must be noted that this interpretation has subsequently been confirmed and has now been enacted under law no. 2003-706 of 1st August 2003³⁰⁵.

In this chapter, we will carry out a comparative analysis of English and French law, firstly because the solution that we advocate, the sell-out right, already exists in English law under section 994 of the 2006 Companies Act and can be triggered by breaches of fiduciary duties, and, secondly, because national corporate legal regimes compete with each other, thereby echoing the cross-border competition for public and private capital. It can therefore be rewarding to compare the particular legal solutions put forward by these different legal systems. The continued enforcement by the French courts of the recently established duty of loyalty, which can be used in the prevention and sanctioning of conflicts of interest,

³⁰² The fact that the chairman by the board can be dismissed at any moment (Art. L. 225-47, para.3) confirms that this chairman is indeed linked to the directors by a *mandat*. "The board of directors shall elect a chairman from among its members who, in order for their appointment to be valid, must be a natural person. The board shall determine his or her remuneration.

The chairman shall be appointed for a term which may not exceed his or her term of office as a director. The chairman shall be eligible for re-election.

The board of directors may dismiss the chairman at any time. Any provision to the contrary shall be deemed null and void'. The equivalent provision in the French law of agency is under Art. 2003, para. 2 of the French Civil Code (*Code civil*).

³⁰³ Couret A., *Le Gouvernement d'Entreprise, la Corporate Governance*, D. 1995, chr., p. 164.

³⁰⁴ Magnier V., *Réception du Droit Américain dans l'Organisation Interne des Sociétés Commerciales*, in dir. Ponsard J.-P., 2000, op. cit. p. 89.

³⁰⁵ See Art. L. 225-35, para. 3, Commercial Code: "The company's chairman or general manager is required to send all the documents and information necessary to perform this task to each director".

should with time constitute a competitive advantage for the minority investor in French private and public companies.

Before we turn to the first and most topical case illustrating the emergence of a fiduciary duty of loyalty under French law between controlling shareholders, directors and non-controlling shareholders, a different approach, which has long prevailed under English law and which embodies a less contractual and more formal, *i.e.* legalistic approach, must first be mentioned.

This approach results from the principle that neither the shareholders nor the company are owed fiduciary duties³⁰⁶ in the absence of any fault or of an explicit contractual agreement. It appears the most clearly in a court decision of 1877: "There is (...) no obligation on a shareholder of a company to give his vote merely with a view to what other persons may consider the interest of the company at large. He has a right, if he thinks fit, to give his votes from motives or promptings of what he considers his own individual interest"³⁰⁷. *A contrario*, a proprietary rights theory of the firm shows that the pursuit of the interest of the company leads towards the satisfaction of the common interest of all the shareholders. It has long been proven that companies in which minority shareholders are treated well fare significantly better in terms of corporate profits than those in which they are not. Fiduciary duties are therefore instrumental in this regard. However, it is mainly when a majority or minority shareholder abuses his position and when this harms the interest of the issuer, rather than the shareholder, that it is acknowledged that such behaviour should be sanctioned on the grounds of the breach of the *affectio societatis* binding the shareholders together.

The idea that the protection of minority shareholders is linked to the company's financial returns is more easily proven with regard to listed companies. It is therefore no coincidence that fiduciary duties have developed more rapidly in this category of company. Indeed, on the stock market, agents continuously act on particular anticipations and one of these is obviously the expectation of a financial return. The trust placed in the ability of the company's controlling shareholders and management to deliver a return on equity also forms part of these anticipations. For instance, when the market for a share is no longer liquid because 95% of the capital is held in the same hands, and consequently the exit conditions initially anticipated in order to maximise financial returns have changed, trust can easily be

³⁰⁶ The expression "fiduciary duty" that we will use in this chapter refers to the generic notion of a duty owed by an agent to his principal. Consequently, with regard to the developments of English law, the expression will span the duties resting on (i) the general equitable principle, strictly speaking under English law the fiduciary duties originating in the duties of trustees, (ii) common law and (iii) statutory provisions.

³⁰⁷ Jessel M. R. in *Pender V Lushington*, 1877, 6 Ch D 70, p. 75, cited in Farrar J. H., *The Duties of Controlling Shareholders*, in *Contemporary Issues in Company Law*, ed. J. H. Farrar, CCH, New Zealand, 1987, p. 189. This position is nowadays obviously exaggerated if compared to the objections usually raised against the expansion of fiduciary obligations between shareholders. See for example Malaurie P., note on Com. 27 Febr. 1996, D. 1996, p. 518. This author writes about the shareholder-manager of a private company that "there is no general obligation of information when a shareholder sells his shares to another". This proposition does not take into account the potential hold-up power of the controlling shareholder-manager-buyer over the minority shareholder-seller.

betrayed. Consequently, a statutory right to sell-out is generally granted³⁰⁸. Other factual conditions, such as the change of purpose of the company, triggering a sell-out right in a listed company are based on the same argument. In this manner, the law governing listed companies sanctions violations of a relationship based on trust between the controlling and the non-controlling shareholders and between shareholders and managers.

We will see in this chapter that enforcing a mandatory disclosure obligation is not always sufficient to ensure that a controlling shareholder will not act against the common interest of the shareholders in a conflict of interest situation. Disclosure will be a solution when the party exercising power, be it a controlling shareholder or a director, deals personally with the non-controlling shareholders, usually in relation to the sale of the latter's shares. However, when the party exercising power and acting on behalf of the company itself structures the transaction so that it acquires a disproportionate part of the benefits, the solution to this agency problem is shareholder approval. Finally, when a party exercising power in the company diverts corporate opportunities away from the company to another entity in which this party holds a larger interest, a non-compete obligation owed to the company is required. We will deal in turn with these three different ways in which a controlling shareholder or a director may divert a disproportionate amount of the company's earnings or assets to themselves and assess the effectiveness of strategies based on fiduciary duties.

2.1 Conflicts of interest when dealing with shareholders' shares

If buying shares in a company was a contract just like any other, it would be somewhat paternalistic to ask for the disclosure of further information in addition to that spontaneously made available by parties negotiating in good faith. However, when negotiating a share purchase agreement, the non-disclosure of a fact that, had it been known to the other party, would have prevented such party from contracting, can be considered as wilful misrepresentation under general contract law and thus trigger the nullity of the agreement. In an increasing number of circumstances, such as when contracting with the general public (consumers)³⁰⁹ or when dealing with complex matters, a specific obligation to inform or give advice to the other party has been developing in contract law, based on statutory provisions or on precedents depending on the jurisdiction. An obligation to disclose information prior to the conclusion of the contract, that, had it been known, would have prevented the beneficiary of the obligation of information from entering into the contract or would have led such beneficiary to do so under

³⁰⁸ See under French law, Art. 236-2, *AMF* General Regulations: Where the majority shareholder(s) hold, in concert within the meaning of Art. 233-10 of the Commercial Code (*Code de commerce*), 95% or more of the voting rights of a company whose investment certificates and, if applicable, voting rights certificates, are or were admitted to trading on a regulated market, any holder of such certificates may apply to the *AMF* to require the majority shareholder(s) to file a buyout offer for those securities.

Once it has made the necessary verifications, the *AMF* rules on such application in the light of, inter alia, the state of the market for the securities concerned and the information provided by the applicant. If the *AMF* declares the application to be acceptable, it notifies the majority shareholder(s), which must then file a buyout offer, within a time limit set by the *AMF* and drawn up in terms that can be deemed acceptable by it.

³⁰⁹ See for instance Art. L. 111-1 of the French Consumer Code.

different terms, is also more strictly enforced in case law, when there is an *intuitu personae* aspect to the contract, for instance when its purpose is the purchase of partnership shares³¹⁰ or when the contract is concluded between family members. Also, during the lifetime of the company, *i.e.* for as long as performance of the corporate contract continues, shareholders have a reciprocal duty of cooperation which implies an enhanced information obligation when dealing with one another. It follows that the courts may be more demanding in terms of disclosed information in cases of share sales between two shareholders of the same company. It will otherwise be accepted that each party may benefit from the potentially mutual information asymmetry affecting the transaction. On the subject of the suitability of general laws to the sale of shares, it is worth observing beyond the issue of the disclosure of information that when control of the company is transferred, the suitability of the general law of sale is questionable because, in contrast to the usual contractual scenario, parties other than those having made an undertaking can be affected because of the majority principle. This acts as justification for extraordinary solutions such as mandatory takeover obligations when a given threshold of the voting rights (*e.g.* 33%) is crossed in listed companies.

2.1.a. The prohibition on insider trading in private companies

The duty of loyalty owed by executive officers, directors and controlling shareholders to individual shareholders has been recognized in case law in France in 1996 and has been upheld in other decisions rendered since then. The background is roughly the same in a landmark case before the commercial section of the *Cour de cassation* dated 27 February 1996³¹¹ and in the subsequent decisions: the chief executive officer of a company convinced several shareholders to sell him their shares, either directly or indirectly, for a certain price, without disclosing that a potential buyer for these shares was prepared to pay a higher price³¹².

This is a situation which, if it involved the shares of a listed company, would be characterized as insider trading. Two reasons justify the regulation of insider trading in listed companies: for the efficient operation of the market from a technical point of view and damage to other players in the market from a fairness point of view. This latter justification illustrates the existence of an implicit obligation regarding the disclosure of certain information to the shareholders and the market at large. It is also with regard to the supply of information, except that it was in connection with a private company, that the principle of a fiduciary duty owed to individual shareholders under certain circumstances was established under French law via a decision dated 27 February 1996 rendered by the *Cour de cassation*.

³¹⁰ See for example Com. 21 April 1959, Bull. civ. III, p. 162, no. 178; 8 March 1965, Bull. civ. III, p. 147, no. 173; 22 November 1971, Bull. civ. IV, p. 261, no. 279.

³¹¹ Com. 27 Feb. 1996, J.C.P. 1996, Ed. G, 22665, p. 283, note J. Ghestin; D. 1996, p. 518, note Malaurie Ph.; RD bancaire et bourse, janvier-février 1997, p. 27, obs. M.-A. Frison-Roche and M. Germain; Quot. Jur., no. 39, 14 May 1996, p. 9, note P.M.

³¹² See also Com. 22 May 2004, D. 2004, 1599, observations by Alain Lienhard and D. 2004, 2923, observations by Lamazerolles E. This case upheld Com. 27 February 1996.

The detailed facts of the decision of 27 February 1996 were as follows: the chief executive officer (PDG) of a private company was in possession of inside information, on the basis of which he bought the shares of a shareholder who was to become plaintiff in the case. The chief executive officer sold these shares shortly afterwards to a third party for a much higher price on the basis of information he had had prior to the transaction with the shareholder. According to the court, the chief executive officer had thereby breached “a duty of loyalty [that] weighs on a corporate officer with regard to all shareholders, in particular when he acts as an intermediary for the sale of their share interest”. It can also be imagined that the chief executive officer at fault could have been found liable under provisions of company law such as articles L. 225-251³¹³ and L. 225-252³¹⁴ of the French Commercial Code, which sanction acts of mismanagement. Prof. Dominique Schmidt agrees more generally that “the corporate officer who acts in a situation of conflict of interests dictated by advantages sought for himself or for a group of shareholders is liable on the basis”³¹⁵ of these provisions. The general question behind this decision is that of determining to what extent inside information can be used by corporate officers and directors within a private company for their own benefit when dealing with fellow shareholders. The court held that any corporate officer in possession of this type of information must either refrain from using it or disclose it, otherwise he may be found civilly liable for breach of his fiduciary duty of loyalty.

This question leads to an interesting comparison between the legal regimes of listed and unlisted companies. In listed companies, the use of private information to make a profit, insider dealing, is a criminal offence in many legal systems whereas in similar circumstances within a private company, only a civil penalty can be imposed for the use of private information. The seriousness of the criminal prosecution in relation to a listed company can be explained by the fact that it is the efficient operation of the stock market itself which is at stake. Alternatively, the absence of civil sanctions for insider trading involving listed securities, as it is the case under French law, can be explained by the impossibility for a market player to prove that he has suffered a loss because of the anonymity surrounding stock market transactions. Also, as the stock market is liquid, the market player cannot claim to have bought or sold a security with this specific insider in mind. As a result, the market player cannot prove the fact that the knowledge of the private information would have prevented him from contracting.

³¹³ Art. L. 225-251: “The directors and managing director shall be individually or jointly and severally liable to the company or third parties either for infringements of the laws or regulations applicable to limited liability companies, or for breaches of the memorandum and articles of association, or for tortuous or negligent acts of management.

If more than one director, or more than one director and the managing director, have participated in the same acts, the Court shall determine the share to be contributed by each of them to the compensation awarded”.

³¹⁴ Art. L. 225-252: “Apart from actions for personal loss or damage, shareholders may either individually or in an association fulfilling the conditions laid down in Art. L. 225-120, or acting as a group in accordance with conditions to be laid down by an Order approved by the *Conseil d'Etat*, bring an action for liability on behalf of the company against its directors or managing director. The plaintiffs shall be authorised to sue for compensation for the full amount of the loss or damage suffered by the company, to which damages shall be awarded if necessary”.

³¹⁵ (“*le dirigeant qui agit sous l'empire d'un conflit d'intérêts dicté par des avantages recherchés pour lui-même ou pour un groupe d'actionnaires engage sa responsabilité sur le fondement*”), Dominique Schmidt, in *Les conflits d'intérêts dans la société anonyme*, Editions Joly, coll. *Pratique des Affaires*, p. 283.

We shall now turn to the justification of what equals a *de facto* importation of insider trading in the private company following the 27 February 1996 case. Traditionally, the justification of the sanction of insider trading has been twofold. A distinction may be drawn between regulations in favour of the efficient operation of the market on the one hand and the breach of the implicit investment contract on the other hand. However, the argument based on the transparency required for the technical operation of the market, resulting from the particular importance of the notion of information in the formation of prices on financial markets, is irrelevant in unlisted companies. The implicit investment contract is entered into between the market and the managers of the company, who are considered as *de jure* insiders³¹⁶. An analogy with the private company can nevertheless be made on the basis of this notion. Both types of company converge on the necessity to reduce agency costs which can restrict access to capital. Since efficient investor protection fosters stock market confidence and therefore increases liquidity, it indirectly underlies the argument of the investment contract in the private company. Indeed, those who invest funds in a company thereby accept the loss of their supervisory powers over such funds. They do so because they entrust³¹⁷ the managers to maximize the return on their interest and, to this end, both parties enter into an implicit investment contract. This idea is common to private and public companies in so far as, as we saw earlier, the hypothesis of the maximization of shareholder value applies without distinction to both. This is why the maximization of shareholder value should also, as already argued, constitute the purpose of the corporate contract in the private company.

The corporate contract in the private company and the investment contract in the listed company are comparable from the shareholders' and the investors' protection standpoint respectively. With regard to the use of private information to make a profit out of a share transfer, it is therefore understandable that

³¹⁶ Art. L. 465-1 of the French monetary and financial code, sanctioning insider trading: "Executives of a company referred to in Art. L. 225-109 of the Commercial Code (*Code de commerce*) [the chairman, managing directors and directors], or persons who, through the practice of their profession or the performance of their functions, obtain privileged information concerning the prospects or the situation of an issuer whose securities are admitted to trading on a regulated market or the likely trend of a financial instrument admitted to trading on a regulated market, either directly or through an intermediary, and who carry out or facilitate one or more transactions before the public has knowledge of that information shall incur a penalty of two years' imprisonment and a fine of 150,000 euros, which amount may be increased to a figure representing up to ten times the amount of any profit realised and shall never be less than the amount of that same profit.

Whoever, through the practice of his profession or the performance of his functions, obtains privileged information concerning the prospects or the situation of an issuer whose securities are admitted to trading on a regulated market or the likely trend of a financial instrument admitted to trading on a regulated market, and communicates that information to a third party outside the normal framework of his profession or his functions shall incur a penalty of one year's imprisonment and a fine of 150,000 euros.

Any person, other than those referred to in the previous two paragraphs, who knowingly obtains privileged information concerning the situation or the prospects of an issuer whose securities are admitted to trading on a regulated market or the likely trend of a financial instrument admitted to trading on a regulated market and directly or indirectly communicates that information, or allows it to be communicated, to a third party before the public has knowledge thereof, shall incur a penalty of one year's imprisonment and a fine of 150,000 euros. If the information in question is used in the commission of a crime or an offence, the sentence shall be increased to seven years' imprisonment and a fine of 150,000 euros if the amount of the profit realised is below that figure.

The penalties imposed by the first paragraph also apply to whoever disseminates in public, via whatever channel or means, any false or deceptive information concerning the prospects or the situation of an issuer whose securities are admitted to trading on a regulated market, or the likely trend of a financial instrument admitted to trading on a regulated market, which would be likely to influence the price thereof."

³¹⁷ Hervé Le Nabasque writes about the chief executive officer in the 27 February 1996 case: "his capacity as of manager inspired trust", in *Le Développement du Devoir de Loyauté en Droit des Sociétés*, RTD com., avril-juin 1999, p. 280. Similarly, Dominique Schmidt: "The latter [the shareholders] named him head of the company and trusted him", in *Les Conflits d'Intérêts dans la Société Anonyme*, Editions Joly, coll. *Pratique des Affaires*, p. 282.

the prohibition should be common to both listed and non-listed companies. Some consequences therefore need to be attached to the breach of the corporate contract and the investment contract caused by insider trading. According to the factual circumstances of the 27 February 1996 decision, the chief executive officer refrained from disclosing private information that would have enabled the shareholder to sell her shares for a price reflecting both past results and the future prospects of the company. The *Cour de cassation* held that, by doing so, the chief executive officer had breached his duty of loyalty owed in his capacity as chief executive officer, which in this specific case included a disclosure obligation owed to the vendor-shareholder who had, in addition, asked the chief executive officer to act as an intermediary. The explicit reference made to the notions of loyalty and trust illustrates the fact that, in the private company, the prohibition on using private information results from “the predominance [...] of a moral objective over a financial objective”³¹⁸, the financial objective, *i.e.* transparency, being a technical condition of the operation of the stock market.

This is not only about fairness however. Fiduciary obligations are also a way to mitigate transaction costs³¹⁹ and the duty of loyalty can also be used as a remedy to conflicts of interest. In the 27 February 1996 decision, the transaction costs resulted from the fact that the selling shareholder was in fact prevented from establishing the relation between the price of the shares and their value. Pursuant to the court decision, “he [the chief executive officer] concealed [the fact that he was given] ... the mission of assisting the members of his family, controllers of the company, to find a buyer for their shares and he did not submit a buy order for the minimum price of FF 7,000 per share”³²⁰. Incidentally, it is welcome news that where there is no market for the shares, the court seeks to verify the existence of a minimum link between the share price and the value of the company³²¹.

This justification of the prohibition on insider trading in private companies on the grounds that it makes it impossible to establish a link between the share price and the company’s intrinsic value, is confirmed *a contrario* by the theory of capital markets efficiency. Pursuant to this financial theory, the share price reflects all available information at a given time for any one company. Consequently, any private information held by an insider is in theory already known by the market which decides to buy or sell on its basis, thus making this piece of information an element in the determination of the market price. The theory of capital markets efficiency therefore challenges the very notion of private information, *i.e.* information not yet known by the market, and also as a consequence the necessity for a regulation of information on the market. Where markets are not efficient, as is the case for the market in unlisted shares, the intrinsic value of the shares is less likely to be reflected in their price. This is why a mandatory disclosure regime is of a particular importance in private companies. One rule of this

³¹⁸ Frison-Roche M.-A. and Germain M., note on Com. 27 Feb. 1996, *op. cit.*, p. 27.

³¹⁹ See *supra* Part 2, chapter 2.

³²⁰ Com. 27/02/1996, *op. cit.*

³²¹ Frison-Roche M.-A. and Germain M., note on Com. 27 Jan. 1998, *RD bancaire et bourse*, juillet-août 1998, p. 146.

disclosure regime ought to be for directors and executive officers to disclose or to refrain from using private information, which if frequently found on the market for unlisted shares³²², when dealing with the shares of other shareholders.

The 27 February 1996 decision and the subsequent decisions which upheld it add a purely civil sanction applicable to insider trading by directors, executive officers and controlling shareholders in unlisted shares in addition to the criminal and sometimes administrative sanctions imposed on insider trading in listed shares. In this seminal decision, the knowledge of the existence and the content of the negotiations conducted by the chairman with the future buyer, which was concealed from the selling shareholder, definitely constituted private information pursuant to the definition given by article 621-1 of the *AMF* General Regulations on the *manquement d'initié*, which is the administrative sanction applicable for insider dealing under French law: "any information of a precise nature that has not been made public, relating directly or indirectly to one or more issuers of financial instruments [...] and which, if it were made public, would be likely to have a significant effect on the prices of the relevant financial instruments or on the prices of related financial instruments". In the unlisted company, insider trading could be described, in light of the 27 February 1996 decision, as follows: the sale or purchase of securities by a corporate officer, director or controlling shareholder in light of a piece of information that could have a significant effect on the share price and that is not known by the contracting shareholder.

What differs from the criminal offence of insider trading in listed companies is, logically, the scale of the disclosure of the information at stake, and the range of those subject to this requirement to "disclose or abstain". On the first point, the transaction based on the information at stake, triggering the criminal offence in listed companies, occurs before such information has come to the knowledge of the public, in other words, on the basis of non-public information. In private companies, the reference to the public, *i.e.* the market, is irrelevant and it will therefore be the asymmetry of information between contracting partners, therefore introducing an agency perspective that will justify the civil sanction of the use of private information. This basis for the obligation of information was stated in particularly clear terms by a U.S. court under similar circumstances: "The officers and directors of such corporation, because of their official connection therewith, have a knowledge of its assets and liabilities, the condition of its business, its prospects for the future, and the value of the stock which it would be difficult if not practically impossible for the ordinary shareholder to obtain. In such a case it seems reasonable to require such officers or directors to make full disclosure of all pertinent facts when selling to, or purchasing from, a shareholder in the corporation"³²³. It is an illustration of the risk incurred by shareholders of a private company since they are at the mercy of managers', directors' or controlling shareholders' potential opportunism, resulting from the asset specificity of their investment. As stated

³²² A more general system must be devised for the diffusion of information, preferably based to some extent on that applicable to listed companies. See *supra* Part 2, Chapter 1, Information Supply in Private Companies.

³²³ Phillips J, in *Dunnett v. Arn*, 71 F 2d 912, cited in J. L. Farrar, *The Duties of Controlling Shareholders*, 1987, op. cit. p. 194.

above, because of this asset specificity, a shareholder has no real alternative as to the choice of his contracting partners, which gives the latter additional hold-up power over the former.

2.1.b. Who is subject to the prohibition on insider trading in private companies?

Another question raised by the civil sanction of insider trading in private companies is who must be included among the contracting partners? This is the question regarding the scope of this specific obligation of information. The 27 February 1996 court decision makes a corporate officer liable, in this case – the chief executive officer. The issue is to determine whether the use of some private information can be blamed on corporate officers alone because, in the context of a transfer of shares, they owe a “duty of loyalty” to “every shareholder”, to quote from the court decision, or whether any controlling shareholder and *a fortiori* any shareholder are under this same obligation. We have already seen that under general French contract law, a particular information obligation is placed upon members of a family who are party to a share transfer or when it is partnership shares which are transferred.

Continuing with our comparison of the insider dealing regimes for listed and unlisted companies, it must be observed that many persons are punishable for insider trading in listed companies and also on the occasion of the mere disclosure of some private information³²⁴, regarding a listing company, to a market player. These persons are the corporate officers, the directors and more generally anyone holding such information because of his profession or function, which includes shareholders³²⁵. It is the specificity of the context of these criminal offences, *i.e.* the efficient operation of the stock market, which explains why the scope is so broad. In the private company, what should be the scope of the persons punishable on the basis of the violation of the duty of loyalty? It must first be noted that the persons likely to hold private information which may affect the price of unlisted shares are in much more limited number than in the context of the stock market. Given the relatively limited contacts between unlisted companies and the financial industry³²⁶, the corporate officers, directors and controlling shareholders are the most concerned by the regulations governing the use of private information. These are the persons who owe a duty of loyalty, one of the consequences being the prohibition of insider trading in the private company. Generally, this duty applies from the moment that the person involved benefits, because of his status or his factual situation, from another person’s trust. Positions other than that of corporate officer also

³²⁴ See in French law, Art. L. 465-1, subsection 3, of the French monetary and financial code: “Any person, other than those referred to in the previous two paragraphs, who knowingly obtains privileged information concerning the situation or the prospects of an issuer whose securities are admitted to trading on a regulated market or the likely trend of a financial instrument admitted to trading on a regulated market and directly or indirectly communicates that information, or allows it to be communicated, to a third party before the public has knowledge thereof, shall incur a penalty of one year’s imprisonment and a fine of 150,000 euros. If the information in question is used in the commission of a crime or an offence, the sentence shall be increased to seven years’ imprisonment and a fine of 150,000 euros if the amount of the profit realised is below that figure”.

³²⁵ As it results in French law from Art. L. 465-1 of the French monetary and financial code and from Art. 2, *Règlement COB* no. 90-08, now codified under Art. 622-1 of the *AMF* General Regulations.

³²⁶ With the exception of unlisted companies in business with private equity firms.

implicitly involve this relationship where trust is confided by one person to another: controlling shareholders should therefore be included in the scope of the prohibition.

Another decision by the French courts can be used to illustrate who should be covered by a disclosure obligation resulting from the duty of loyalty. A judgment dated 27 January 1998 rendered by the commercial section of the *Cour de cassation* voided a transfer of shares because the buyer, who was a controlling shareholder, had concealed the true value of the shares from his contracting partner who was at that time a minority shareholder³²⁷. This is a way of mitigating transaction costs arising out of relations of power within the firm. It follows from this case that there is an obligation for a controlling shareholder to disclose private information when transferring shares to a fellow shareholder.

This is an interesting decision because shareholders do not traditionally owe fiduciary duties to each other or to their company. As shareholders do not have access to details of the other shareholders' assets invested in the company, because after its incorporation the company becomes the owner of the shareholders' contributions, those shareholders do not manage the capital and therefore do not owe the corresponding duties in relation to this mission. As already argued, we consider that the interposition of the legal personality of the company hides important fact-based relationships. Consequently, when, as in the 1998 case, it is recognized that in practice controlling shareholders have access to non-controlling shareholders' contributions and that the former may exploit this access to serve their own interests, then a fiduciary responsibility is produced. The fiduciary obligation applies to managers, directors and controlling shareholders who act as agents of the other shareholders, even if, regarding the latter, such an obligation does not rest on status-based relationships.

The reality of the power of a shareholder enjoying the benefits of the corporate control of the company is well depicted in the judgment of Lord Lindley M. R. in the English decision *Allen v. Gold reefs of West Africa*³²⁸. According to this judgment, the power of a shareholder "must, like all other powers, be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities. It must be exercised, not only in the manner required by law, but also *bona fide* for the benefit of the company as a whole, and it must not be exceeded. These conditions are always implied, and are seldom, if ever, expressed"³²⁹. It is worth noting that here, as with the recognition under French law of a duty to inform the directors owed by the chairman, no reference is made to any formal legal basis. This is a confirmation that obligations may arise out of a *de facto* situation³³⁰.

³²⁷ See Com. 27 Jan. 1998, observations by Frison-Roche M.-A. and Germain M., *RD bancaire et bourse*, July-August 1998, p. 146.

³²⁸ (1900) 1 Ch. 656.

³²⁹ *Ibid.*, 671.

³³⁰ See Rider B. A. K., *A Special Relationship on the Special Facts*, *The Modern Law Review*, Vol. 41, No. 5 (Sep., 1978), pp. 585-589.

A disclosure obligation also applies in the case of a transfer of shares between two shareholders who do not belong to the majority group. If, despite being outside the controlling group, one of them held some private information, constituting for the other party a fact that, had it been known, would have prevented him from contracting or would have induced him to contract on different terms, then this would constitute wilful misrepresentation³³¹. However, it would not constitute a breach of a fiduciary duty of loyalty since minority shareholders are not entrusted with any power that would make them subject to such a duty. The economic rationale for the sanctioning of this wilful misrepresentation could then be the necessary respect for the allocation of profit and loss in proportion to the respective contributions of capital of the shareholders. Using private information for one's personal benefit, to the detriment of a fellow shareholder, on the occasion of a transfer of the company's shares, would be a breach of the initial allocation pursuant to which the shareholders had made their commitment. In other words, it would amount to a deviation from the common interest of the shareholders which is to maximise value for the group.

Finally, with respect to the scope of the persons liable on the basis of the disclosure obligation resulting from a duty of loyalty³³², the situation in which the purchaser of the shares acts in another capacity in addition to that of executive officer must be mentioned. In the 27 February 1996 decision, the chief executive officer also acted as intermediary for the placement of the minority interest of the plaintiff. The interpretation of one legal commentator was therefore that "the corporate officer is liable because he committed himself to acting as a middleman to sell the shares of Ms A. [the plaintiff]"³³³. This is a position which rests more on a general contract law analysis of the placement agreement between the chief executive officer and the selling shareholder than on the trust that, as a chief executive officer, the purchaser inspired in that selling shareholder. The fact that the chief executive officer-buyer had been acting as a middleman was considered under the 27 February 1996 court decision "as a kind of aggravating circumstance (...) of the fault (...) committed" by the chief executive officer³³⁴ but not as the triggering event of the obligation of loyalty. The basis of the fiduciary obligation is to be found in the position of director and not of middleman for the sale of the shares.

³³¹ See under French law for the conditions of the wilful misrepresentation by omission (*réticence dolosive*) Civ., 15 Jan. 1971, Bull. civ. 111, no. 38, p. 25.

³³² More generally, under English law, directors are personally bound by the general equitable principle, even though their power is collective as a board and their obligations do not terminate with the end of their functions. In French law, Art. L. 225-251, para. 1 of the French Commercial Code provides that the directors are responsible individually or jointly, according to the case.

³³³ "Le dirigeant est ici rendu responsable car il s'était engagé à servir d'intermédiaire pour vendre les actions de Mme A", Malaurie P. note on Com., 27 Feb. 1996, Quot. Jur., no. 39, 14 May 1996, p. 11.

³³⁴ "n'a été retenu par la Chambre commerciale que comme une sorte de circonstance aggravante 'particulière' de la faute d'omission commise par le cessionnaire", Ghestin J., note on Com. 27 Feb. 1996, J.C.P. 1996, Ed. G, 22665, p. 288. Similarly, Prof. Le Nabasque writes about the quality of intermediary that for the court it is not "a condition of the liability of the officer", in *Le Développement du Devoir de Loyauté en Droit des Sociétés*, RTD com, April-June 1999, p. 279.

2.1.c. A common trend in French and English law

Various decisions factually very close to this case were rendered in the UK³³⁵, leading to comparable but not similar conclusions. In *Percival v. Wright*³³⁶, several shareholders launched an action to set aside a sale of shares on the ground that the directors, as purchasers, should have informed the selling shareholders that they were engaged in negotiations for the sale of the company which would have significantly increased the value of the shareholders' shares³³⁷.

The court held that the management of a company does not owe a fiduciary duty to shareholders to avoid misusing corporate information for its own benefit. In this respect, this decision is different from the landmark 27 February 1996 case where the court held that a duty of loyalty was owed to the shareholders. In *Percival v. Wright*, the duty was owed by the management to the company. The particular circumstances of the case are worth noting: the directors did not approach the shareholders with a view to obtaining their shares, rather, the shareholders themselves approached the directors and named the price at which they were willing to sell. The interpretation given in *Percival v. Wright* is consistent with the above-mentioned consequences of the incorporation of the company, *i.e.* that shareholders do not owe fiduciary duties either to other shareholders or to the company, and that directors owe fiduciary duties to the company only, as agents, and not to the shareholders.

Percival v. Wright therefore represents an orthodox view of fiduciary duties which was later refined by the decision of the New Zealand Court of Appeal in *Coleman v. Myers*³³⁸. It is with this decision that the French 27 February 1996 decision can really be compared since this case recognised a fact-based fiduciary duty owed by directors to shareholders. In *Coleman v. Myers*, the shareholders complained that the directors had bought their shares without disclosing the financing plan for the buy-out of the rest of the capital. The court considered that such non-disclosure constituted a breach of the fiduciary obligation owed to shareholders, which arose on the basis of the *de facto* situation. Justice

³³⁵ *Allen v. Hyatt* (1914) 30 T.L.R. 444, P.C.; *Briess v. Woolley* (1954) A.C. 333, H.L.

³³⁶ *Percival v. Wright* (1902) 2 Ch 421. see B. Rider A. K., *Percival v. Wright*. Per Incuriam, The Modern Law Review, Vol. 40, No. 4 (Jul., 1977), pp. 471-476.

³³⁷ Swinfen Eady J. states (at 425-27) that: ". . . It is urged that the directors hold a fiduciary position as trustees for the individual shareholders, and that, where negotiations for sale of the undertaking are on foot, they are in the position of trustees for sale [...] It is contended that a shareholder knows that the directors are managing the business of the company in the ordinary course of management, and implicitly releases them from any obligation to disclose any information so acquired. That is to say, a director purchasing shares need not disclose a large casual profit, the discovery of a new vein, or the prospect of a good dividend in the immediate future, and similarly a director selling shares need not disclose losses, these being merely incidents in the ordinary course of management. But it is urged that, as soon as negotiations for the sale of the undertaking are on foot, the position is altered. Why? The true rule is that a shareholder is fixed with knowledge of all the directors' powers, and has no more reason to assume that they are not negotiating a sale of the undertaking than to assume that they are nor exercising any other power. [...] I am therefore of opinion that the purchasing directors were under no obligation to disclose to their vendor shareholders the negotiations which ultimately proved abortive. The contrary view would place directors in a most invidious position, as they could not buy or sell shares without disclosing negotiations, a premature disclosure of which might well be against the best interests of the company. I am of opinion that directors are not in that position".

³³⁸ (1977) 2 N.Z.L.R. 225. See also previously *Gadsden v. Bennetto* (1913) 3 W.W.R 1109 and *Allen v. Hyatt* (1914) 30 T.L.R. 444, P.C.

Cooke stressed that *Percival v. Wright* “would merely exclude any automatic fiduciary duty, leaving open the possibility of such a duty falling on a director in particular circumstances”³³⁹.

The question now focuses on the test to identify these particular circumstances. Justice Woodehouse observed that it “may not be possible to lay down any general test [...] There are nevertheless some factors that will usually have an influence [...] They include, I think, dependence upon information and advice, the existence of a relationship of confidence, the significance of some particular transaction for the parties and, of course, the extent of any positive action taken by or on behalf of the director or directors to promote it”³⁴⁰. He also added asymmetry of information and experience as triggering factors. Other factors were suggested by Justice Cooke: “the facts giving rise to the duty are the family character of this company; the positions of father and son in the company and the family; their high degree of inside knowledge; and the way they went about the takeover and the persuasion of the shareholders”³⁴¹. The subjective, factual nature of this test makes it hard to conceptualize but the common factor seems to be the abuse of a relation of confidence. However, there is a “hard” side to this fact-based liability and it is that the directors could have an indirectly effect on shareholders’ assets by diminishing shareholder value.

In the decision of the New South Wales Court of Appeal in *Brunninghausen v. Glavanics*³⁴², the existence of a duty owed by directors to shareholders was also acknowledged on the grounds that the transaction did not concern the company. In this case, one shareholder purchased shares from his brother-in-law. The plaintiff and vendor argued that the purchaser, who was also a company director, had failed to disclose the existence of simultaneous negotiations for the sale of the company. According to Justice Handley, “If the defendant had a fiduciary duty to the plaintiff he could not contract to purchase his shares that day without disclosing the existence of the other provisions”³⁴³. On the relevance of the principle of *Percival v. Wright* to the case: “The question is whether the principle applies in a case, such as the present, where the transaction did not concern the company, but only another shareholder”³⁴⁴. Justice Handley asserted that the fact that certain duties were owed by directors to the company “should not preclude the recognition of a fiduciary duty to shareholders in relation to dealings in their shares where this would not compete with any duty owed to the company”³⁴⁵.

As one commentator remarked, *Brunninghausen v. Glavanics* is an illustration of the fact that courts have recognised the existence of some fiduciary duties owed by directors to shareholders, but

³³⁹ Ibid. 330.
³⁴⁰ Ibid. 325.
³⁴¹ Ibid. 330.
³⁴² (1999) 46 N.S.W.L.R. 538, CA.
³⁴³ Ibid. 568.
³⁴⁴ Ibid. 549.
³⁴⁵ Ibid.

Justice Handley's comments are rather too vague to identify the basis for the fiduciary characterisation³⁴⁶. In this case, the particular circumstances were that the director, as a controlling shareholder, owed a fiduciary duty to the plaintiff and the latter was therefore "at the mercy of" and "vulnerable to abuse by" the defendant³⁴⁷. Also, the transaction involved a "gross disparity in price" and a "quick profit"³⁴⁸. *Brunninghausen v. Glavanics* is particularly revealing because a separate obligation to act in the personal interest of the plaintiff was recognised whereas there was no commitment from the defendant to advise the plaintiff on the sale of his shares to a third party, as was the case in the French 27 February 1996 decision. The obligation was identified despite the absence of any such aggravating circumstance. The same generality of the duty was acknowledged in *Stein v. Blake* as Justice Millet found that "Directors owe fiduciary duties[...] to the shareholders to advise them properly so that they are not induced or compelled to part with their shares at an undervalue"³⁴⁹. Therefore, no additional agreement between the parties was needed.

The recent decision of the Court of Appeal of England and Wales in *Peskin v. Anderson*³⁵⁰ is part of a series of judgments requiring the existence of special circumstances to justify the enforcement on directors of fiduciary duties to individual shareholders. This case concerned the de-mutualisation of the Royal Automobile Club, following which all members of the club were entitled, on a cut-off date, to receive payment of a certain sum of money for their interest in the business. Various former members of the club, who had withdrawn their membership prior to the cut-off date, commenced proceedings against the directors seeking damages for breach of a fiduciary duty to disclose the plans relating to the de-mutualisation.

The court held that, in this case, there were no circumstances which justified an exception to the principle of *Percival v. Wright* that the director owes fiduciary duties to the company only. However, by doing so, the court confirmed that directors will owe fiduciary duties to shareholders (as distinct from the company) if there is a special factual relationship between the directors and the shareholders which is capable of giving rise to fiduciary obligations.

According to Justice Mummery, "Those [fiduciary] duties are, in general, attracted by and attached to a person who undertakes, or who, depending on all other circumstances, may be treated as having entrusted, the care of his property, affairs, transactions or interests to him"³⁵¹. In the case in question, the special circumstances for the plaintiffs were that the directors had information that they knew would be relevant to the members' decisions to retire. However, for Justice Mummery, this was not

³⁴⁶ See Flannigan R., *Fiduciary Duties of Shareholders and Directors*, *Journal of Business Law*, May 2004, 277-302.

³⁴⁷ *Ibid.* 558.

³⁴⁸ *Ibid.* 559.

³⁴⁹ (1998) 1 B.C.L.C. 579, CA.

³⁵⁰ (2001) 1 B.C.L.C. 372, CA. See Arsalidou D., *Director's Fiduciary Duties to Shareholders: the Platt and Peskin cases*, *Company Lawyer*, 2002, 23 (2), 61-63.

³⁵¹ *Ibid.* 379.

sufficient to characterise the special circumstances. An additional circumstance was needed. He observed that “there was nothing special in the factual relationship [...] in particular there were no relevant dealings, negotiations, communications or other contact directly between the directors and the members...”³⁵².

It follows that a fiduciary duty may arise under the principle laid down by *Peskin v. Anderson* where:

1. “directors are brought into close contact with shareholders (through dealings, negotiations, communications and other contact directly between the directors and the shareholders); and
2. the relationship is capable of generating fiduciary obligations (such as an obligation to use confidential information acquired by the directors in that office, for the benefit of the shareholders)”³⁵³.

Because of the requirement that there be a direct “contact” between the directors and the shareholders for the duty to arise, this case sets out a more restrictive approach than that adopted by the French 27 February 1996 decision. Indeed, as we observed above, the latter decision did not analyse the contacts that existed between the parties as a necessary condition to the characterization of the fiduciary relationship.

The introduction in France by the 27 February 1996 court decision of a disclosure obligation resulting from a duty of loyalty owed to shareholders by the persons exercising power in the company, in return for their power, harmonises the protection of shareholders in listed and unlisted companies. As it has already been stated, interpreting relationships of power within private companies in the form of implicit contracts makes it possible to trigger certain obligations under a duty of loyalty. It introduces into French law a broad foundation on which to base the sanctioning of conflicts of interest originating from an asymmetry of information. French case law, although somewhat limited in volume, seems less demanding in this regard than English law in *Peskin v. Anderson* with respect to the characterization of the circumstances triggering the fiduciary duties.

Overall, non-controlling shareholders seem to be better protected against the opportunism of their agents. The agency costs for minority shareholders will thus be reduced by the disclosure obligation resulting from a duty of loyalty owed by directors and controlling shareholders. The enforcement of this obligation in French law is indeed a positive step since only shareholders in listed companies had previously benefited from effective protection against insider dealing, thanks to financial market regulations.

³⁵² Ibid. 384.

³⁵³ Noakes D. April 2001 Corporate Law Electronic Bulletin, Centre for Corporate Law and Securities Regulation, University of Melbourne.

2.2 Conflicts of interest when dealing with the company

Under English law, the general equity principle applicable to directors requires that they make sure that their personal interest does not conflict with the obligations they owe to the company. English case law has thus developed a set of rules applicable to situations likely to give rise to conflicts of interest and therefore to agency costs. There are various situations in which a company's profits or assets can be diverted during transactions between a director or a controlling shareholder and his company. The director can be a direct party, for instance to a service agreement with the company, or alternatively he may be involved indirectly via an interest in the other party, for instance as a director of another company.

The regulation of conflicts of interest within a company is commonly found in the legislation or the corporate governance codes of EU Member States as various illustrations will show and we will make a comparison of the approaches taken under English and French law. For instance, article 4.3.4 of the German corporate governance code provides that "All members of the management board shall disclose conflicts of interest to the supervisory board without delay and inform the other members of the management board thereof. All transactions between the enterprise and the members of the management board, as well as any individuals close to them or companies in which they have a personal association, with must comply with standards customary in the sector. Major transactions shall require the approval of the supervisory board"³⁵⁴. Also, with regard to members of the supervisory board, article 5.5.2 of the same code stipulates that "Each member of the Supervisory Board shall inform the Supervisory Board of any conflicts of interest which may result from a consultant or directorship function with clients, suppliers, lenders or other business partners"³⁵⁵.

Pursuant to Luxembourg's *loi concernant les sociétés commerciales* (law on commercial companies) dated 10 August 1915, "The director who has an interest contrary to that of the company in a transaction submitted for approval to the board of directors must let the board know and must have this declaration acknowledged in the minutes. He cannot take part in this deliberation. Transactions in which a director would have had an interest in opposition with that of the company must be reported at the next general assembly before the vote of other resolutions"³⁵⁶.

³⁵⁴ Art. 4.3.4 of the Deutscher Corporate Governance Kodex: "Jedes Vorstandsmitglied soll Interessenkonflikte dem Aufsichtsrat gegenüber unverzüglich offenlegen und die anderen Vorstandsmitglieder hierüber informieren. Alle Geschäfte zwischen dem Unternehmen einerseits und den Vorstandsmitgliedern sowie ihnen nahestehenden Personen oder ihnen persönlich nahestehenden Unternehmungen andererseits haben branchenüblichen Standards zu entsprechen. Wesentliche Geschäfte sollen der Zustimmung des Aufsichtsrats bedürfen".

³⁵⁵ Art. 5.5.2 of the Deutscher Corporate Governance Kodex: "Jedes Aufsichtsratsmitglied soll Interessenkonflikte, insbesondere solche, die auf Grund einer Beratung oder Organfunktion bei Kunden, Lieferanten, Kreditgebern oder sonstigen Geschäftspartnern entstehen können, dem Aufsichtsrat gegenüber offenlegen".

³⁵⁶ Art. 57, law of 10 August 1915: "L'administrateur qui a un intérêt opposé à celui de la société, dans une opération soumise à l'approbation du Conseil d'administration, est tenu d'en prévenir le conseil et de faire mentionner cette déclaration au procès-verbal de la séance. Il ne peut prendre part à cette délibération.

Il est spécialement rendu compte, à la première assemblée générale, avant tout vote sur d'autres résolutions, des opérations dans lesquelles un des administrateurs aurait eu un intérêt opposé à celui de la société", (author's translation).

Under Belgian law, "If a director has, directly or indirectly, a financial interest in opposition with a decision or a transaction involving the board of directors, such interest must be disclosed to other directors before the board deliberates"³⁵⁷. In addition, this statement, as well as the reasons behind the director's personal interest, must be mentioned in the minutes of the board's decision on the transaction. The Italian *Legge Draghi* of 24 February 1998 provides for a similar principle³⁵⁸.

Under English law, with respect to a transaction between a director and his company, the general principle of equity provides a legal framework that has subsequently been extended by statute law. The legal regime for such transactions therefore results from a combination of rules originating in case law and statute law. The first source provided that the directors involved must provide complete information to the shareholders who vote on the signature of the transaction or its *ex post* ratification, although this procedure could be circumvented by drafting the articles of association to this effect. As a consequence, a law was enacted which repeated the director's obligation to disclose his interest in the transaction³⁵⁹. The only sanction applicable to the breach of this obligation – which is in fact optional since an opt-out still remains possible– is a fine³⁶⁰. Consequently, if the articles of association do not stipulate disclosure by the relevant director as a condition for the validity of the transaction with the company, the transaction will be valid despite the absence of any disclosure on the part of the director. The prevailing principle with respect to such a situation of conflict of interests under the general equitable principle and statute law results from two cases: *Hutchinson v. Brayhead Ltd*³⁶¹ and *Guinness v. Saunders*³⁶² and has led to the conclusion that "It would mean that a director could profit at the expense of the company notwithstanding that he had breached his statutory duty as a director"³⁶³.

It must be noted however that there are some situations governed by Part X of the 2006 Companies Act in which the common law principle of shareholder approval is restored. Part X does indeed contain a series of statutory provisions requiring shareholder consent for potentially self-interested transactions, such as service agreements³⁶⁴ and employment agreements exceeding 5 years with

³⁵⁷ Art. 523, para. 1: "Si un administrateur a, directement ou indirectement, un intérêt opposé de nature patrimoniale à une décision ou à une opération relevant du conseil d'administration, il doit le communiquer aux autres administrateurs avant la délibération au conseil d'administration. Sa déclaration, ainsi que les raisons justifiant l'intérêt opposé qui existe dans le chef de l'administrateur concerné, doivent figurer dans le procès-verbal du conseil d'administration qui devra prendre la décision" (author's translation).

³⁵⁸ Legge Draghi, 24 February 1998: "The directors must report in a timely manner, in accordance with the methods set out in the articles of association and at least once per quarter, to the supervisory board on all commercial activities and all transactions having a major economic, financial or capital impact, carried out by the company or by any controlled company; reference should in particular be made to any transactions involving potential conflicts of interest". (author's translation) ("*Gli amministratori riferiscono tempestivamente, secondo le modalità stabilite dall'atto costitutivo e con periodicità almeno trimestrale, al collegio sindacale sull'attività svolta e sulle operazioni di maggior rilievo economico, finanziario e patrimoniale, effettuate dalla società o dalle società controllate; in particolare, riferiscono sulle operazioni in potenziale conflitto di interesse*".)

³⁵⁹ See Sections 182 and following, Companies Act 2006.

³⁶⁰ Section 183 (1 and 2).

³⁶¹ (1968) 1 Q.B. 549, C.A.

³⁶² (1990) 2 A.C. 663. H.L. See, Davies P. L., Gower's Principles of Modern Company Law, op. cit., p. 613.

³⁶³ Davies P. L., Gower's Principles of Modern Company Law, op. cit., p. 614.

³⁶⁴ Part X, 318.

directors³⁶⁵, golden handshakes or “substantial property transactions”³⁶⁶. Also, the Listing Rules of the London Stock Exchange require shareholder approval and prevent the relevant directors from voting on all related-party transactions, except for certain transactions such as small-scale operations or credit agreements concluded on normal commercial terms³⁶⁷. This regime applying to listed companies is interesting not least because it applies not only to directors and shadow directors of the issuer but also to its parent and subsidiaries and to “persons exercising a significant influence” on the issuer. This latter notion is illustrative of the realism of market-led regulation. The applicable regime requires notification to be made, including the name of the related party and details of the nature and extent of such party’s interest in the transaction or arrangement, followed by the sending of a circular to the shareholders of the issuer containing the information, the obtaining of shareholders’ approval for the transaction either before it is entered into or, if the transaction is conditional on approval being granted, before its completion, and finally requires that the related party does not vote on the relevant resolution and takes all reasonable steps to ensure the abstention of all of his associates³⁶⁸. Again, section 182 has an advantage over the equivalent provisions of the French Commercial Code (*Code de commerce*) (Art. L. 223-19 for *SARLs*, L. 225-38 and L. 225-40 for *SAs*)³⁶⁹ in that it covers not only the contracts themselves but also, in a more effective way, “any transaction or arrangement”, i.e. whether or not a contract³⁷⁰. This is important as minority shareholders will benefit from even more effective safeguards if the scope of protection is wide³⁷¹.

However, regarding the scope of the supervision of related-party transactions, it must be noted that sections 182 and following apply to directors and to shadow directors³⁷² but not to executive chairmen, as opposed to French law³⁷³. The French regime also applies to shareholders holding more than 10% of the voting rights. Applying the procedure of control to shadow directors is an efficient means of monitoring controlling shareholders. In effect, the notion of shadow director aims at applying the same obligations as for *de jure* directors to all persons “in accordance with whose directions and instructions

³⁶⁵ Section 188 of the Companies Act 2006.

³⁶⁶ Section 190.

³⁶⁷ See FSA Handbook, L.R. 11 Annex 1.1, for an exhaustive list of transactions to which the chapter 11 of the Listing Rules does not apply.

³⁶⁸ FSA Handbook, L. R. 11.1.7.

³⁶⁹ Art. L. 225-38, French Commercial Code: “Any agreement entered into, either directly or through an intermediary, between the company and its general manager, one of its assistant general managers, one of its directors, one of its shareholders holding a fraction of the voting rights greater than 10% or, in the case of a corporate shareholder, the company which controls it within the meaning of Art. L. 233-3, must be subject to the prior consent of the board of directors.

The same applies to agreements in which a person referred to in the previous paragraph has an indirect interest.

Agreements entered into between the company and another firm are also subject to prior consent if the company’s general manager, one of its assistant general managers or one of its directors is the owner, an indefinitely liable partner, a manager, a director or a member of that firm’s supervisory board or, more generally, is in any way involved in its management”.

³⁷⁰ Section 185 (1). However with regard to Art. L. 225-38, it should be noted that “the notion of *convention* is larger than that of contract”, Merle P., *Droit commercial, Sociétés commerciales*, 4th ed., 1994, Dalloz, coll. Précis, p. 379.

³⁷¹ One example of the same factual and therefore realistic approach to the definition of a contract has also prevailed in French law with respect to the characterization of the action in concert. The *CMF*, now the *AMF*, in its 13 November 1998 decision, grasped actions in concert as “facts that the common interest of the parties suffices to create and their discord to destroy”. This means that not only formal contracts can be grasped as actions in concert. It results from this realistic approach a better protection of shareholders because thus comprehended, an action in concert was recognized, which triggered a compulsory takeover and thus the buy out of the minority.

³⁷² Section 187 (1).

³⁷³ Art. L. 225-38, para. 1.

the directors of the company are accustomed to act³⁷⁴, and this definition may potentially catch the behaviour of a controlling shareholder. In order to identify a shadow director as the potential controlling shareholder, it is necessary to make a comparison between the notion of the shadow director and that of the *de facto* director. The *de facto* director has the appearance of a *de jure* director except for the fact that he was not formally appointed, whereas the definition of the shadow director “presupposes that there is a board of directors who acts in accordance with instructions from someone else, the *éminence grise* or shadow director³⁷⁵. Therefore, the scope of sections 182 and following includes the monitoring of all transactions between a shareholder and the company he controls. However, the efficiency of these provisions is limited by the fact that this monitoring is not performed directly by the shareholders. Direct supervision by the shareholders³⁷⁶ would make sense, from an agency perspective, because this would counterbalance the sizeable powers of the persons subject to the monitoring procedures³⁷⁷.

The regime resulting from section 177 of the 2006 Companies Act does not guarantee the shareholders a sufficient amount of information to enable them to be aware of the existence of a conflict between the individual interest of the director and the general interests of the company (*i.e.* shareholder value maximisation), on the one hand, and to avoid the actual occurrence of such conflicts of interest, on the other hand. Concerning the identification of conflicts of interest, if a director discloses in advance the name of the companies in which he has an interest³⁷⁸, he is then able to avoid divulging the exact nature of his interest when entering into a transaction with that company. This provides a system of dubious efficiency: as explained by Prof. Davies, a shareholder who “at the time of the notice [...] held only 100

³⁷⁴ Section 251 (1) and (2), Companies Act 2006.

³⁷⁵ *Re Lo-Line Electric Motors Ltd* (1988) Ch. 477, cited in Davies P.L., *Gower's Principles of Modern Company Law*, op. cit., p. 183.

³⁷⁶ Under French law, authorisation results from a board decision. Here too, the supervision would be more efficient, because more impartial, if the general shareholders' meeting rather than the board of directors was competent to authorise related-party agreements involving a director or any shareholder holding more than 10% of the voting rights. If there are no minority representatives on the board, its supervision might appear to be the control of the officer by his peers. This risk increases when directors have seats on the board of several different companies: the directors then fetter their discretion.

³⁷⁷ The directors have no individual powers, but collectively “The board of directors determines the broad lines of the company's business activities and ensures their implementation [and] without prejudice to the powers expressly vested in meetings of the shareholders, and in so far as the memorandum and articles of association permit, it deals with all matters relating to the conduct of the company's business and decides all pertinent issues through its deliberations”. The same goes for the chairman who, as a director, is subject to the regime set out at Art. L. 225-38 of the French Commercial Code. Lastly, chief executive officers (*directeur généraux*) have in practice considerable powers determined in concert by the board and the chairman, and according to the law, including powers with respect to third parties that are identical to those of the chairman: Art. L. 225-56, I. – “The general manager shall be vested with the widest possible powers to act on behalf of the company in all circumstances. He shall exercise his power subject to those that the law allocates explicitly to shareholders' meetings and to the board of directors.

They shall represent the company in its dealings with third parties. The company shall be bound even by those acts of the general manager not covered by the purpose of the company unless it is able to prove that the third party was aware that the act exceeded these objects or that could not have known it in view of the circumstances, the simple publication of the memorandum and articles of association being excluded from constituting this proof.

Provisions in the memorandum and articles of association and decisions of the board of directors limiting the powers of the managers resulting from this article shall not be demurrable with respect to third parties”.

The same idea is behind the rule which forbids a member of the management to benefit from the credit of the company, for the very reason that he controls in practice the use of such credit. The same goes for the regulation of the acquisition by a company of goods belonging to a shareholder and of the approval of a contribution in kind. Such provisions which aim at preventing conflicts of interest provide for an implicit obligation of loyalty which should require the relevant person to abstain from voting on the transaction in question.

³⁷⁸ Section 185 (1) and (2).

shares and mentioned that in the notice, [would not] [...] have to give notice if he increased his holdings even if that gave him a controlling interest³⁷⁹.

The English law regime appears to offer less protection than articles L. 225-38 and L. 225-40 of the French Commercial Code with respect to the effective avoidance of transactions that unduly advantages a director or harms the company, since it does not submit the transactions to the vote of the shareholders. Section 182 (2) provides for disclosure to the board of directors only, which corresponds to the first stage of the French procedure³⁸⁰. Consequently, it is to be feared that without a consultation of those whose interests are at stake – *i.e.*, the shareholders since the company is a party to the transaction – the goal of the procedure will be jeopardised. One English case dated 1996 illustrates the inability of this procedure to provide efficient protection for the shareholders: in *Neptune Ltd. v. Fitzgerald*, it was held that the meeting of the board of directors called to make a decision on the transaction could consist of one single director, which in this case was the director involved in the transaction. This is unlike the situation that would occur in a French *EUURL* (a sole shareholder *SARL*) which is defined by article L. 223-19, para. 3³⁸¹. In *Neptune Ltd. V. Fitzgerald*, this “declaration to oneself” was made in a company made up of several shareholders who were consequently left at the mercy of the director’s opportunism.

However, French law took a step back regarding the amount of information disclosed when articles L. 225-37 and L. 225-68, relating to the report on internal supervision presented to shareholders by the chairman of the board, were modified pursuant to the law of 26 July 2005. These articles now state that this report must be filed in public companies only.

The interest of the company, and therefore that of the shareholders, can also be contradicted and corporate wealth diverted on the occasion of the use of corporate property, opportunity or information, or if the agents compete against the company.

2.3 Conflicts of interest when using corporate opportunities or assets

2.3.a. Transactions involving a company’s property, information or opportunity

One category of transaction is subject to shareholder approval under English corporate law: transactions involving the company’s property, information or opportunity. The applicable regime is set out by the 2006 Companies Act³⁸². A fiduciary obligation must be added in this regard, which results from the general equitable principle and which we will examine below. It prescribes in a very general way that

³⁷⁹ Davies P. L., *Gower’s Principles of Modern Company Law*, op. cit., p. 629.

³⁸⁰ Art. L. 225-38, para. 1: “...prior authorisation of the board”.

³⁸¹ “By derogation to the provisions of subparagraph one, if a company enters into an agreement with its sole member, this shall simply be entered in the register of decisions”. See also Art. 42-2, al. 2, D. 1967.

³⁸² Sections 190-196, Companies Act 2006.

the director must refrain from benefiting from any corporate property, information or opportunity without the informed consent of the company. Under Section 191 (1) to (5) of the 2006 Companies Act, corporate property transactions are deemed substantial when their value exceeds GBP 100,000 or is over GBP 2,000 and represents more than 10% of the company's net assets. These transactions must be submitted to the shareholders for approval. The equivalent provision in French law is set out at article L. 225-101 of the French Commercial Code (*Code de commerce*)³⁸³, which makes any acquisition by a company, within the first two years following its incorporation, of property belonging to a shareholder subject to monitoring procedures³⁸⁴ and to a vote by the shareholders (the scope of protection offered is therefore wider than under English law) when its value exceeds 10% of the share capital³⁸⁵. After this two-year period, the shareholders' protection results from the procedures set out by the aforementioned article L. 225-38. The sanction of the violation of the requirement to consult the shareholders is identical under section 195 (2) and article L. 225-101: the acquisition is voidable³⁸⁶. One shortcoming of the procedure under English law, specific to unlisted companies, must however be noted: directors are not prevented from voting at the board meeting making a decision on the transaction in which they are involved. The abstention, required by French law in similar circumstances³⁸⁷, which makes an efficient contribution to the prevention of conflicts of interest, is limited in English law to listed companies³⁸⁸. However, it is in companies comprising a few shareholders only that the abstention from voting of the person involved is in practice the most necessary.

The monitoring by shareholders of the exercise of power within the company under English law therefore results from statutory duties provided for in the Companies Act 2006 and from fiduciary duties originating in case law. The latter, which derive from the general equitable principle, include the duty owed by a director when using a corporate opportunity or information.

³⁸³ Art. L. 225-101: "Where, within two years of registration, a company acquires an asset belonging to a shareholder which is worth at least one-tenth of its share capital, a valuer shall be appointed by a Court order to value the asset in question on his own liability, on an application by the chairman of the board of directors or the management, as the case may be. The appointment of the said valuer shall be subject to the incompatibility rules set out in Art. L. 225-224.

The valuer's report shall be made available to the shareholders. The routine shareholders' meeting shall rule on the valuation of the asset, failing which the acquisition shall be void. The seller shall not have the right to vote either on its own behalf or as a representative.

The provisions of this Article shall not apply where the acquisition is effected on the Stock Exchange, under the supervision of a judicial authority or in connection with the company's ordinary business, concluded on normal terms and conditions".

³⁸⁴ The monitoring procedure is the same as that applicable to contributions in kind provided for under Art. L. 80.

³⁸⁵ See also, Art. 148-1, D. 1967.

³⁸⁶ Art. L. 225-101, para. 2: "The ordinary shareholders' meeting shall rule on the valuation of the asset, failing which the acquisition shall be void". However, if Art. L. 225-38 was to apply, and if the transaction was not submitted to the shareholders meeting, the transaction would not be voidable except for the case of a fraud. See, Paris, 26 June 1990, Rev. soc., 1991, p. 137, Y.G.

³⁸⁷ Art. L. 225-40: "The interested party must inform the board immediately upon becoming aware of an agreement to which Art. L. 225-38 applies. They may not participate in the vote on the requested prior approval of the Board. The chairman of the board of directors shall advise the auditors of all agreements authorised and shall submit them to the general meeting for approval.

The auditors shall present a special report on the agreements to the meeting, which shall rule on this report.

The interested party may not participate in the vote and their shares shall not be taken into account for the calculation of the quorum and the majority". and L 225-101, para. 2.

³⁸⁸ Listing Rules, para. 11.5 (a).

A decision illustrative of this specific duty is *Regal (Hastings) Ltd v. Gulliver*³⁸⁹ rendered by the House of Lords. Pursuant to the facts of this case, the directors of a company had breached their fiduciary obligation because "(i) what the directors did was so related to the affairs of the company that it can properly be said to have been done in the course of their management and in utilisation of their opportunities and special knowledge as directors; and (ii) (...) what they did resulted in a profit to themselves"³⁹⁰. English case law later specified what the general equitable principle implies with respect to the use of corporate information or opportunity. The question is: can a director personally invest in an idea that the board of directors, on behalf of the company, has decided not to use? The answer will certainly be yes if, while refusing the opportunity for itself, the company, through a shareholders' resolution, expressly authorised a director to make use of it³⁹¹. Such an authorisation has sometimes been given by the board to one of its members and it was legitimately criticised³⁹². An *ex post* ratification by shareholders having all necessary information and assembled in shareholders' meeting could compensate for this procedural shortcoming.

Finally, a precision is needed as to the determination of the nature of corporate opportunities or information whose personal use triggers a monitoring procedure. In order to do so, it is necessary to consider what comes to the knowledge of a director within his functions. Prof. Paul Davies thus recommends that corporate opportunities which are to be used personally and which require the approval of the shareholders should be not only the opportunities actively pursued by the company but all opportunities falling within the scope of activity of a director³⁹³. In this regard, American law refers to the notion of 'line of business' whose generality makes it possible to trigger a shareholder vote each time a director wishes to use information obtained in the context of the exercise of his duties in the company for his personal interest. The scope of monitoring is thus extended beyond the sole opportunities that the company said it wanted to use. In French law, subject to subsequent developments in the relevant case law, the prevention of conflicts of interest of this nature with regard to the use of corporate opportunities or information would be part of the loyalty duty regime provided by the 24 February 1998 decision which established a general, non-compete obligation owing to the company.

2.3.b. Credit transactions with the company

As part of the comparison of the fiduciary duties, in the agency-related sense, owed by agents under English and French law, the statutory obligation prohibiting directors from entering into credit

³⁸⁹ (1942) 1 All E.R. 378; (1967) 2 A.C. 134n., cited in Davies P. L., *Gower's Principles of Modern Company Law*, op. cit., p. 616.

³⁹⁰ Per Lord MacMillan at [1967] A.C. 153

³⁹¹ *New Zealand Netherlands Society v. Kuys* (1973) 1 W.L.R. 1127, P.C., cited in Davies P. L., *Gower's Principles of Modern Company Law*, op. cit., p. 620. In this decision, the authorisation had been granted to a corporate officer who was not a director.

³⁹² See the decision of the Privy Council, *Queensland Mines Ltd v. Hudson*, (1978) 52 A.L.J.R. 379, P.C., cited in Davies P. L., op. cit., p. 620.

³⁹³ See Davies P. L., op. cit., p. 621.

transactions with the company must be mentioned. English law deals with this prohibition in sections 197 to 214 of the 2006 Companies Act. French law provides for a protection system with similar effects under articles L. 225-43³⁹⁴ and L. 242-6, 3° of the Commercial Code (*Code de commerce*). The principle is identical since article L. 225-43 and sections 197 and 198 provide for a sanction when a loan is granted by the company to a director³⁹⁵ as well as when a security interest in connection with a loan is granted to a director. It must be noted that under English law, this principle is extended to quasi-loans granted by a company, which forms part of a group including a listed company³⁹⁶. Certain sub-sections of the 2006 Companies Act also extend the scope of the prohibition on credit transactions. This objective is reached under French law through the use of the words “loans from the company irrespective of their form” in article L. 225-43, para. 1. Under English law, the persons concerned by this statutory obligation are the directors, as well as the shadow directors, which could make it possible to prevent some transactions between a controlling shareholder and the company, depending on the involvement of such shareholder with the management. Under French law, the prohibition is extended to include managing directors (*directeurs généraux*) and the representatives of legal entities acting as directors³⁹⁷.

In addition, the protection of minority shareholders resulting from the prohibition on credit transactions is made more efficient under English law with the obligation to obtain prior authorisation from the shareholders meeting for any expenses incurred by the directors on behalf of the company. If authorization is not granted, the funds must be reimbursed by the director within six months following the shareholders meeting³⁹⁸. In any event, the amount of the funds allocated to the directors’ expenses on behalf of the company is capped at GBP 200,000³⁹⁹. No equivalent monitoring mechanism exists under French law where the shareholders have, for instance, no means of monitoring indirect remuneration, such as advantages in kind⁴⁰⁰. A means of controlling indirect remuneration does exist thanks to the criminal sanction applicable to the misappropriation of corporate assets and funds, however the extreme seriousness of this sanction may entail excessive consequences. French law also provides for the

³⁹⁴ Art. L. 225-43: “In order for the contract to be valid, directors other than legal personalities shall be prohibited from contracting loans from the company irrespective of their form, from arranging for it to grant them a loan account or other borrowing whatsoever, or to arrange for the company to stand surety for them or act as their guarantor in respect of their obligations to third parties.

However, if the company operates a banking or financial establishment, this prohibition shall not apply to current commercial transactions entered into under normal conditions.

The same prohibition shall apply to the general manager, to assistant general managers and to permanent representatives of directors, which are legal personalities. It shall also apply to the spouse and relatives in the ascending and descending line of the persons referred to in this article, as well as to any intermediary.

The prohibition shall not apply to loans granted to directors elected by the employees by the company in application of the provisions of Art. L. 313-1 of the construction and dwelling place code”.

³⁹⁵ Or to a director of a holding company in English law, and “to any to any intermediary” (“*toute personne interposée*”) (Art. L. 225-43, al. 3).

³⁹⁶ Section 200 (1).

³⁹⁷ Art. L. 225-43, para. 3.

³⁹⁸ Section 204.

³⁹⁹ Section 204 (2).

⁴⁰⁰ French law provides that the board may authorise the reimbursement of travel expenses incurred by directors on behalf of the company (Art. 93 para. 2, D. 23 March 1967), but the efficiency of the protection against conflicts of interest may be in doubt as the task of monitoring a director’s behaviour falls to his peers.

monitoring of exceptional remuneration paid to directors⁴⁰¹, resulting from such transactions being subject to the procedures described by article L. 225-38 referred to above. Finally, English and French law converges on the transactions to be excluded from the scope of monitoring. These are, under English law, small and short-term loans which would be included under French law in the category of “ordinary operations concluded in normal conditions”⁴⁰². Intra-group transactions, even though they constitute a risk of transfer of corporate wealth outside of the control of the minority shareholders, are an exception to the prohibition. Under section 333, these transactions are not subject to any control. This is different under French law as, although intra-group transactions are outside of the scope of the prohibition, they are nonetheless submitted to the approval procedure described by article L. 225-38.

2.3.c. Competing with the company

Fiduciary duties owed by agents also enable the sanctioning of acts of competition adverse to the company since these acts may result from the use of the power drawn from an agency relationship. The obligation not to compete with the company was introduced in French law by a court decision dated 24 February 1998⁴⁰³, which was confirmed by a judgment dated 12 February 2002⁴⁰⁴. The 1998 decision stresses the fact that the obligations are owed by executive officers to the company. The facts of this case were as follows: a corporate officer had set up a company, soon after resigning⁴⁰⁵ from his position as chief executive officer, which was competing with his former employer. According to the court, his position as chief executive officer entailed that “he was bound by an obligation of loyalty owed to the company”⁴⁰⁶. It is as the agent of the company and not as a party to an employment contract, which he might have contracted as an employee, or as an agent of the shareholders that the court found him to be bound by such an obligation. The recognition of this obligation was facilitated by the fact that the

⁴⁰¹ Art. L. 225-46: “The board of directors may grant exceptional remunerations for missions or mandates conferred upon directors. In such cases, these remunerations shall be charged to operating expenses and subject to the provisions of Articles L. 225-38 to L. 225-42”.

⁴⁰² Art. L. 225-39: “The provisions of Art. 225-38 are not applicable to agreements relating to current operations entered into under normal terms and conditions.

Such agreements are nevertheless made known to the chairman of the board of directors by the interested party unless they are of no significance to any party, given their objective or their financial implications. A list of such agreements and their objectives is sent to the members of the board of directors and to the auditors by the chairman”. English law uses a comparable expression in section 207 (3)(a): “in the ordinary course of the company’s business” and at arm’s length.

⁴⁰³ Cass. com., 24 Feb. 1998: Bull. Joly, 1998, p. 813, para. 266, note Petit B.; Rev. sociétés, 1998, p. 546, note Coquelet M. L.; D. affaires, 1998, p. 850; Quot. jur., 19 May 1998, p. 4; JCP, 1998, ed. E, no 17, p. 637; See also an earlier case withholding the sanction of a former manager (*gérant*) for violation of his loyalty duty because he had launched a competing business while managing his company: Cass. com., 7 June 1994: Rev. sociétés, 1995, p. 275, note Vatinet R.; Bull. Joly, 1994, p. 1232, para. 336, note Saintourens B.

⁴⁰⁴ See Cass. com., 12 February 2002, Rev. sociétés 2002, 617, note Saintourens B.

⁴⁰⁵ The principle laid down under the 24 February 1998 decision of *Cour de cassation* provides that directors have an obligation not to compete against the company after they have quit. In the same way, under English law, a director will remain compelled not to use any private information obtained while exercising his functions (See for instance, *Industrial Development Consultants Ltd v. Cooley* (1972) 1 W.L.R. 443).

⁴⁰⁶ “Il découlait qu’il était tenu à une obligation de loyauté à l’égard de cette entreprise”, Cass. com., 24 Feb. 1998, D. Aff., 14 May 1998, no. 117, p. 850, note M.B. See also, Godon L., L’Obligation de Non-Concurrence des Dirigeants Sociaux, Bull. Joly. Soc., Jan. 1999, p. 5.

employees of the former company, hired in the new firm, had been released by the chief executive officer from their promise not to compete against the company.

A difference with the specific situation when shareholders deal with the controlling shareholders or the directors or executive officers on the basis of inside information is that the non-compete obligation is owed to the company and not to the shareholders individually. Also, it was held in the 24 February 1998 French decision that the non-compete obligation continues to be owed by the director/executive officer even after his departure from the company⁴⁰⁷. This somewhat extensive interpretation of the obligation can be explained by the fact that the obligation rests on the power exercised by the relevant person and not on his status⁴⁰⁸. For instance, in the 24 February 1998 decision, the chief executive officer had used his power to release the employees from their obligation not to compete against the company.

Unlike French law, the seminal case under English law on directors competing with their company states that there is no fiduciary duty preventing them from competing with their company⁴⁰⁹. This is the case, even though English partnership law, which inspires the regime of fiduciary obligations in English joint-stock companies, provides for a non-compete duty. On the contrary, the general principle for joint-stock companies laid down in *London and Mashonaland Exploration CO Ltd v. New Mashonaland Exploration Ltd*, provides that a director has the right to directly engage in a competing business or to be a director in a competing company. Sedley LJJ held in *Plus Group Ltd v. Pyke* on the contrary that the director owed a non-compete duty to his company except when he had been excluded from the management of the company⁴¹⁰. This position is comparable with a French court decision rendered by the commercial section of the *Cour de cassation*, which held that a shareholder in a *SARL*⁴¹¹ was not bound by a non-compete obligation in so far as he exercised "neither management functions nor any remunerated work"⁴¹². It shows that this obligation, where it exists, is more fact-based than status-based.

⁴⁰⁷ However, the establishment of this abstention duty after the officer leaves the company is not new. See, Com. 7 May 1980, Bull. civ. IV, no. 179, cited in M.B. note on Cass. com., 24 Feb. 1998, D. Aff., 14 May 1998, no. 117, p. 851.

⁴⁰⁸ In the same way, provisions dealing with the misappropriation of corporate goods and funds and with abusive use of votes (Art. L. 242-6 of the French Commercial Code) are illustrations of the fact that the obligation of loyalty, which is underlying, lies with whoever exercises power.

⁴⁰⁹ *London & Mashonaland Exploration Co. v. New Mashonaland Exploration Co.* (1891) W.N. 165.

⁴¹⁰ *Plus Group Ltd v. Pyke* (2002) 2 B.C.L.C. 201, CA.

⁴¹¹ For a comparative and historical approach to the SARL and equivalent private limited liability company types in Germany, the UK and the US, see Guinnane T., Harris R., Lamoreaux N., Rosenthal J.-L. "Ownership and Control in the Entrepreneurial Firm: An International History of Private Limited Companies", Center Discussion Paper n° 959, Economic Growth Center, Yale University, December 2007.

⁴¹² "...d'un arrêt relativement ancien rendu par la Chambre commerciale de la Cour de cassation qui a permis d'affirmer que le simple porteur de parts d'une SARL n'était pas tenu à une telle obligation dans la mesure où il n'exerçait "aucune fonction de gérance ni d'emploi salarié", Godon L., L'Obligation de Non-Concurrence des Dirigeants Sociaux, Bull. Joly. Soc., January 1999, p. 5. The case mentioned dates back to 11 February 1964, Bull. civ. III, no. 67.

Despite its being authoritative thanks to its regular application⁴¹³, the principle of *Mashonaland* does not seem consistent with the fiduciary duties of the persons in power in the company to avoid all conflicts between their duties to the company and their personal interests or duties to a third party.

Chitty J's justification in *Mashonaland* was that there was no contractual provision in the articles of association of the company providing for a non-compete duty. This seems to be too formal a line of reasoning because the duties of loyalty and good faith are attached to directors by analogy with their trustee-like duties. Another criticism can be made of the principle that directors may compete with the company: in terms of the agency cost that fiduciary duties aim to reduce, this principle amounts to placing the burden of the proof that directors do not misuse company assets on the company. As the costs resulting from compliance with a rule are best left to the party for whom such costs are the lowest, and given the asymmetry of information between the director and his principal, *i.e.* the company, it would seem that the director is better placed to know when his interest prevails over that of the company. Consequently, it would make more sense in this regard for the principle to be one of prohibition rather than one of vigilance on the part of the company⁴¹⁴.

The situation under English law should not however be exaggerated since there exists a principle of prohibition of the diversion of corporate opportunities. A standard case of breach of fiduciary duty under English law is where a director resigns, goes off and founds a competing company but, before or after he goes, takes steps to ensure that business opportunities which belonged to his previous company are diverted to the new company⁴¹⁵.

Under English law, competition against a company by its own shareholders may give rise to a sell-out right based on section 979 of the 2006 Companies Act for unfair prejudice and this frequently results in a judge granting the plaintiff a right to be bought out. This action makes it possible for a shareholder to go to court when the strategy carried out in his company is affected by the controlling shareholder's interest in a competing company. For example, a majority shareholder could divert the business to another company in which he also has an interest⁴¹⁶. The scope of section 994 is wide enough⁴¹⁷ to compensate for the absence of a directors' obligation not to compete unfairly, deriving from the duty of loyalty.

We have seen how English law, mainly with the general equitable principle, and French law, with the newly discovered duty of loyalty and various statutory provisions, deal with personal interests of

⁴¹³ See for example, *Mordecai v. Mordecai* (1988) 12 N.S.W.L.R 58 and *Berlei Hestia (NZ) Ltd v. Fernyhough* (1980) N.Z.L.R 150.

⁴¹⁴ See Grantham R., *Can Directors Compete with the Company?* Modern Law Review, vol. 66, 109.

⁴¹⁵ See for example *CMS Dolphin Ltd v. Simonet* [2001] 2 BCLC 704.

⁴¹⁶ See for example, *Cook v. Deeks* (1916) 1 A.C. 553, P.C. and *Re Stewarts (Brixton) Ltd* (1985) BCLC 4, cited in Davies P. L., *op. cit.*, p. 646 and 738.

⁴¹⁷ "...the sections are drafted so as to protect the interests of the members and not just their rights", Davies P. L., *Gower's Principles of Modern Company Law*, *op. cit.*, p. 736.

agents, or duties to other persons, which conflict with their duties to the company and sometimes to the shareholders. Shareholders as principals can also be protected from the diversion of corporate wealth by obliging their agents to act in good faith in the best interests of the company, not to exercise their power for purposes other than that for which they were conferred, and finally not to fetter their discretion as to how they shall act. Also, we will consider briefly the duty of care of common law and the comparable statutory provisions under French law because corporate earnings and assets can be affected by a breach of the duty of care. Indeed, as Profs. Easterbrook and Fischel note: “what is the difference between working less hard than promised at a given level of compensation (a breach of the duty of care) and being compensated more than promised at a given level of work (a breach of the duty of loyalty)?”⁴¹⁸.

2.4 Other fiduciary duties reducing agency costs

2.4.a. Acting in good faith

Another way in which controlling shareholders and directors can be prevented from diverting corporate wealth is by imposing an obligation of good faith on them. The director’s individual obligation of good faith, the first consequence of the general equitable principle, is owed under English case law to the company and not to the shareholders⁴¹⁹. Pursuant to a case we have already come across, directors are required to act in a *bona fide* manner in what they consider to be the interest of the company. The reference to the notion of the interest of the company will make the implementation of the duty harder for the shareholders both in terms of proof and regarding the right of action. As always with this reference, it raises the question of the definition of the company’s goal, a subject we already dealt with as part of the shareholder/stakeholder debate. Pursuant to court decisions, it is the director’s role to answer this question. The fact that this fiduciary obligation is owed to the company is not consistent if the fiduciary obligation is to be an attribute of the facts-based agency relationship between directors and shareholders. Moreover, and it is also at odds with this underlying basis, the English statute adds to the pursuit of the company’s interest, the necessary pursuit of the employees’ interest⁴²⁰. This confuses the foundation and the implementation of the fiduciary obligation. Indeed, even though the statute provides that the powers of the directors must be exercised in the interests of employees, the latter have not been granted the legal means to have their interests enforced⁴²¹. In short, the result of this lack of coherence between the rationale for the duty, *i.e.* the agency relationship between managers and shareholders, and the beneficiaries of this duty, “is to dilute directors’ accountability to shareholders rather than to strengthen

⁴¹⁸ Easterbrook F. H. and Fischel D. H., *op. cit.*, p. 103.

⁴¹⁹ See *Percival v. Wright* (1902) 2 Ch. 421.

⁴²⁰ See Section 172, Companies Act 2006. The shareholders’ interest is nevertheless mentioned: “the interests of the company’s employees in general, as well as the interests of its members”.

⁴²¹ See Section 175 (5) and (6), Companies Act 2006 which mentions, in the developments relating to the implementation of the duties, those pursued in the interest of the company only.

their accountability to employees⁴²². The freedom given to directors to define the interests in the name of which they owe their obligations - including consequently the determination of what constitutes the interest of the shareholders - contradicts the acknowledgment of shareholders-directors agency issues that the fiduciary obligations are meant to mitigate. It also seems odd that the determination of the interests to be protected by the obligation be left to the person subject to such obligation. The enforcement of such an obligation could therefore be less efficient because the proof of its violation will require the demonstration of how the director comprehended the interest of the company⁴²³.

2.4.b. Exercising power for a proper purpose

Under English law, a more objective measure of fiduciary obligations of directors results from their obligation to exercise their powers for a proper purpose. We are concerned here with the factual situation, for instance where controlling shareholders who are also directors vote against a resolution in general assembly to launch litigation concerning a breach of fiduciary duties by these same directors. In such circumstances, the controlling shareholders may be acting in bad faith or for an improper purpose.

This obligation must be distinguished in English law from the one that prescribes compliance with the memorandum and articles of association⁴²⁴, which is mirrored under French law by article L. 225-251, para. 1, of the French Commercial Code (*Code de commerce*) which makes directors liable for violations of the articles of association. The 'proper purpose' requirement prevents directors from exercising their powers for any purpose other than that for which they were laid down. The legal position on this issue was established with regard to the power of directors to issue new shares⁴²⁵. In *Howard Smith Ltd v. Ampol Ltd*, the judges ruled that the use of the power to issue new shares in order to dilute the share interest of a majority shareholder who was in a position to harm a new shareholder was improper. The same strategy could be implemented under French law on the basis of the power granted to the extraordinary shareholders' meeting to authorize the board of directors⁴²⁶ or the chairman⁴²⁷ to issue securities. This behaviour would be defined as an abuse of power by article L. 242-6, 4° of the

⁴²² Davies P. L. op. cit., p. 603.

⁴²³ For an assessment of the reference to the interest of the employees, as part of the larger notion of corporate interest, under French law, see the developments supra on the determination of the corporate interest.

⁴²⁴ Section 40 (5), Companies Act 2006; see under French law a similar provision, Art. L. 225-251, al. 1: "The directors and the managing director shall be individually or jointly and severally liable to the company or third parties (...) for breaches of the memorandum and articles of association (...)".

⁴²⁵ (1974) A.C. 821.

⁴²⁶ Art. L. 225-129-1 as amended by Art. 5, ordonnance no. 2004-604 of 24 June 2004: "When the extraordinary general meeting decides to effect a capital increase, it may delegate the power to determine the terms and conditions of the issue of securities to the board of directors or the executive board".

⁴²⁷ In listed companies only. See Art. L. 225-129-4 as amended by Art. 5, ordonnance no. 2004-604 of 24 June 2004: "In limited companies whose securities are admitted to trading on a regulated market:

a) The board of directors may, within limits which it has previously set, delegate to the general manager or, with his agreement, to one or more delegated general managers, the power to decide to proceed with the issue, or to postpone it;

b) The executive board may delegate to its chairman or, with his agreement, to one of its members, the power to decide to proceed with the issue, or to postpone it.

The designated persons report to the board of directors or the executive board on the use made of that power in the manner stipulated by the latter".

Commercial Code. This criminal offence would affect the directors who use, pursuant to article L. 242-6, “the prerogatives which they possess or the votes which they have in this capacity, in bad faith, in a way which they know is contrary to the interests of the company”⁴²⁸. The reference to this latter criterion is not found so clearly in English law where the “proper purpose” depends on the extensive or restrictive drafting of the articles of association. The determination of this fiduciary obligation will therefore result from the scope of the directors’ prerogatives which are freely determined by contract. Particular importance is given here to the initial expectations of the shareholders in their capacity as authors of the articles of association, and of those who subsequently became members of the company, and thus implicitly endorsed the corporate contract. This reference to the initial expectations of the shareholders also plays a role in section 979 of the 2006 Companies Act, whose spirit is close to this fiduciary duty and which gives a right to sell out when the legitimate expectations of shareholders have been breached. Again, it confirms the idea that the protection of shareholders is efficient only when the parties concerned are considered, in concrete terms, through their expectations, interests and power relationships.

2.4.c. Protecting freedom of action

The third rule, resulting from the general equitable principle, makes directors subject to an obligation not to fetter their future discretion. This is a protection against strategies aimed at freezing the allocation of power. Any agreement between directors or between a director and a third party to determine how to vote at board meetings or how to use their powers is thus prohibited. This is coherent with their mission, which is to represent the shareholders as a whole and not only the shareholders responsible for their election. In France, the case law applicable to captive directors follows the interpretation applicable to voting agreements between shareholders. Any agreement between two directors whose purpose is the appointment of one of them to the position of chairman is therefore invalid because it amounts to preventing one of the two from sitting again during the following period⁴²⁹. This would indeed be a blow to both the *ad nutum* dismissal of directors, which would be contrary to the interest of the shareholders, and to the voting freedom of the directors. These requirements are identical to those provided for by case law concerning shareholders agreements. Between shareholders, indeed, the validity of voting agreements depends on (i) the consequences on the freedom of vote in shareholders meetings and (ii) the impact on the interests of the company. Another way, under French law, to provide for an obligation not to fetter one’s future discretion, which would contradict the broad

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Art. L. 242-6: “The following shall be punished by a prison sentence of five years and a fine of € 375,000: (...)

3° If the chairman, directors or managing directors of a S.A. use the company’s property or credit, in bad faith, in a way which they know is contrary to the interests of the company, for personal purposes or to encourage another company or undertaking in which they are directly or indirectly involved;

4° If the chairman, directors or managing directors of a S.A. use the powers which they possess or the votes which they have in this capacity, in bad faith, in a way which they know is contrary to the interests of the company, for personal purposes or to encourage another company or undertaking in which they are directly or indirectly involved”.

⁴²⁹ Com. 8 May 1963, JCP 1963, II, 13282, note J.R.

mandate given to the board to “manage by its resolutions the affairs of the company”⁴³⁰, may be to have recourse to the criminal sanctions provided for in case of abuse of powers and votes⁴³¹.

2.4.d. Acting with care

The diversion of corporate wealth can also be associated with a breach of the duty of care. This specific duty has developed differently from the duty of loyalty under the umbrella of the general equitable principle. It seems that judges scrutinise good faith more closely than the degree of care taken by directors when carrying out their tasks. It is certainly a consequence of the business judgement rule, pursuant to which the judge will abstain from criticising a board resolution when it was given sufficient consideration. Moreover, it seems easier for a judge to determine the existence of a conflict of interests breaching the duty of loyalty than to assess the relevance of a corporate officer’s business decision. This is because the judicial costs of detecting disloyalty are lower than the costs of monitoring the negligence of the officer, as well as, consequently, the cost of potential errors made by judges⁴³². However, the difference between the duty of loyalty and the duty of care must be mitigated since both have in common the fact that they constitute agency costs burdening the wealth of the shareholders as a group. Even if it is sometimes difficult to distinguish both types of duties with respect to the consequences of their respective breaches, the structure of the shareholding makes the occurrence of one or the other more likely. It can be argued that in private companies, where the capital is held by a limited number of shareholders, the interest of the manager, who is likely to hold a significant part of the share capital, will therefore, as a shareholder, be to run the company with care. On the other hand, the size of his shareholding and the extent of his management powers generate a rational incentive to behave opportunistically towards the other shareholders and therefore to breach his duty of loyalty and let his personal interests prevail.

The difference between the two types of duties remains when it comes to the identification and sanction of any breach. The market is more suited to scrutinising the degree of care and, as has been said, it is easier for a judge to identify disloyal behaviours. Concerning the sanctioning of breaches, tort law is more dissuasive with regard to conflicts of interest than the market-generated pressure aimed at obtaining the resignation of the corporate officer. Directors’ civil liability could also be used to sanction any breach of a duty of care. Under French law, the use of article L. 225-251 of the French Commercial Code (*Code de commerce*)⁴³³ could make it possible to sanction a breach of an implicit duty of care within companies which are not subject to market pressures, *i.e.* private companies. It would then be necessary

⁴³⁰ Art. L. 225-35, Commercial Code.

⁴³¹ Art. L. 242-6, 4: “The following shall be punishable by a prison sentence of five years and a fine of € 375,000: (...) 4° If the chairman, directors or managing directors of an S.A. use the powers which they possess or the votes which they have in this capacity, in bad faith, in a way which they know to be contrary to the interests of the company, for personal purposes or to encourage another company or undertaking in which they are directly or indirectly involved”.

⁴³² See Easterbrook F. H. and Fischel D. H. (1991) *op. cit.*, p. 103.

⁴³³ This article deals with the liability of directors in case of mismanagement or breach of the law. See above.

to set as a standard that the failure by a director to act conscientiously and carefully⁴³⁴ constitutes an act of mismanagement. In that case, article L. 651-2 of the Commercial Code⁴³⁵ - which triggers, in case of mismanagement, the liability of *de jure* and *de facto* directors in the event of there being insufficient funds at the time of the winding-up of the company – could also be a way to enforce the duty of care. Such an implicit duty seems already to have been enforced in some cases brought before the *Cour de cassation*. In one such case, a director was found liable because he had failed to carry out the effective supervision of his management⁴³⁶. In the same way, pursuant to a decision rendered by the Paris Court of Appeal, “the wrongful abstention of directors had contributed to the occurrence of the damage suffered by the company”⁴³⁷. This is coherent with the purpose of the mandate given to the directors by the shareholders, which includes the duty to monitor those in charge of the collective corporate wealth.

French law is therefore moving towards an objective definition of the duty of care. The same is also true of English law, which bases the duty of care⁴³⁸ on an objective criterion defined in the Insolvency Act of 1986⁴³⁹. The control of the use of the director’s prerogatives is based on the example of “a reasonably diligent person having both (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company and (b) the general knowledge, skill and experience that that director has”⁴⁴⁰. However, this objective duty is comprehended *in concreto* by the courts. As a consequence, the sanctioning of any breach will vary depending on whether the person involved is an executive or non-executive director and depending on the size of the company. Unfortunately, the latter may imply that fewer demands are made of directors of private companies than those of public companies in this regard, although the basis of their duties is the same and the stakes are as important.

We have based our analysis in this chapter on the fact that fiduciary duties mitigate agency costs, which is particularly true of the fiduciary duties owed to individual shareholders. As the 27 February 1996

⁴³⁴ “affirmer que la faute de gestion est le fait de n’être pas un bon administrateur, consciencieux et diligent”, Germain M., L’Intérêt Commun des Actionnaires, in *Où se Situera Demain le Pouvoir dans les Sociétés Cotées?* Cahiers de Droit de l’Entreprise, April 1996, p. 15.

⁴³⁵ Art. L. 651-2: “Where it appears during the course of an administrative order or winding-up proceedings of a legal person that there are insufficient assets, the court may decide, if management errors have contributed to this lack of assets, that all or some of the debts of the legal person shall be borne, with or without joint and several liability, by all or some of its paid or unpaid *de jure* or *de facto* directors.

Proceedings shall be statute barred three years after the judgment setting out the recovery plan or, where there is none, the judgment ordering winding-up.

The amounts paid by the directors in application of the first sub-paragraph shall be included in the debtor’s estate. These amounts shall be divided between all the creditors on a *pro rata* basis”.

⁴³⁶ See Com. 25 March 1997, JCP, Ed. E, 1997, par. 531.

⁴³⁷ “...l’abstention fautive des administrateurs avait participé à la réalisation du préjudice subi par la société”, Paris, 4 Feb. 1994, Bull. Joly, Apr. 1994, 121.

⁴³⁸ *Norman v. Theodore Goddard* (1991) BCLC 1027 and *Re D’Jan of London Ltd* (1994) 1 BCLC 561.

⁴³⁹ See section 214 (4) as well as Davies P.L., *Gower’s Principles of Modern Company Law*, op. cit., p. 642.

⁴⁴⁰ Section 214 (4), Insolvency Act, 1986

decision of the French courts shows, fiduciary duties are owed to individual shareholders when the person exercising power deals with the shareholders' property in the company, *i.e.* their shares. However, most often, fiduciary duties are owed to the company and not to individual shareholders, as the breach of duty arises out of the misuse of corporate assets. Even though they are not owed to individual shareholders, provided such breaches of duty can be properly enforced, for example by a derivative action, minority shareholders are still protected by them because assets are kept within the company and not appropriated by the directors, acting either for themselves or on behalf of controlling shareholders.

The study, from a theoretical standpoint, of the fiduciary duties owed by directors and also by controlling shareholders, especially in private companies, due to the ownership structure of those companies, has showed their common basis in both public and private companies. The reference to agency theory has made it possible to demonstrate the essentially conflictual relationship of the interests within companies, which are inherent in their power structures. This is true even though the distribution of power resulting from the ownership structures differ in public and private companies. The power structure within public companies is usually characterised by a separation between ownership and control, which results from a widely dispersed shareholding structure and from the existence of professional managers exercising power although it has been seen that listed firms in Continental Europe can however be less open. The same pattern of separation between ownership and control is also characteristic of power in private companies, though this is less often stated, but obviously for reasons other than the dispersion of share capital ownership. This reason is, as we have seen when identifying the policy issues in Part 1, the mechanism that allows the firm to operate, *i.e.* the majority principle. This principle leads to a separation between ownership and control since all the corporate power is concentrated pursuant to majority decisions despite the existence of non-controlling shareholders. Obviously, for efficiency reasons, unanimity is not a desirable alternative in corporations however, in the absence of any effective transferability of shares, the operation of private companies resulting from this power organisation raises difficulties. The solutions require the balancing of information asymmetry on the one hand by providing better information to shareholders with respect to the organisation of power in their company⁴⁴¹, and the enforcement of fiduciary duties on the other hand. But this is not sufficient to counter the adverse effects of the majority principle. The radicality of the majority principle requires a radical response in the form of a sell-out right which, as we will see later, should be triggered when the corporate contract is breached, intentionally or inadvertently.

In conclusion, it should be noted that the expansion of the duties owed by persons holding power in the company, by status or *de facto*, is at least indirectly rooted in A. Berle and G. Means's observations on the separation between ownership and control in 1932⁴⁴², which has inspired much work in the field of

⁴⁴¹ See supra Part II, chapter 1.

⁴⁴² See Means A. A. and Means G. C., *The Modern Corporation and Private Property*, New York, Macmillan, 1932, with a revised edition in 1968.

corporate governance consisting essentially of the revival of a factual observation of microeconomics in order to turn this into a normative theory. Such corporate governance theories therefore constitute the implementation in law of the idea that the company is a combination of factual interests and, consequently, that the notion of power is central to any study focusing on its legal organisation. Under the influence of the globalisation of financial markets, reflections on this theme as well as certain related legal effects have begun spreading from U.S. listed companies to companies listed outside the U.S., regardless of the applicable legislation. On the basis of a common microeconomic analysis of unlisted and listed companies through the agency theory, the scope of corporate governance ideas should be extended not only geographically but also functionally to another type of company, *i.e.* the private company. The field of fiduciary duties is one example. The private company's power structure, which shares with the listed company the separation between ownership and control, would therefore benefit from the more advanced state of development of fiduciary duties in listed companies and the monitoring of the exercise of power thus provided. However, for the time being, over-arching fiduciary duties do not provide an adequate level of minority protection in private companies which therefore need to be supplemented by a sell-out right.

PART 3. WHY THE SELL-OUT RIGHT IS THE BEST REMEDY

CHAPTER 1 THE SELL-OUT RIGHT AND THE CONTRACTUAL NATURE OF THE COMPANY

A contractual, as opposed to an institutional, approach to the firm places the emphasis on the fact that the company is based on the voluntary participation of its members. In this regard, when for the minority the difference between the decision-making power, which is very limited, and the potentially major risks incurred, which is inherent in the majority voting procedure and yet necessary to the operation of the company, is such that it profoundly affects the circumstances which prevailed at the time of the initial investment, then this shareholder should be given the right to reconsider his investment decision and thus, subject to a court approval, have his shares bought out by the majority. Introducing such a mechanism, in effect compensating for the absence of an efficient market for the shares by means of a statutory provision, is consistent with a contractual approach to the company. Indeed, pursuant to the analysis of the company as a nexus of contracts, the function of company law is identical to the general function of contract law in other fields, *i.e.* the legislator ought “to provide interested parties with standard form contracts to save them trouble and money; to protect the parties against error and fraud; to ensure the definition of the public order; to prevent the contracts from harming third parties; [and] to protect the contractors in the event of substantial modifications to the information given and to the content of the initial pact”⁴⁴³. This underlines the fact that in an organisation based on the voluntary participation of its members, respect for the terms of the initial commitment is of primordial importance⁴⁴⁴.

The function described above cannot be left to market forces only (where such forces exist, *i.e.* in the listed company) as the shares of the minority would then be affected by a discount⁴⁴⁵. Introducing a statutory provision establishing a sell-out right partakes, together with the articles of association, the fiduciary standards and the duties of the shareholders, directors and managers, of a system considered to be optimal by the shareholders with respect to the level of risk accepted and the opportunities expected by them. These provisions of various origins constitute “the outlines of the relations between the corporate actors”⁴⁴⁶ which set up the framework of investment decisions. Since this framework does not make it possible to foresee all of the facts occurring during the running of a company, those norms have to be supplemented by the decisions of the management of the company and by the resolutions of the board of directors and the general shareholders’ meetings. The contractual nature of the statutory provisions included in the initial corporate pact is finally confirmed by the fact that, as with the other terms

⁴⁴³ Didier P. (1997) *op. cit.*, p. 241.

⁴⁴⁴ “On the other hand, even in contractual matters there is room enough for mandatory provisions like those protecting (...) the contractors themselves, when one of them avoids his obligations or when one of the parties intends to make modifications thereto”, (“*D’autre part, même en matière contractuelle, il y a place pour des dispositions impératives comme celles qui visent à protéger (...) les contractants eux-mêmes, quand l’un d’entre eux se dérobe à ses obligations ou que l’une des parties entend y apporter des modifications*”), Didier P., *La Théorie Contractualiste de la Société*, *Rev. sociétés*, (1), Janv.-mars. 2000, p. 99.

⁴⁴⁵ This is why mandatory public offers exist on the stock market.

⁴⁴⁶ Easterbrook F. H. and Fischel D. R. (1993) *op. cit.*, p. 195.

of the pact, how they are judged will be reflected in the price of the shares. It follows that a company which had not adopted a contractual arrangement considered to be efficient by the market would be at a competitive disadvantage when raising capital.

It results from the voluntary participation of shareholders, which gives the company its contractual nature, that any decision breaching the initial contractual arrangement cannot be forced unilaterally upon a party, unless this party is itself to renounce the initial pact. Compared with the other agreements entered into by the company with its employees or its creditors, the contract concluded between the shareholders and the company is specific in that "They [the shareholders] are the only voluntary constituency whose relation with the corporation does not come up for periodic renewal"⁴⁴⁷. In theory, the shareholders are indeed committed for the duration of the company (unless they find a purchaser for their shares, which is an uncertain prospect in private companies) and in the event of a winding-up of the company, they come in last in terms of financial rights. In the absence of any market for the shares, this theoretical description of the private company is barely attenuated in practice. It follows that the minority shareholders will not have very much encouragement to conduct the necessary monitoring of the agents, *i.e.* the majority shareholders and managers. Two structural constraints impede them: firstly, the majority principle which increases the power of the controlling shareholders, and secondly, prolonging the majority principle in that it also freezes the minority's action and completes the demonstration of the inefficiencies of the private company's corporate governance in terms of agency control mechanisms, the absence of a sell-out right which, subject to court approval, could indeed operate as a counterweight to the power resulting from the majority principle.

The study of the basis for a sell-out right in the private company shows that the monitoring costs of the agents imply expectations on the part of minority shareholders which, when disappointed (for instance following certain transactions or amendments to the articles of association), ought to give rise to a right to be bought out by the majority shareholders.

Shareholders depend on the actions of the agents, which are obviously unforeseeable but are also difficult to monitor or simply to know in time. However, the uncertainty inherent in the actions of agents is moderated when these agents are themselves shareholders. This is because they are supposed to act with a view to the achievement of the common interest of the shareholders, *i.e.* shareholder value maximisation, because they are under an obligation to do so pursuant to their fiduciary obligations or because required to do so by statute law as is the case in France⁴⁴⁸ and also because, in an ideal world, while pursuing their own personal interest they also supposedly pursue this common interest. However, the reality of business practices shows how naive this proposition can be: it is the

⁴⁴⁷ Williamson O. E., *Corporate Governance*, op. cit., p. 159.

⁴⁴⁸ See in French law, Art. 1833 of the French Civil Code (*Code civil*): "Every firm must have lawful objects and be formed in the common interest of the members".

interdependence of behaviour within the company which will trigger the supply of information to shareholders, as game theory shows. Now, not all existing information in the company is available. The shareholder is presented with the maximum amount of all existing information immediately before the beginning of the interaction between the members of the company, *i.e.* at the time of the initial investment, when the shareholder becomes a member of the company. In theory, this information is reflected in the purchase price of the shares. In accordance with the theory of rational anticipations, the expectations of the shareholder are thus based on this “ideal period” in terms of information, when he reviews the content of the articles of association and of all shareholder agreements mentioned therein and duly disclosed, and which, together with such articles of association, constitute the implicit corporate contract.

The hypothesis of the shareholder making anticipations on the basis of information given to him is particularly suited to the context of the stock market because this is a sector renowned for its efficiency in terms of data processing. Investors’ rational anticipations can therefore be used as justification for the mandatory public offer at the time of the transfer of control of a listed company. The underlying explanation is that the change of control contradicts the anticipations of the investor who bought shares in the company based on the fact that the company was controlled by certain particular shareholders. When the expectations at the origin of the investment decision fail to materialise, the investor is offered the right to be bought out, hence the mandatory public offer. In the private company where it is not desirable in practice to trigger a sell-out right after every transfer of control, it will therefore be the more general notion of breach of the implicit corporate contract which will give rise to the withdrawal of the shareholder for legitimate reasons, subject to court approval. So as not to give rise to minority opportunism, the majority shareholders should have the right to state their own legitimate reasons to oppose the buy out of the minority.

Basing the sell-out right for the benefit of minority shareholders in private companies on the deception of their rational anticipations with regard to certain transactions resulting in fundamental changes or intentional breaches of the corporate contract entails making reference to the notion of probability (x chances that this situation will materialise) and consequently to the notion of potentiality, which is inherent in reasoning based on the notion of power such as the agency theory. Similarly, a body of laws based on reasoning in terms of power, such as competition law, is full of references to the notion of potentiality. It is a consequence of the fact that often “the execution of the contract, normally virtually contained in its formation, seems to become simply potential”⁴⁴⁹. This potentiality makes the offer of an exit route to the minority shareholder all the more necessary because states of nature are themselves only potential and these shareholders are not in position to control their agents.

⁴⁴⁹ Frison-Roche M.-A., *L’immatériel à Travers la Virtualité*, in *Archives de Philosophie du Droit*, t. 43, *Le Droit et l’immatériel*, Sirey, 1999, p. 142. Potential, as opposed to virtual, means that the outcomes of an event are more open.

In addition, since on the occasion of the introduction of a statutory provision regarding a sell-out right, the relationship between the majority and the minority would be subjected to the scrutiny of the courts, then in accordance with the nature of the law, the potential adverse effects of this relationship could become virtual (rather than potential) once more, *i.e.* the majority would be encouraged not to diverge from a linear development of the implicit corporate contract which unites these parties. As a party to a relationship defined by legal boundaries, the controlling shareholder would be less likely to adopt behaviour diverging from that to which he committed himself vis-à-vis his fellow shareholders at the time of their association. This is therefore the aim of a sell-out right, which can operate as a threat. In addition, the reference to the notion of potentiality with regard to the triggering of the sell-out right will have another characteristic: it will make it possible for the minority shareholder to quit, for example on the occasion of a substantial alteration of the articles of association, even before its situation is objectively altered and the value of the shares affected, as a consequence of this material change. In the end, this will add dynamism to the market for shares in the private company.

Establishing a sell-out right as a sanction of either the intentional deception or the serious alteration of anticipated behaviour is to give importance to the notion of trust in the company. As we have seen, the progressive development of fiduciary obligations in case law illustrates this trend. With regard to the sell-out right, the trust placed by the minority shareholder in the controlling shareholder for the implementation of common objectives will be measured against the standard of the breach of the implicit corporate contract.

CHAPTER 2 WHAT IS A BREACH OF THE IMPLICIT CORPORATE CONTRACT?

The meaning of the breach of the implicit corporate contract, and therefore the notion underlying the events triggering a sell-out right in the private company, is to be found in regulations governing listed companies. In a common approach to both listed and unlisted companies in terms of the nexus of contracts, the corporate contract concluded in the private company is directly drawn from the implicit contract concluded between management, shareholders and the market in the listed company. One difference within the private company is that the parties involved in this contract are not management, shareholders and the market taken collectively as a group of potential shareholders, but only the majority shareholders and the minority shareholders. The respective legal rights and duties of these parties echo each other and are not dissimilar in both types of company, except when it comes to exit routes. The minority shareholder of the private company and the financial market contribute to the financing of companies, in return for which both are granted the right to a share in the profits, to monitor the use of power and finally a right to liquidity, subject to practical restrictions in the private company. As for the party exercising power, it accepts an obligation to respect the common anticipations of either the shareholders or the market, depending on whether the company is listed or not.

The events triggering the sell-out right applicable to listed companies (*offre publique de retrait*) under French law illustrate this idea of the breach of a pact, and could therefore form the logical foundation of a sell-out right in the private company. French law regards all events affecting the fundamentals of the allocation of power as decided at the time of the investment (including the transformation of a listed company into a *société en commandite par actions*, because the *gérant commandité* or manager cannot be dismissed), the significant alteration of the articles of association, or the absorption of the company by its parent as being breaches of the implicit corporate pact. These statutory provisions also refer to events affecting the fundamentals of the allocation of profits, such as the reorientation of the business or the removal of dividends.

It has been said that the implicit pact uniting the shareholders as well as pacts between the shareholders and corporate management can go through difficult periods during the lifetime of a company. Causes of friction are mainly related to the supply of information regarding the company and the consequences of the majority principle on decision making. The paroxysm of these risks affecting the efficiency of any type of company is reached in the private company when a shareholder, because of his majority and the absence of the effective transferability of the shares, is irremediably in power. In this case, this shareholder has no rational incentive to behave in the common interest of the community of shareholders. This state of affairs inevitably gives rise to various agency costs ascribable to both parties because there is no counterweight to the majority and because to a certain extent the minority has no choice.

In the private company, when the allocation of power is permanently frozen and tensions therefore develop between shareholders, minority shareholders can usually obtain the court-ordered dissolution of the company. However, this outcome is inadequate when the company is profitable⁴⁵⁰ when the courts will usually appoint a temporary receiver to keep the company afloat. The intervention of a third party in corporate affairs is usually a first step towards the enforcement of the minority's rights. To this end, French law provides that a management expert may be appointed by the courts following a request from the minority seeking the provision of information regarding certain suspect corporate actions⁴⁵¹. The resulting report can be used as a base for a legal action being taken against the

⁴⁵⁰ See under French law, Art. 1844-7 of the French Civil Code (*Code civil*): "A firm comes to an end:
1° By the expiry of the time for which it was formed, except for an extension of duration decided in accordance with Art. 1844-6;

2° By the achievement or the extinction of its objects;

3° By annulment of the firm agreement;

4° By anticipated dissolution decided by the members;

5° By anticipated dissolution ordered by the court on application of a member for just reasons, notably in case of non-performance of his obligations by a member, or of disagreement between members which paralyses the running of the firm;

6° By anticipated dissolution ordered by the court in the case provided for in Art. 1844-5;

7° "By the effect of a judgment ordering the winding-up" (Act no 88-15 of 5 Jan. 1988);

8° For any other reason specified in the memorandum or articles".

⁴⁵¹ See Art. 225-231, alinea 1: "*Une association répondant aux conditions fixées à l'article L. 225-120, ainsi que un ou plusieurs actionnaires représentant au moins 5% du capital social, soit individuellement, soit en se groupant sous quelque forme que ce soit, peuvent poser par écrit au président du conseil d'administration ou au directoire des questions sur une ou plusieurs*
(*cont'd*)

management. Except for the dissolution of the company, which is a brutal solution if the company is profitable, current remedies for the breach of duties by the management or the controlling shareholder imply that the minority shareholder of a private company remains within the company even though he is not happy with what he sees. These remedies are mainly the award of damages in court if harm can be proven and more generally the increasing of the financial liability of the shareholder at fault. In case of abuse of power by the majority, defined by French case law as an action “contrary to the general interest and with the purpose of favouring members of the majority to the detriment of the members of the minority only”⁴⁵², damages can be awarded and the disputed resolution may be annulled by the courts. All these remedies may satisfy a shareholder who wishes to keep his investment in the company because he believes that, despite some breaches of the common interest of the shareholders, his investment is still worthwhile. However this shareholder could think differently since life is seriously more complicated in a private company, due to its *intuitu personae* character once personal relationships between shareholders have been damaged. As things currently stand, in several legal systems in Continental Europe, and unlike the owner of listed shares, this shareholder is unable to exit the company under these circumstances.

As a device designed to alleviate the adverse effects of the majoritarian orientation of the law of corporations, why is the sell-out right better suited than other existing statutory relief?

The first alternative that comes to mind is the existence of the markets in the context of which companies operate. The most powerful ones are the market for shares and its correlate, the market for corporate control, but there are no such markets in the context of private companies, except for private companies under successive leverage buyout transactions. With such transactions, the prevention-of-opportunism function of the market for corporate control can be matched when private equity firms buy stakes in the share capital and thereby fulfil a function equivalent to the monitoring of this market. Another market-based device that is absent from the private company is the market for managers. Moreover, the manager-owned structure of most private companies contributes to the entrenchment of

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opérations de gestion de la société, ainsi que, le cas échéant, des sociétés qu'elle contrôle au sens de l'article L. 233-3. Dans ce dernier cas, la demande doit être appréciée au regard de l'intérêt du groupe. La réponse doit être communiquée aux commissaires aux comptes.

A défaut de réponse dans un délai d'un mois ou à défaut de communication d'éléments de réponse satisfaisants, ces actionnaires peuvent demander en référé la désignation d'un ou plusieurs experts chargés de présenter un rapport sur une ou plusieurs opérations de gestion.

Le ministère public, le comité d'entreprise et, dans les sociétés faisant publiquement appel à l'épargne, l'Autorité des marchés financiers peuvent également demander en référé la désignation d'un ou plusieurs experts chargés de présenter un rapport sur une ou plusieurs opérations de gestion.

S'il est fait droit à la demande, la décision de justice détermine l'étendue de la mission et des pouvoirs des experts. Elle peut mettre les honoraires à la charge de la société (...). If the petitioners do not meet the requirement of 5% of the share capital, they can petition for an expertise in futurum, based on the code of civil procedure (Art. 145). An equivalent mechanism exists in UK law conducted by the Secretary of State, see Davies P. L., op. cit., Chapter 25 Breach of Corporate Duties: Administrative Remedies, p. 691-704.

⁴⁵² Com. 18 April 1961, J.C.P. 1961, II, 12 164, Bastian D.

corporate officers, making it hard to align the interests of shareholders with those of the owners-managers.

Another means of providing protection for the minority against potential abuses by the majority is obviously to make contractual arrangements to this effect. In private companies, as with checks on the corporate control, only a certain category of minority shareholders, private equity funds or other professional investors, will be strong enough to contract around majoritarian rules and the *de facto* illiquidity⁴⁵³. So, this is only a very partial solution and the sell-out right is precisely aimed at those who do not have sufficient bargaining power to either influence the corporate control or negotiate some sort of a buyout.

In addition, other statutory provisions usually aim at providing protection for minority shareholders, from supermajorities to fiduciary duties and mandatory disclosures. Supermajorities are more useful for monitoring the control of a company if its share capital is spread among numerous shareholders, *i.e.* in a public company. Another reason why this is not sufficient to protect the minority is that the scope of decisions taken by supermajority is necessarily limited, otherwise the company would run the risk of being paralysed. It is usually confined to the alteration of the articles of association, mergers and substantial sales of assets. Other fundamental decisions such as the distribution of a dividend can be taken in ordinary shareholders' meeting with a simple majority vote or to some extent, under French law for instance, including the payment of a dividend in advance without any vote by shareholders, decided by the board of directors.

Alternatively, suits brought by minority shareholders for violations of fiduciary duties can be an efficient way to solve agency problems. However, the incentive for a shareholder-plaintiff to bring a derivative suit can be limited since, despite the fact that the suit is being brought by the shareholder in the name of the company, the shareholder will pay all legal fees in advance whereas any damages paid will go to the company's coffers. If he is successful and damages are awarded, the best the shareholder can hope for is an increase in the value of the company as a whole. With respect to the suit that the shareholder can bring in his personal name, *ut singuli*, its potential is limited, because it is difficult to prove personal damage. Only very direct damages will provide a basis for this type of lawsuit, for instance the misappropriation by a director of a dividend owed to the plaintiff⁴⁵⁴.

As for mandatory disclosure rules, their effectiveness is greater in listed companies where the transparency of the stock market requires the disclosure of information (we have already examined

⁴⁵³ For a different point of view arguing that contractual flexibility may be sufficient to fight minority oppression, for instance by giving minority shareholders veto power in some circumstances, see: Guinnane T., Harris R., Lamoreaux N., Rosenthal J.-L. "Ownership and Control in the Entrepreneurial Firm: An International History of Private Limited Companies", Center Discussion Paper n° 959, Economic Growth Center, Yale University, December 2007, p.9.

⁴⁵⁴ CA Paris, 2 May 1935, Gaz. Pal. 1935. 2. 113.

disclosure in the private company elsewhere)⁴⁵⁵. It has been shown how paucity of information leads to majority opportunism and how disclosure regulations can more efficiently prevent conflicts of interest. In any case, mandatory disclosure and a sell-out right fulfil different functions: mandatory disclosure aims at identifying relations of power between shareholders and potential sources of conflicts of interest within the company and the focus is therefore *ex ante*, whereas the sell-out right operates *ex post* as a solution. In this way, both devices are complementary.

With respect to the listed company, in addition to the liquidity of the market, two features provide efficient protection for minority shareholders: mandatory public offers and the various sell-out rights. In the event of a change of control, mandatory bid rules make it possible for the minority shareholder to sell his shares at the same price as the majority, thus compensating for the consequences of the majority principle, which would result in the payment of a majority premium. The evolution of the balance of power and the consequences of the majority principle determine the launch of a mandatory public offer. The rationale behind mandatory bids has been described in this way by the French courts: this technique aims at “avoiding certain shareholders becoming prisoners of other shareholders or of the strongest”⁴⁵⁶. In similar circumstances, stock market regulations provide for several remedies involving sell-out rights based on strict requirements.

Under French law, when one or several shareholders hold either alone or in concert 95% of the share capital of a company, they can ask the *Autorité des Marchés Financiers (AMF)* to compel the controlling shareholders to purchase their shares⁴⁵⁷. In this way, the powerless state of other shareholders is acknowledged. The *AMF* will order the purchase only if there is little liquidity on the market for the shares⁴⁵⁸. It should be noted that the right to sell out to the majority shareholders is not automatic even when the market for the shares is illiquid. The regulator verifies if the minority shareholders can sell their shares within a reasonable period of time and under normal financial terms⁴⁵⁹. The petition by the minority may well be rejected however if it comes right after a public offer having been

⁴⁵⁵ See supra Part II, Chapter I, The Supply of Information in the Private Company.

⁴⁵⁶ Ord. réf., T. com. Paris, 19 Oct. 1995, *Nouvelles Frontières International*.

⁴⁵⁷ See Art. 236-1, *AMF General Regulations*: “Where the majority shareholder(s) hold, in concert within the meaning of Art. 233-10 of the Commercial Code (*Code de commerce*), 95% or more of the voting rights of a company whose shares are or were admitted to trading on a regulated market, any holder of voting equity securities who is not part of the majority group may apply to the *AMF* to require the majority shareholder(s) to file a proposed public buyout offer. Once the *AMF* has made the necessary verifications, it rules on such application in the light of, inter alia, the state of the market for the securities concerned and the information provided by the applicant. If the *AMF* declares the application to be acceptable, it notifies the majority shareholder(s), which must then file a buyout offer, within a time limit set by the *AMF* and drawn up in terms that can be deemed acceptable by it”.

See under UK law, sections 983 and 985 of Part XIII A of the Companies Act 2006.

⁴⁵⁸ See Com. 6 May 1996, *Société financière Circe*, Bull. civ. IV, no. 123, p. 107 and the communiqué of CBV dated 12 January 1990, Darty.

⁴⁵⁹ “...ce requérant et les personnes qui se sont jointes à sa demande ne sont pas en mesure de céder leurs titres dans des conditions normales de délai et de cours”, CMF, 28 Feb. 2001, Bis, *Revue CMF*, no. 37, April 2001, p. 176.

ignored by these minority shareholders⁴⁶⁰ as judges do not allow this opportunity to sell out to be used to remedy shareholder apathy.

Other events which could potentially trigger a sell-out right in listed companies refer to a corporate decision breaching the corporate contract binding the majority and the minority, which can be either (i) the transformation of the company into a *société en commandite par actions*⁴⁶¹, (ii) a significant alteration to the articles of association⁴⁶², (iii) the absorption of the company by its parent company⁴⁶³, (iv) the sale of all or most of the assets⁴⁶⁴, and (v) “ the reorientation of the corporate activity or the suppression, for several fiscal years, of any remuneration of the capital”⁴⁶⁵.

It is only in the hypothesis of the transformation of a listed company into a *société en commandite par actions* that there is an obligation for the controlling shareholder to offer to purchase the shares of the minority shareholders, which is telling with regard to the rationale behind such a sell-out right. Other hypotheses are subject to the approval of the *AMF*. Indeed, the transformation into a company of a radically different nature especially in terms of shareholder rights, since the control of the company can permanently be frozen, constitutes for its shareholders a profound modification of the reasons underlying their initial investment. This provision thus compensates for the use, even legitimate, made of the majority principle, when it results in an objective (*i.e.* unintentional) breach of the implicit corporate pact. Other sell-out right triggering events confirm this idea. The purpose of article 236-6 of the *AMF* General Regulations referring to the “significant alterations of the articles’ provisions” implicitly refers to the deterioration of the terms of the implicit corporate pact. Other examples of alteration of the articles relating to the transferability of shares refer to the shareholders’ rights, which shows that what is indirectly protected here is in effect the terms agreed to by each party at the time of the initial investment.

Another sell-out right triggering event was later inserted, which refers to groups of companies whose formation by means of the takeover of listed companies constitutes a threat to the market pact

⁴⁶⁰ See Viandier A., OPA, OPE, Garantie de Cours, Retrait, OPV, Litec, 2003, p. 365.

⁴⁶¹ Art. 236-5, *AMF* General Regulations: “Where a public limited company (*société anonyme*) whose equity securities are admitted to trading on a regulated market is converted to a limited partnership with shares (*société en commandite par actions*), the person(s) that controlled it prior to conversion, or the active partners in the limited partnership with shares, are required to file a proposed buyout offer once a resolution regarding the conversion has adopted at a general meeting of shareholders. The proposed offer cannot include a minimum acceptance condition and must be drawn up in terms that can be deemed acceptable by the *AMF*. The offeror informs the *AMF* whether it reserves the right, depending on the result of the offer, to request that all equity securities giving access to the equity and voting rights of the company be listed from the regulated market on which they are traded”.

⁴⁶² Art. 236-6, 1°, *AMF* General Regulations: “The natural or legal persons that control a company must inform the *AMF*: 1. when they intend to ask an extraordinary general meeting of shareholders to approve one or more significant amendments to the company’s articles or bylaws, in particular the provisions concerning the company’s legal form or disposal and transfer of equity securities or the rights pertaining thereto; 2. when they decide in principle to proceed with the merger of that company into the company that controls it, sell or contribute all or most of the company’s assets to another company, reorient the company’s business, or suspend dividends for a period of several financial years. The *AMF* evaluates the consequences of the proposed changes in the light of the rights and interests of the holders of the company’s equity securities or voting rights and decides whether a buyout offer should be made. The proposed offer cannot include a minimum acceptance condition and must be drawn up in terms that can be deemed acceptable by the *AMF*”.

⁴⁶³ Art. 236-6, 2°, *AMF* General Regulations.

⁴⁶⁴ Art. 236-6, 2°, *AMF* General Regulations.

⁴⁶⁵ Art. 236-6, 2°, *AMF* General Regulations.

concluded within each of the companies between the controlling shareholder and the market. The notion of a market pact, which is specific to the listed company, shares the same basis as the fiduciary relationship connecting the majority shareholders with the minority shareholders in the private company, *i.e.* trust. This common basis makes it possible to apply the concept of breach of the implicit corporate pact to both types of companies⁴⁶⁶, and this concept underlies article 236-6, subparagraph 1, point 2, of the *AMF* General Regulations. With this provision, the focus is once again on the market pact, as is the case with mandatory public offers triggered by takeovers, since an option is offered to the minority to be bought out before the merger with its parent company, which is an event which would constitute a breach of the implicit corporate contract.

The *AMF* may also compel an issuer to buy out the minority shareholders if the controlling shareholders decide to sell all or most of the assets of the company. The regulator's decision will depend on the importance of the assets in relation to the company as a whole. For instance, French real estate group Gecina had planned to spin off its residential real estate arm and then float the new entity and sell some of its share capital. The *AMF* was asked to trigger a sell-out right in favour of Gecina's minority shareholders pursuant to article 236-6, 2° of the *AMF* General Regulations. The regulator found that the company could go ahead with its plans since the residential real estate business represented less than 50% of Gecina's total income from leased property, of its EBITDA and net assets⁴⁶⁷.

Among the circumstances giving rise to a sell-out right, it is useful to mention the reorientation of the corporate activity and the suppression of dividends as these show that the breach of the implicit corporate pact acts as the basis for this right. As Prof. M.-A. Frison-Roche writes on the notion of reorientation of the corporate activity, this is an "example of a link expressly established between the activity of the company and the rights consequently granted regarding the shares"⁴⁶⁸. It can also be envisaged that, under similar circumstances in private companies, this notion would justify the purchase by the majority of the dissenting minority's stake. The nature of the activity of a company is indeed crucial to its profitability, which is the purpose of the shareholders' common interest, *i.e.* the shareholder value maximisation, in both public and private companies. If the corporate activity is unilaterally altered, this indeed amounts to the questioning of the initial conditions of profit maximisation which, as we discussed earlier, is at the origin of the investment in a company and, more generally, which justifies the operation of the company itself. Nevertheless, it must be noted that a change of activity can be justified precisely by the poor financial returns generated by the previous activity. The issue here is that the potential obligation for the majority shareholders to buy out the minority should not hamper the company's ability to react to changing economic conditions. This is why the courts should carefully consider this risk when assessing the existence of a valid trigger for the sell-out right. In the same way, it must be noted that

⁴⁶⁶ On which, see M.-A. Frison-Roche (1996) *op. cit.*, p. 19.

⁴⁶⁷ *AMF*, Communiqué, 7 September 2006.

⁴⁶⁸ Frison-Roche M.-A. (1996), *op. cit.*, p. 20.

under the *AMF* regulations applicable to listed companies, the reorientation of the company's activity does not automatically trigger the sell-out right but simply gives the regulator an option to trigger such right.

The suppression of the dividend as a factor triggering a mandatory buyout is also related to the hypothesis of shareholder value maximization as being the common interest of shareholders. In light of the difficulty of monitoring whether a private company is run pursuant to the shareholder value maximisation approach, such a provision is even more necessary in unlisted companies than in listed companies. Indeed, regarding listed companies, the liquidity of the stock market enables shareholders to satisfy their interest by pocketing capital gains, to which can be added the distribution of dividends for those who keep their shares. In the private company with no market for its shares, the dividend is an important source of revenue for the shareholder, whilst another will be the proceeds resulting from a possible profitable dissolution at the end of company's term. Consequently, when a controlling shareholder continuously decides, thanks to its majority power, to allocate corporate profits to the reserves, he is violating his commitment to respect the shareholders' common interest. It could be considered that the allocation of the corporate profits to the reserves is beneficial to the company and that it is just a matter of time before the shareholders reap the benefits of this strategy. But in a private company, when the allocation of power is permanently frozen and there is no possibility to sell shares without a large discount, the minority shareholder is constrained to wait for the dissolution of the company in order to receive his quota of the net assets, which could in the meantime have been diverted, for example by means of exaggerated remuneration paid to majority shareholder managing the company.

A sell-out right would be an appropriate response to the risks of opportunism or to fundamental changes resulting from the majority principle for those shareholders who do not have a market available to provide them with an exit strategy. The majority principle is indeed structurally the opposite of the unanimity characterising the adhesion to the implicit corporate contract and representing the proportionality between the decision-making power and the risk incurred. The efficiency problems of majority-voted collective choices have been shown in detail by public choice theorists. These structural inefficiencies, added to the absence of a market for shares, consequently put private companies at a disadvantage when it comes to attracting investors. This is precisely the problem that the introduction of a sell-out right in the private company aims to solve. We now examine how the sell-out right works in private companies in three jurisdictions, the U.S., the UK and Belgium, before suggesting an alternative model for the sell-out right.

CHAPTER 3 DOES THE NOTION OF BREACH OF CORPORATE CONTRACT ACCOUNT FOR THE REGIMES OF THE APPRAISAL REMEDY UNDER AMERICAN LAW, OF UNFAIR PREJUDICE UNDER ENGLISH LAW AND OF THE SELL-OUT RIGHT UNDER BELGIAN LAW?

A statutory regime defining a sell-out right in favour of minority shareholders in private companies should reflect the bases explained above. As has been demonstrated, these principles already underlie the various situations in which the sell-out right is implemented in French listed companies, as well as, to a certain extent, mandatory public offers in general.

In the United States, the United Kingdom and Belgium, where, in addition to mandatory public offers, a sell-out right in favour of minority shareholders already exists, this remedy is applicable to both listed and unlisted companies. In some cases this right has not been generalized, contrary to the equivalent French provision, but remains restricted to private companies to compensate for the illiquidity of their shares⁴⁶⁹, which would seem logical enough. The American, English and Belgian sell-out right regimes will be analysed to assess their efficiency as an agency control mechanism, before suggestions are made concerning the details of a possible regime combining these various approaches to the sell-out right.

Depending on the regime - the appraisal remedy under American law, the unfair prejudice under UK law or the sell-out right under Belgian law - the scope of the sell-out right will either be restricted to the somewhat traditional sanctioning of oppressive conduct on the part of the majority (which we will call a subjective breach of the implicit corporate contract) or it will be triggered by a change in the nature of the initial investment (which we will refer to as an objective breach of the implicit corporate contract).

3.1 The sell-out right under U.S. law: the appraisal remedy

The appraisal remedy⁴⁷⁰ under American law enables shareholders opposed to certain corporate transactions, such as a merger or the sale of substantially all corporate assets or certain charter amendments, to have their shares bought by the company for their value prior to the event. Payment does not occur until all judicial proceedings have been completed.

⁴⁶⁹ For example, market-out clause exists under Californian law which does not provide an appraisal remedy in case of opposition with the majority concerning a reorganisation when the company is listed on the New York Stock Exchange (Cal. Corp. Code para. 1300, 181). The law of Delaware confines the appraisal remedy, in the event of a merger, to unlisted companies (See Henn H. G. and Alexander J. R., *Laws of Corporations*, West Publishing Co., 1995, p. 999). In the same way, in Californian law the appraisal remedy prerequisites are stricter for listed companies: shareholders in this type of company must have voted against the resolution justifying their exit right, whereas shareholders of unlisted companies can have abstained only (See Buxbaum R. M., *The Dissenter's Appraisal Remedy*, 23, U.C.L.A. L. Rev., 1229 (1976), p. 1235).

⁴⁷⁰ On the appraisal remedy, see Henn H. G. and Alexander J. R. (1995), *op. cit.*; Hamilton R. W., *Corporations including Partnerships and Limited Liability Companies, Cases and Materials*, 6th edition, West Publishing Co., 1997, p. 489; Buxbaum R. M. (1976) *op. cit.*; Comment, *The Right of Shareholders Dissenting From Corporate Combinations To Demand Cash Payment For Their Shares*, 72 Harv. L. Rev. 1132 (1959); Kaplan J. J., *Problems in the Acquisition of Shares of Dissenting Minorities*, 34 B.U.L. Rev. 291 (1954); Levy I. J., *Rights of Dissenting Shareholders to Appraisal and Payment*, 15 Cornell L. Q. 420 (1930); Lattin N. D., *A Reappraisal of Appraisal Statutes*, 38 Mich. L. Rev. 1165 (1940).

The appraisal remedy appeared in American statutes as the nature of the shareholder's rights with regard to the corporation evolved. Initially, each shareholder's consent was required in order to amend the corporate charter however this unanimity rule started to decline when courts allowed individual State statutes to permit the alteration of corporate charters. Following this changes, provisions were added to charters to the effect that alterations could result from a majority vote instead of from unanimity only. This evolution was then extended to major transactions such as asset sales, mergers and changes of control. At the same time, in cases of financial distress, the courts allowed the majority to sell all corporate assets for cash which was then distributed to shareholders via contractual means. When no cash was available, this approach was extended to include sales in exchange for which shareholders received shares of the buyer. The next step was for the courts to authorise such transactions even before the corporation had become insolvent, which led eventually to the current position: it is possible at any time for a majority vote to decide to sell all of the corporate assets for cash or stocks, because of which the minority shareholders' interests are at risk and so the appraisal remedy was introduced.

The minority shareholders first managed to secure cash payments in stock transactions through litigation. In this way, the minority could get the value of its shares instead of being forced into a new corporation or receiving a proportional share in the transaction's returns, however the costs and risks inherent in litigation meant that cash settlements remained frequent. Appraisal statutes were first enacted in this context, offering dissenting shareholders the fair value for their shares, not just a share in the proceeds of the transaction. Today, all U.S. jurisdictions include appraisal provisions in their corporate laws⁴⁷¹.

In this historical perspective, the fact that the appraisal remedy grants shareholders the fair value of their shares is of particular importance to the private company as there is no exit due to the lack of any market for these shares and therefore no market price. It is fairly surprising that out of the total number of appraisal cases, nearly all were brought by shareholders in public corporations and not private companies. This might be because shareholders do not have faith in the market value of their shares. Although this is not the place to discuss the efficiency of financial markets and their capacity to price assets accurately, this attitude shows that it is the fair value aspect of the appraisal remedy rather than the cash exit side that seems to attract shareholders in public companies, whereas for shareholders in private companies, it is the cash exit component of the appraisal that is crucial, followed only to a lesser extent by the fair value aspect.

The causes for the appraisal remedy in the U.S. have long been discussed. Prof. Manning argues that this device is of little use to dissenting shareholders and that it is costly to the issuer⁴⁷². On the other hand, in a widely commented response, Prof. Eisenberg argues that the appraisal remedy is in

⁴⁷¹ See Thomson R. B., *op. cit.*, 10.

⁴⁷² Manning B., *The Shareholder's Appraisal Remedy: An Essay for Franck Coker*, 72 *Yale L. J.* 233 (1962).

effect protecting the minority from being compelled to participate in a different venture and that, from an agency costs perspective, it acts as a monitoring device with regard to management⁴⁷³. Both approaches give an *ex post* assessment of this statutory provision, *i.e.* after the transaction has occurred. Prof. Fischel, analysing this device as an implied contractual term, shifts the focus to an *ex ante* approach, *i. e.* prior to the announcement of the transaction⁴⁷⁴. In this way, he is able to show that the appraisal remedy “is best understood as an implied contractual term that sets the minimum price at which the firm, or a part thereof, can be sold in situations where certain groups are more likely to attempt to appropriate wealth from other groups than to maximize the value of the firm”⁴⁷⁵. This *ex ante* perspective shows that the appraisal remedy not only has the advantages stated above but that it adds value to the firm, to the benefit of all shareholders, whether or not a triggering transaction ever occurs.

The cost of the appraisal remedy must be set against these advantages when it is paid for by the company as is the provided under State statutes. This cost stems from the fact that when a shareholder withdraws capital from the company, the payment may be financed by the sale below their value of some of the company’s assets or by raising new capital. One argument usually put forward against the recourse to this remedy is that it may therefore deter companies from entering into value increasing transactions. Moreover, the procedure leading to the appraisal remedy also has its costs. Assessing the net benefit of this provision is therefore not easy as it rests on factual circumstances however such benefit can be assessed by observing whether the practice is becoming more widespread or dying out. In the U.S., the number of cases and the fact that the Model Corporation Act includes a larger number of transactions potentially triggering the appraisal remedy are therefore positive factors in support⁴⁷⁶ of this mechanism.

Statistics on the number of cases litigated also provide information as to the purpose of the appraisal. It seems that recourse is most frequently made to the appraisal in cases of mergers or similar transactions when the majority forces the minority out and requires it to accept cash in exchange for its shares. Here, the purpose of the mechanism is to counter majority opportunism. This is a different function from the one under which it was established in the 19th century when, as has already been stated, the appraisal remedy was designed for times when the unanimous consent of shareholders in order to make radical changes in the corporation was no longer needed. Fundamental changes could then happen following a supermajority vote and appraisal rights provided liquidity to any shareholder unwilling to remain in a business different from that in which he had first invested. The focus was therefore on radical changes and liquidity rather than on the monitoring of management. These competing rationales

⁴⁷³ Eisenberg M. A., *The Structure of the Corporation: A Legal Analysis*, 1976.

⁴⁷⁴ Fischel D. R., *The Appraisal Remedy in Corporate Law*, *Am. B. Found. Res. J.*, 875, 1983.

⁴⁷⁵ *ibid*, p. 876.

⁴⁷⁶ “The dusty remedy has been much more frequently litigated, as evidenced by more than 100 appellate cases in the past decade.”, Thomson R. H., *Exit, Liquidity, and Majority Rule: Appraisal’s Role in Corporate Law*, 1 *Georgetown L. J.*, 4, 1995; See Fischel *op. cit.*, 882. See also for the previous decade, Seligman J., *Reappraising the Appraisal Remedy*, 52 *Geo. Wash. L. Rev.* 829, 1984.

reflect the range of corporations in which appraisal is sought and the diversity of motives on the grounds of which it is sought. It is therefore logical for the liquidity purpose to be more adapted to private companies where there is no market for shares rather than public corporations where the shareholder can always “vote with his feet”, *i.e.* sell his shares, and where his main concern is usually to obtain a fair valuation. This explains why a market-out clause excluding appraisal when shares are traded on a market is frequently included in statutes. However both approaches can be reconciled given the fact that in private companies the illiquidity of the capital is a factor for minority oppression, bringing back the majority opportunism issue.

To sum up, the appraisal remedy gives shareholders opposing the majority in connection with “extraordinary” matters the right to have the company purchase their shares at their price immediately preceding the vote on the controversial resolution. It therefore gives the shareholder a right to exit a company when, because of a majority decision or decision obtained with the support of the majority, an event seriously affecting the company, and consequently the nature of his investment, occurred without its assent. This free hand granted to the shareholder clearly underlines the antagonism existing between the unanimity which governs the collective decision to become a member of the company and the majority decisions which make the operation of the company possible. The latter are accepted by the minority - *i.e.* it consents to run a risk against which it expressed its opposition or at best no opinion at all - as long as such decisions remain within the limits of what was initially agreed. The transactions considered as modifying the original corporate contract between shareholders are usually the transfer of all the assets of the company, mergers, the sale of the company against shares of the acquirer and certain alterations of the corporate charter affecting the rights of the shareholders⁴⁷⁷. This form of sell-out remedy is also sometimes used by American judges as a sanction of oppressive behaviour by the majority shareholder⁴⁷⁸.

U.S. courts have brought to light the basis of the right to oppose the majority and ask for the purchase of shares on the occasion of the sale of all of the assets of a company. When all the assets are transferred (except if the company is failing), any shareholder can claim a contractual right to the continuation of the company in accordance with its original charter. Moreover, when the assets are transferred in exchange for shares in another company, shareholders have a right not to be constrained to invest in a business concern other than that which they originally joined⁴⁷⁹. The generality of these principles made it possible for the courts to grant an appraisal remedy even where all the legal prerequisites had not been met, so long as the proposed transaction modified the “essential nature” of the

⁴⁷⁷ Model Business Corporation Act, see Henn H. G. and Alexander J. R. (1995) *op. cit.*, p. 998.

⁴⁷⁸ “...relief for unfair oppressive conduct might include requirement that corporate purchase shares of minority shareholders”.

Miller v. Magline, Inc., 105 Mich. App. 413, 306 N.W.2d 533 (1981), *ibid.*

⁴⁷⁹ See *Geddes v. Anaconda Copper Mining Co.*, 254 US 590, 596 (1921) (dictum) mentioned in *The Right of Shareholders Dissenting From Corporate Combinations To Demand Cash Payment For Their Shares*, *op. cit.*, p. 1133.

company, as well as the nature of the relationships between the shareholders⁴⁸⁰. This was the case when a merger led to the shareholders of the surviving company becoming joint owners of a company twice the size, exercising a different activity and whose shares had a different nominal value, the control of which had been transferred into the hands of the shareholders of the acquired company⁴⁸¹. This display of legal realism is worth noting, as it made possible the observation that the shareholders of the surviving company were running greater risks in this transaction than the shareholders of the absorbed company⁴⁸².

However wide the bases underlying the appraisal remedy, these do not include the transfer of control as such. The peculiarity of the transfer of control is that on the surface it takes the form of a bilateral exchange while in reality it is a complete reorganisation of the company, in effect making the transaction not bilateral but multilateral. This is because this reorganisation actually affects every single member of the company⁴⁸³ and therefore threatens the implicit corporate contract, since the transfer of control modifies the allocation of power which was itself one of, if not the determining factor in the shareholder's decision to invest. However, not every transfer of control does, of course, constitute a breach of the corporate contract and this is why under American law the purchase of minority shares is mandatory only if the transfer of control triggers a change in the following parameters: the size of the company, the nature of its activity, its financial structure and the respective weight of its shareholders. These limits as to the consequences attached to a transfer of control are justified. Indeed, when a transfer of control occurs on the stock market, the buy-out of the minority which results from the mandatory public offer is the consequence of a market principle: the respect for equality between the market players⁴⁸⁴. In the absence of any such principle in private companies, the change of control as a potential reorganisation hidden behind what looks like a mere exchange between the transferor and the transferee could provide sufficient grounds to justify the purchase of the minority shares. However, this would amount to importing the obligation for the acquirer to launch a 100% take-over bid, *i.e.* a kind of mandatory public offer in unlisted companies, which is hardly a desirable result. For this reason, the sell-out right in the private company should be triggered only when the minority undergoes (i) an objective breach of the implicit corporate contract, *i.e.* a significant transformation, or (ii) an intentional breach of the implicit corporate contract, *i.e.* a majority oppressive conduct. Also, it would be preferable for the majority shareholder to bear the cost of the shares, otherwise the dissuasive effect of this agency control mechanism would be lost. In addition, it seems advisable to include the minority shareholder of

⁴⁸⁰ See *Farris v. Glen Alden Co.*, 393 Pa 427, 143 A.2d 25 (1958), mentioned in *The Right of Shareholders Dissenting From Corporate Combinations To Demand Cash Payment For Their Shares*, op. cit., p. 1140.

⁴⁸¹ *Farris v. Glen Alden Co.*, op. cit.

⁴⁸² In assets against shares transactions, California law grants an appraisal remedy to dissenting shareholders in the acquiree company but also in the acquirer's. See Buxbaum R. M. (1976) op. cit., p. 1230.

⁴⁸³ See Didier P. (Nov. 1995) op. cit., p. 74, and see supra, *The Reasoning Process in Terms of Power of Finance Law and the Reasoning Process in Terms of Legal Entity of Company Law*.

⁴⁸⁴ See Frison-Roche M.-A., *Le Principe d'Égalité des Compétiteurs sur le Marché Boursier*, Bull. Joly Bourse, nov.-déc. 1993, p. 726.

companies taking over another company within the scope of the protection offered. The meeting of both of the aforementioned criteria is required by American case law, in addition to the transfer of control itself, before an appraisal remedy can be granted.

The preceding observations show that the appraisal remedy is based on foundations similar to those underlying the provisions included in the *AMF's* General Regulations regarding listed companies. This remedy should also be applicable to the minority shareholders in private companies.

In the U.S., litigation over the appraisal remedy shows that this is mostly triggered in the context of squeeze-outs⁴⁸⁵, *i.e.* when it suits the majority. This legal device does not operate in the exclusive interest of the minority, as statistics show. In this way, the appraisal remedy becomes nothing more than a cash-out exit. Another limitation on the use of the appraisal remedy is the fact that about half of the U.S. States withdraw this provision when a market does exist for the company's shares. A third hindrance is that statutes will often limit the application of the appraisal remedy to the company disappearing following a merger and apply it to the surviving company only if the merger results in a significant change in the business. The drawback here is that the transaction can easily be arranged so as to avoid appraisal remedies, for instance by having a subsidiary created as a special purpose vehicle for the target, thereby denying the application of the parent company shareholders' appraisal rights. Some States avoid these risks for minority shareholders by providing appraisal remedies in case of *de facto* mergers, *i.e.* when the sole raison d'être of a transaction is to hide a merger.

Finally the appraisal remedy works as a compromise between the majority and the minority. The idea that an appraisal remedy smoothens the transition between the unanimity principle, which governs the conclusion of the corporate contract, and the majority principle, necessary to the operation of the company, is uncontroversial in American legal doctrine: "It is generally thought that appraisal statutes were enacted to accommodate the interests of the majority shareholders in freedom to effect corporate combinations to that of the minority shareholders in not being compelled to accepting fundamental changes in the nature of their investment"⁴⁸⁶. Even more explicitly: "Its primary purpose is to insure the constitutionality of statutes authorising merger or sale of assets without unanimous consent"⁴⁸⁷. In that way, this mechanism illustrates that decision-making in a company, be it in the hands of a few shareholders or exercised more or less independently by corporate management, triggers duties arising out of such power and owed to other shareholders. The appraisal remedy therefore operates as a sanction of the violation of fiduciary duties, thus maintaining, through the threat thereby constituted, the confidence in a given power arrangement on which the investment decision rests. This specific basis is

⁴⁸⁵ Thomson R. H. *op. cit.*, 10.

⁴⁸⁶ In *The right of Shareholders Dissenting From Corporate Combinations To Demand Cash Payment For Their Shares* *op. cit.*, p. 1143.

⁴⁸⁷ In *Ballantine & Sterling, California Corporation Laws (1949 ed.)*, 432, mentioned in *The right of Shareholders Dissenting From Corporate Combinations To Demand Cash Payment For Their Shares*, *op. cit.*, p. 1143.

essential because this principle alone will make it possible to attach consequences to the objective (*i.e.* non intentional) breach of the corporate contract. In legal systems where this specific basis is not acknowledged, the sell-out right has to rest on the intentional breach, *i.e.* the concept of fault. However, the mere intent to change some rules of the corporate game is not necessarily constitutive of a fault as such. It is nevertheless necessary to enable those who have not given their consent to opt out, which is precisely what the sell-out right fails to do in legal systems in which it rests on the concept of unfair prejudice, as is the case in the UK.

3.2 Section 994 of the UK Companies Act 2006

Section 994 of the UK Companies Act 2006 provides that a shareholder may go to court in order to seek a remedy when “[t]he company’s affairs are being or have been conducted in a manner which is unfairly prejudicial to the interest of its members (including at least himself) or that any actual or proposed act or omission of the company (including any act or omission on its behalf) is or would be so prejudicial”. There is no statutory definition of the notion of unfair prejudice. For instance, in *Brownlow v. GH Marshall*⁴⁸⁸, it was held that what might be fair in a commercial environment might not be so in a family firm. If a court decides to give relief, it may do so by ordering that the petitioner’s shares be purchased by either the shareholder at fault or by the company. The scope of this statutory provision includes the exercise of power by the controlling shareholders acting in their capacity either as shareholder or as director. It also includes the creditors in the role of the petitioner⁴⁸⁹. It indirectly confers upon them, at certain moments of the operation of the company, an approval right on the exercise of power. It therefore confirms the idea that such an approval right goes hand-in-hand with the level of risk incurred, *i.e.* the person who ultimately runs the marginal risk of profit or loss attached to a decision is the person who will benefit from the right to have a say in the decision or be refunded. In addition, if, on the occasion of an investigation into a company, the Secretary of State concludes that the operation of the company wrongfully caused prejudice to some or all of the shareholders, he may petition the court for unfair prejudice⁴⁹⁰. It should be noted that section 994 applies to both private and public companies, listed or unlisted, although it will be seen that, in practice, the basis on which the complaint for unfair prejudice rests makes it an instrument more suited to private companies. As an instrument based on the factual notion of interest rather than the legal notion of right, as will be seen below, section 994 can bridge the gap between different types of companies such as listed and unlisted. This welcome realism was demonstrated in *Re A Company* where a judge, petitioned under section 994, used provisions of the City Code on Takeovers and Mergers, although applicable to listed companies only, to assess the behaviour

⁴⁸⁸ *Brownlow v. GH Marshall* [2002] 2 B. C. L. C. 321.

⁴⁸⁹ Section 27, Insolvency Act 1986.

⁴⁹⁰ Section 995, Companies Act 2006.

of directors of a private target company in their communications with shareholders and consider that any advice given by the directors should be in the interest of the shareholders⁴⁹¹.

Under section 994, it was decided in *Re Haden Bill Electrical Ltd* that a shareholder's dismissal from the board of directors of a private company entitled him to have his shares purchased if it was expected that his return on investment would result from directors' fees or because his presence on the board was justified by the necessary supervision of his investment⁴⁹². This example illustrates the attention paid by the courts to the implicit nature of the shareholders' mutually binding agreement. In the case providing this precedent, it is therefore not so much a right resulting from a contract in the legal sense which is protected, but rather an expectation, that is to say a factual notion as opposed to a legal notion. This is consistent with the approach of contract economics which does not always refer to the contract as a legal concept but rather to the arrangement which would have been reached by rational shareholders wishing to organise their relationships as residual claimants.

Section 994 is of interest in the search for the optimal sell-out right regime because it is designed to protect the interests of the shareholders and not only their legal rights⁴⁹³. It therefore follows that section 994 enables non-controlling shareholders to seek the punishment for breaches of directors' and controlling shareholders' duties where harm is done to the company and not just to individual shareholders pursuant to the principle of *Foss v. Harbottle*, when the company has taken no action itself and irrespective of whether a derivative action is available or not⁴⁹⁴. In this way, in the situations mentioned in the previous chapter with regard to the enforcement of fiduciary duties⁴⁹⁵ such as the diversion of the company's business to a rival company in which the controlling shareholder holds an interest⁴⁹⁶, the exercise of the directors' powers for an improper purpose⁴⁹⁷ or the failure of directors to act in the bona fide interests of the company⁴⁹⁸, petitions have been accepted by the courts. It should be noted that for the same facts, for instance a breach of a fiduciary duty, a shareholder complaint based on section 994 may also be filed where the company is also prosecuting or a shareholder is also suing derivatively if that was allowed. This approach in terms of interest and not only legal rights therefore enables a shareholder to exit the company because his interests were harmed by a wrong done to the company and the restrictive rule of *Foss v. Harbottle* is thus relaxed. As Hoffmann L.J. comments:

⁴⁹¹ (1986) B.C.L.C. 382.

⁴⁹² *Re Haden Bill Electrical Ltd* [1995] 2 BCLC 280.

⁴⁹³ See *Re A Company* (no. 00477 of 1986) (1986) B.C.L.C. 376.

⁴⁹⁴ *Re A Company* (no. 5287 of 1985) (1986) 1 W.L.R. 281; *Re Stewarts (Brixton) Ltd.* (1985) B.C.L.C. 4; *Lowe v. Fahey* (1996) 1 B.C.L.C. 262.

⁴⁹⁵ See supra Part II, Chapter 3.

⁴⁹⁶ A situation found in *Cook v. Deeks* (1916) 1 A.C. 553, P.C.

⁴⁹⁷ *Re A Company* (1988) 1 W.L.R. 1068.

⁴⁹⁸ *Re Saul D. Harrison & Sons plc* (1995) B.C.L.C. 14.

“Enabling the court in an appropriate case to outflank the rule in *Foss v. Harbottle* was one of the purposes of the section”⁴⁹⁹.

The protection of the shareholder’s interests and not just their legal rights also makes it possible to catch behaviours which, if not unlawful, are nevertheless unfair and thereby trigger a remedy under section 994. The fact that legitimate expectations may be disappointed despite the controller’s conduct having been completely lawful inspires the model sell-out right proposed by us below, and which could be triggered in the event of an objective breach of the corporate contract.

This objectivity is also found in section 994 in the concept of unfair prejudice. The petitioner has to show that his interests were exposed to an unfair prejudice due to the controllers’ behaviour. The harm done will give rise to an action under section 994 although the controller had no intent to cause harm to the victim and no proof of such an intention is therefore required from the petitioner⁵⁰⁰.

Re Haden Bill Electrical, dealing with an exclusion from the board of directors, it had been agreed between the minority and the majority shareholders that the former would sit on the board in order to ensure the value of his investment. English case law thus developed the concept of legitimate expectations⁵⁰¹, which shows a factual and therefore realistic, as opposed to legalistic, approach to the operation of companies. Prof. Farrar refers to the existence between the shareholders of “a special facts fiduciary relationship arising from the circumstances”⁵⁰². Legitimate expectations may arise “out of a fundamental understanding between the shareholders which formed the basis of their association but was not put in contractual form”⁵⁰³. The notion of legitimate expectations seems to have first appeared in *Ebrahimi v. Westbourne Galleries Ltd*⁵⁰⁴ where Lord Wilberforce held that equity may enable courts to infer legal rights from “equitable considerations (...) of a personal character arising between one individual and another, which make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way”⁵⁰⁵. It follows that petitioners under section 994 may be bought out by the majority if this majority behaved wrongfully by breaching the constitutive contract of the company, composed of its memorandum and articles of association, of the common law and equitable rules relating to the exercise of power by the company’s governing bodies and of the statutory rules imposing duties on persons exercising power in the company⁵⁰⁶. Thus defined, the corporate contract in itself gives rise to legitimate expectations. Petitions under section 459 may also be successful if, outside the broadly defined

⁴⁹⁹ *Re Saul D. Harrison & Sons plc*. [1995] BCLC 14 at 19.

⁵⁰⁰ Davies P. (1997) op. cit., p. 747 citing *Re Bovey Hotel Ventures Ltd.*, unreported, but set out and approved at (1983) B.C.L.C 290.

⁵⁰¹ *Re Saul D. Harrison & Sons plc*. [1995] BCLC 14 at 19, per Hoffmann L.J.

⁵⁰² In Farrar J. H., *The Duties of Controlling Shareholders*, Contemporary Issues in Company Law, Ed. J. H. Farrar, CCH, New Zealand, 1987, p. 193.

⁵⁰³ *Re Saul D. Harrison & Sons plc*. [1995].

⁵⁰⁴ (1973) A.C. 360, HL.

⁵⁰⁵ *Ibid.* 379.

⁵⁰⁶ DTI, *Modern Company Law for a Competitive Economy: Developing the framework* (March 2000), para. 4.71.

constitution of the company, it can be proven that the petitioner's additional legitimate expectations have been breached. This would require proof of a sort of informal prior agreement between the parties. This notion is well adapted to companies in which the members know each other personally, in particular family firms, which are a widespread ownership structure for private companies, as has already been observed⁵⁰⁷.

In concrete terms, it seems now established, for instance, that exclusion from management may be sufficient grounds to justify a petition under section 994. In *Richards v. Lundy*⁵⁰⁸, it was held that the removal from office of a director owning 10% of the share capital was sufficient to justify a petition under section 994 despite the fact that he had made no substantial financial contribution to the company. Regarding the above-mentioned notion of legitimate expectations, the House of Lords has taken a restrictive stance in *O'Neill v. Phillips*⁵⁰⁹ and has emphasised the necessarily contractual nature of the concept of unfair prejudice and thus that the petition will not be successful unless there is proof of some sort of agreement.

However, the Scottish courts seem to remain more willing to back petitions on the grounds of more loosely defined legitimate expectations, upholding for instance that legitimate expectations could exist in addition to the articles of association and that the court should therefore enquire whether any of the parties had agreed to specific arrangements on an informal basis⁵¹⁰. The reference to an arrangement on an informal basis illustrates the fact that the remedy is more likely to be granted if the implicit corporate contract is loosely defined. Implicit fiduciary relationships, reflecting agency relationships, supplemental to statutory provisions, corporate charters, shareholder agreements and also informal arrangements, together jointly form the implicit corporate contract. Case law based on section 994 shows that a sell-out remedy is granted to any shareholders who can prove the breach of one of these implicit conventions. Their implicit character is the result of the fact that the shareholders did not bear in mind every factual situation that could occur when investing in the company. For this reason, these implicit conventions require the shareholders to act as they would have had the conclusion and application of contracts been without cost⁵¹¹. This justification is very clearly stated in the aforementioned decision *Re Saul D. Harrisson*: informal arrangements between shareholders arise "out of a fundamental understanding between the shareholders which formed the basis of their association but was not put into contractual form"⁵¹². These informal arrangements generally aim at power and there are numerous examples in small companies where shareholders petition the court in order to obtain a right to exit because they are permanently excluded from management. With this reference to the exercise of power,

⁵⁰⁷ See supra Part I Chapter 1.

⁵⁰⁸ *Richards v. Lundy* [1999] B.C.C 786.

⁵⁰⁹ (1999) 1 W.L.R. 1092 at 1102.

⁵¹⁰ *Anderson v. Hogg* [2000] SLT 634.

⁵¹¹ The decision to form a company results from the intention to carry on an activity while limiting transactions costs.

⁵¹² *Re Saul D. Harrisson & Sons plc.* [1995] BCLC 14 at 19, per Hoffmann L.J.

cases brought under section 994 offset the flaws of the most important element of the corporate contract, *i.e.* the majority principle. This is exactly what a sell-out right should be about: a remedy against a power freeze and a remedy against subjective breaches of the corporate contract.

Contrary to French statutory law where the right of a minority shareholder to be bought out is confined to the listed company, English case law tends to identify these implicit contracts whose breach may trigger an exit opportunity in small companies only. The reason is that, for the courts, the obligation which takes precedence over the corporate charter (as originally drafted) springs from the shareholders' mutual trust. In listed companies, or even in unlisted but large companies with many shareholders, it will be hard to prove the existence of informal agreements or understandings between the shareholders if only for the simple reason that the shareholders are unlikely to be in contact with each other. In this regard, Jonathan Parker J. took the radical view that "the concept of 'legitimate expectation' (...) can have no place in the context of public listed companies"⁵¹³. However, a petition under section 994 could potentially be successful in a large company if it based on the "concrete" part of the corporate contract, *i.e.* the articles of association, the memorandum or a breach of a fiduciary duty.

There is a difference between the regime of a sell-out right based on the objective idea of the breach of the implicit corporate contract and the same remedy as a relief for subjective, unjust conduct. Consequently, it does not seem possible under English law to base the minority shareholder's appraisal remedy on grounds common to both the public and the private company. This is because, in private companies, the fiduciary bond between shareholders is exposed only in order to understand the injustice to be relieved by a sell-out right or other mechanism. In listed companies however, the courts seem more reluctant to track down injustices in the name of this provision, probably also due to the fact that stock market liquidity offers in itself a solution. In practice, the sell-out right envisaged as an ethical remedy is disadvantageous because it offers no exit to the minority shareholder who is stuck with his investment because of the regular and therefore non-faulty exercise of majority rule.

3.3 The sell-out right under Belgian law

In addition to the procedures of the appraisal remedy under U.S. law and of unfair prejudice under English law, which belong to common law systems, we will now look at a third example in Continental Europe to illustrate a sell-out right for just reasons. The sell-out right under Belgian law is an interesting subject for comparative study because it applies to closely held *sociétés anonymes* whose legal regime has a lot in common with the eponymous form of companies in France. With regard to the potential introduction of a sell-out right into French law and comparable corporate legal systems, there is therefore a lot to be learned from the Belgian example. The sell-out right operates under Belgian law

⁵¹³ *Re Astec (BSR) Plc* (1998) 2 B.C.L.C. 556.

under two different rationales: in closely held companies, it is used as a conflict-solving mechanism and additionally, in listed companies, it is also a stock market regulation used to guarantee the market liquidity. We will concentrate on the corporate governance aspect of this regulation to assess its efficiency as an agency control mechanism.

In Belgian law, as in any jurisdiction, agency problems between shareholders can be solved by implementing contractual mechanisms which have been devised *ex ante*, such as shareholder agreements including mutual call and put options on the shares. In addition, Belgian law provides for various *ex post* mechanisms to solve conflicts. One or several shareholders representing at least one percent of the voting rights or a share of the capital equal to 1,250,000 euros can request the appointment of a third party expert if there are indications of serious damage or risk of serious damage to the interests of the company⁵¹⁴. Also, any interested party may request the appointment by the courts of a temporary administrator if the majority shareholders abuse their position or if the company's decision-making organs are blocked⁵¹⁵. Shares may also be seized by a judge so as to prevent the exercise of prerogatives and votes during shareholders' meetings and meetings of the board of directors may be annulled if they result from an abuse of their position by majority shareholders⁵¹⁶. Finally, the company may be wound up for just cause⁵¹⁷.

The sell-out right, which comes on top of these measures, can be implemented in case of conflicts between shareholders under Belgian law. Parliamentary debates prior to the voting in of the sell-out right statute show that this was devised as a mechanism to solve problems between members of closely held companies, especially family firms, in which, as discussed earlier, agency problems are rife⁵¹⁸. The statute which provides for the sell-out right, *i.e.* the right for a shareholder to compel the majority shareholders of the company in which such shareholder invested to buy his shares under certain circumstances also provides, symmetrically, for a squeeze-out right that compels a shareholder to sell his shares under certain circumstances. The squeeze-out (*exclusion*) can be triggered when shareholders, including but not limited to those who jointly hold 30% of all existing voting rights, may petition in court with just motives for a particular shareholder to be ordered to sell all of his shares to the petitioners. The sell-out right (*retrait*) may be triggered by any shareholder who petitions in court for the relevant

⁵¹⁴ "s'il existe des indices d'atteinte grave ou de risque d'atteinte grave aux intérêts de la société". See on the "expert-vérificateur", Art. 168 of the Belgian *Code des sociétés*.

⁵¹⁵ On which see, Foriers P.-A. (1992) *Les Situations de Blocage dans les Sociétés Anonymes*, RDC, 466; Malherbe P. and Gollier J.-M. (1994) *Les Procédures de Résolution des Conflits Internes. Le Retrait Obligatoire des Minoritaires*, in *Les Nouvelles Relations entre Actionnaires*, Séminaire Vanham & Vanham, 25 November 1994 cited in Georges E. (2005) *Essai de Généralisation d'un Droit de Retrait dans la Société Anonyme*, LGDJ, 117.

⁵¹⁶ See on the abuse of the majority position under Belgian law: Foriers P.-A. (1994) *Observations sur le Theme de l'Abus de Droit en Matière Contractuelle*, comment on Cass. 30 January 1992, RCJB, 189.

⁵¹⁷ See Art. 645 of the Belgian *Code des sociétés*. See also: Benoit-Moury A. (1986) *Des Justes Motifs de Dissolution des Sociétés Commerciales de l'Article 1871 du Code civil à l'article 102 des L.C.S.C.*, in *Liber Amicorum Jan Ronse*, Story Scientia, Bruxelles, 147.

⁵¹⁸ See Doc. parl., Ch. repr., 1214/5, 1989-90, cited in Georges E. (2005) *Essai de Généralisation d'un Droit de Retrait dans la Société Anonyme*, LGDJ.

shareholders to be obliged to buy all of his shares as well any convertible securities owned by him⁵¹⁹. This legal action cannot be triggered by the company or one of its subsidiaries⁵²⁰, which shows that such actions are more about solving conflicts between certain shareholders than imposing a sanction in the name of the company. Moreover, corporate funds are not affected by either procedure.

It should first be noted that the sell-out and squeeze-out rights are mechanisms that apply in closely held *sociétés anonymes* only⁵²¹. The cornerstone of the legal regime governing both mechanisms is proof of the valid reasons (*justes motifs*) underlying the relevant petitions. The definition of these reasons via the equivalent provision in Dutch law which requires the petitioner to demonstrate that the targeted shareholder's behaviour has been so detrimental to the company that the petitioner can no longer be reasonably expected to remain in the company as a shareholder, one of the main influences on the introduction of these mechanisms into Belgian law, has now been rejected. These grounds were considered to be overly vague and the intention of the Belgian legislator was that the sell-out and squeeze-out rights should be a factual aspect of corporate life, a way to solve shareholders' conflicts, and not exclusively a penalty imposed if damage was caused to the company⁵²². The same expression "*justes motifs*" is used to trigger the abovementioned winding up of companies, although the expression cannot apply in the same way to both winding up and squeeze out. If the company can be wound up for objective reasons, such as cash flow problems when financing is no longer available, this particular motive could not justify the squeezing out of a shareholder. This motive would only become grounds for a squeeze-out if the financial problems of the company could be attributed to one particular shareholder. Regarding the sell-out right, as the rationale is essentially one of protection of minority shareholders, "*justes motifs*" will be factual circumstances demonstrating that majority shareholders have abused their position vis-à-vis the minority. The following factual circumstances have been deemed valid to justify the enforcement of the sell-out right under Belgian law: in a company consisting of three shareholders with equal interests in the capital, two of them were found guilty of having conspired against the third shareholder; the refusal by one shareholder to answer questions regarding irregularities in the accounts; a shareholder who invested in a company on the condition that he would subsequently be able to buy more shares and own half of the share capital, and was later denied the right to do so; the absence of mutual trust and cooperation⁵²³. The central idea is that both the sell-out right and the squeeze-out right

⁵¹⁹ See Art. 642, para. 1 of the Belgian *Code des sociétés*: "*Tout actionnaire peut, pour de justes motifs, demander en justice que les actionnaires à l'origine de ces justes motifs, reprennent toutes ses actions ainsi que les actions convertibles en actions ou droits de souscription qu'il détient*".

⁵²⁰ See Art. 636 of the Belgian *Code des sociétés*.

⁵²¹ See Art. 635 of the Belgian *Code des sociétés*. The underlying rationale for the exclusion of public companies of the regime of the benefit of the sell out right is certainly that the situation of the shareholders of those companies cannot be as bad as that of shareholders of private companies because the shareholder of a widely held company may always find a buyer for his shares, especially if the company is listed.

⁵²² "*Le constat d'une situation de fait plutôt qu'une sanction*", Amendement Laverge and Vanthillo, Doc. Parl., Ch. Repr., 1086/2, 440, cited in Georges E. (2005) op. cit.

⁵²³ See <http://www.legalex.be>

should solve subjective problems, *i.e.* interpersonal problems between the shareholders, rather than sanction objective damages caused to the company.

The court which decides on a squeeze-out or sell-out right is bound by the contractual arrangements between shareholders aimed at restricting the transfer of shares. Pursuant to article 639, paragraph 1, of the Belgian Company Code, “the judge will see to it that the rights resulting [from shareholders agreements] are enforced when he orders a squeeze out”⁵²⁴. There are exceptions however regarding rights of first refusal and pre-emption rights: the law states that rights of first refusal in the context of squeeze-outs are not binding upon the courts. It would indeed be impossible to enforce the transfer of shares inherent in the squeeze-out if this shareholder agreement were in force. Regarding pre-emption rights, the law provides that the courts may be substituted for any party designated in the by-laws or via an agreement to set the exercise price of the pre-emption right⁵²⁵. The courts also have the right to reduce the period applicable for the exercise of pre-emption rights⁵²⁶. Following the squeeze-out, these shareholder agreements restricting the free transfer of shares are transferred to the petitioners. Finally, the statutory legal regime of the squeeze-out and sell-out right is mandatory, and no derogation can be specified in the by-laws or by contractual arrangement.

The valuation of the shares is left to the courts⁵²⁷. Statutory provisions include no details with regard to valuation methodology, however the courts may seek the assistance of an expert whose opinion is not binding⁵²⁸. In practice, petitioners will only request a squeeze-out via the courts after having themselves valued the shares that they may be forced to purchase. The courts will certainly be influenced by the petitioners’ valuation of the shares. As stated above, as a matter of principle, the courts should abide by the terms on which the parties, who know the company best, had agreed within shareholder agreements entered into prior to the petition. It therefore follows that the provisions regarding the valuation of the shares in these shareholder agreements will be useful to the judge. It can also be expected that the expert will take these contractual provisions into consideration since he takes his instructions from the courts. It is important to note regarding the valuation of shares that the price set will be objective and should not include a discount so as to constitute an indemnification for the petitioners⁵²⁹. Once the courts have ordered the execution of the squeeze-out, the petitioner must pay

⁵²⁴ Art. 639, para. 1 of the Belgian Company Code: “*Le juge veille à respecter les droits qui résultent de ces derniers lorsqu’il ordonne la cession forcée*”.

⁵²⁵ Art. 639, para. 1 of the Belgian Company Code: “*peut se substituer à toute partie désignée par les statuts ou convention pour fixer le prix d’exercice d’un droit de préemption*”.

⁵²⁶ Art. 639, para. 1 of the Belgian Company Code: “*réduire les délais d’exercice des droits de préemption moyennant un escompte*”.

⁵²⁷ Art. 640, para. 1 of the Belgian Company Code: “*Le juge condamne le défendeur à transférer, dans le délai qu’il fixe à dater de la signification du jugement, ses actions au demandeur, et les demandeurs à accepter les actions contre paiement du prix qu’il fixe*”.

⁵²⁸ Art. 962 of the Belgian *Code judiciaire*.

⁵²⁹ See Closset-Marchal G. (1983) *Éléments Communs aux Procédures ‘comme en référé’, in Le Développement des Procédures ‘comme en référé’, in L’application dans le Temps des Lois de Droit Judiciaire Civil*, Bruylant, 17.

the price and the defendant must transfer the shares to the petitioners in direct proportion to their existing stakes in the company⁵³⁰.

Belgian corporate law also provides for an objective mechanism applicable to closely held companies that is directly inspired by stock market regulations. This aims at allowing one or several majority shareholders holding more than 95% of the company's voting rights, either alone or in concert, to offer to buy out the remaining 5%⁵³¹. With the exception of shareholders having expressly refused in writing to transfer their shares under the offer, all shares not presented to the offer are automatically transferred to the majority shareholder. This differs from the squeeze-out in that there is no need to demonstrate a subjective reason as the objective threshold of 95% suffices to trigger the offer. In groups of companies, this mechanism facilitates intra-group exchanges and it is also a way for minority shareholders to exit a company in which the balance of power has moved irremediably in favour of the majority.

This brief analysis of the sell-out right mechanism under Belgian law shows that it is designed to address subjective breaches of the corporate contract and not non-faulty breaches. Apart from this difference regarding the scope of the triggering events, which is a substantial difference from the basis for the sell-out right described above, we will take inspiration from the Belgian mechanism for the general sell-out right model to be proposed below.

The control of the balance of power, implemented through an exit right for minority shareholders, belongs to those provisions in the company's organisation that cannot be expressly formulated due to business uncertainty and complexity. The control of the balance of power is therefore not the result of reasoning in terms of fairness or equity. Moreover, such reasoning is confined to the monitoring of the majority's faults and to any potential resulting damages. However, we have already seen that an efficient degree protection can only be provided if there are consequences in the event of the unrestricted exercise of majority power, even before this has caused damage to the minority's interests, *i.e.* before the value of the investment is affected. In order to understand it, it is necessary to reflect on the idea developed by Prof. P. Didier that the company's charter is an organisational contract (a contract setting up framework for an organisation and not only for a simple exchange). Viewed as an organisational contract, the company is a positive or negative sum game, therefore making reference to the Pareto

⁵³⁰ See Art. 640, para. 3 of the Belgian Company Code: "*La reprise s'effectue, le cas échéant, après l'exercice des éventuels droits de préemption visés par le jugement, au prorata du nombre d'actions détenues par chacun, à moins qu'il en ait été convenu autrement*".

⁵³¹ See Art. 513 of the Belgian Company Code: Any individual or moral entity who, acting alone or in concert, holds 95% of the voting rights of a closely-held *société anonyme*, may offer to buy all of the securities with a voting right in the company. At the end of the offer, with the exception of the securities whose owner has expressly indicated his refusal to sell in writing, all securities that have not been presented to the offer are transferred to the initiator.

optimum test, and not a zero sum game as a bilateral exchange can be. Consequently, an exit right ought to be a legal entitlement when the following sub-optimal situation occurs: one entity (the majority) cannot become better off without simultaneously making another entity (the minority) worse off. This situation would result in the breach of the implicit corporate contract on which the corporate game rests. It is therefore on the concept of efficiency rather than on that of fairness that an appraisal remedy should be based. A private company equipped with an appraisal remedy would operate as a more efficient organisation, as it would benefit from a comparative advantage in the competition for capital. The existence of the stock market thus explains the structural advantage in favour of the listed company and, reflecting this market perspective, Prof. Fischel has shown that the share price is higher for companies with an appraisal remedy than those without one⁵³². The alternative reasoning in terms of fairness, which can justify a sell-out right regime, remains correlated with reasoning in terms of persons, pursuant to which the company is a person, meaning that shareholders are amalgamated into another entity, *i.e.* the company as a legal entity. This is a legalistic, as opposed to realistic, reasoning process in that it does not grasp the real nature of the firm, including the private company, *i.e.* a nexus of markets in competition for sources of financing, on the one hand, and for the sale of their goods and services, on the other hand.

The circumstances governing the triggering of an appraisal remedy for the benefit of the minority shareholder, in U.S., UK and Belgian law, lead to the conclusion that economic criteria are to be preferred over ethical criteria if the function of this exit route really is to be a third alternative between unanimity and the majority principle, and not just a sanctioning mechanism in case of oppression by the majority. These economic criteria will ultimately be used to determine under what circumstances a sell-out right for the minority shareholder in a private company should be triggered.

In jurisdictions in which there is no general sell-out right, the introduction of such an agency control mechanism has sometimes been envisaged at the statutory level. For instance in France, the introduction of a sell-out right in the private company has already been proposed by the French Senate⁵³³ but was subsequently rejected by the National Assembly. The draft law included a provision granting an exit right to the minority shareholder of the private company in the event of wrongful or prejudicial behaviour, which would have been subjected to appraisal by the courts. Unfair conduct by both the majority and the minority would have been addressed⁵³⁴. The other circumstances leading to the triggering of the mechanism those stipulated by articles 236-5 and 236-1 of the *AMF* General Regulations, dealing with the transformation of a *société anonyme* into a *société en commandite par actions* and with circumstances in which the controlling shareholders hold more than 95% of the share capital⁵³⁵. A similar initiative was later envisaged in another bill, introduction in addition to the valid reason requirement that

⁵³² Fischel D. R., *The Appraisal Remedy in Corporate Law*, Am. B. Found. Res. J., 875, 1983.

⁵³³ Art. 30 bis inserted by the *Sénat* in the *Loi portant diverses dispositions d'ordre économique et financier*.

⁵³⁴ It was acknowledging the fact that the minority may be at the origin of a breach of the corporate pact constituting a minority abuse, *i. e.* an oppressive conduct, which may result in the mandatory sale of its shares to the majority.

⁵³⁵ See *supra* on these provisions.

the abovementioned 95% threshold requirement. However, such a regime make the private company sell-out right far too restrictive. It has already been seen that, because of its rationale, a breach of the corporate contract is not necessarily the result of a crushing majority or of wrongful behaviour.

One of the two privately-sponsored bills proposing a reform of French company law, one includes provision for the introduction of a sell-out right in the private company and one does not. There is indeed no mention of such a right in the report presented by the Paris Chamber of Commerce⁵³⁶ however a working group led by various employers' associations did at the end of 2003 suggest the introduction of such a sell-out right, as well as a squeeze-out right, into all non-listed companies⁵³⁷. Minority shareholders of unlisted companies could therefore use this right when one or several shareholders acting in concert have more than 90% of the voting rights and if the majority shareholders plan to:

- (i) hold an extraordinary shareholders' meeting to vote on significant changes to the articles of association, including changes to the form of the company and to the conditions for the transferability of the shares and voting rights; or
- (ii) decide on the sale or the contribution of all or substantially all the assets of the company; or
- (iii) decide on the reorientation of the business; or
- (iv) waive the payment of dividends during several financial years despite this being financially possible.

Majority shareholders would have to pay a price equal to the value of the shares and if no agreement can be reached on such price, the valuation of the shares must be carried out in accordance with the objective methods generally used for asset transfers, including the nominal value, the profits, the existence of subsidiaries and business prospects⁵³⁸.

The conditions for the implementation of this sell-out right show that the rationale is to attach consequences to essential alterations of the corporate contract by the majority shareholders. Under EU law, the same rationale seems to underpin a proposal by the report of the "High Level" group of company experts to introduce a sell-out right in case of restructurings. The Commission "intends to consider such

⁵³⁶ *Chambre de commerce et d'industrie de Paris*, Pour une Réforme du Droit de la Société Anonyme Non Cotée, October 2003.

⁵³⁷ MEDEF-AFEP-ANSA joint project Pour un Droit Moderne des Sociétés, November 2003.

⁵³⁸ *Ibid*, Art. 94 .

an introduction as part of the modernisation of the Second Directive, which the Commission regards as a priority for the short term⁵³⁹.

It should finally be noted that since 2002, German law provides for a squeeze-out right in private companies when the controlling shareholders hold more than 95% of the share capital⁵⁴⁰ but no sell-out right has as yet been introduced when this threshold is crossed.

CHAPTER 4 PROPOSITION OF A GENERAL MODEL OF SELL-OUT RIGHT IN THE PRIVATE COMPANY

An event triggering the sell-out right must result from the exercise of the majority principle and a breach of the corporate contract existing between shareholders. It is therefore obviously not any majority decision that will open the right for the minority shareholders to be bought out by the majority, but only any majority decision which contravenes the corporate contract. The notion of the corporate contract refers to the set of rules governing the closely held company⁵⁴¹ which consists of the company's articles of association, shareholder agreements and all decisions voted by its shareholders in general meeting which are consistent with the common interest of the shareholders to maximise shareholder value⁵⁴².

It is to the extent that there is no intentional or unintentional breach of the corporate contract that the exercise of the majority principle appears legitimate in closely held companies. The idea behind the legitimate exercise of the majority principle is the rationale of a legal mechanism applicable to listed companies under French company law. This legal mechanism provides that minority shareholders may petition the market regulator, which may in turn order the majority to buy out the minority shareholders when the share capital of the company is 95% majority-owned, a significant change is made to the articles of association, the company is to be absorbed by its parent company, most of assets of the company have been assigned, the company's corporate purpose is changed or finally when no dividend has been paid for several years. Also, according to this regulation, when the company is converted from a *société anonyme* into a *société en commandite par actions*, this being a type of company in which the corporate control cannot be challenged, then the buy-out of the minority by the majority is mandatory and not just an option. All these circumstances triggering an optional or mandatory buy-out have in common the fact that they involve a contradiction of shareholders' expectations based on the corporate contract. As such, there is no rationale specific to the stock market which would justify the non-application of this sell-out right in closely held companies. In listed companies, as in unlisted closely held companies, the sell-out right should operate within the context of the majority principle as a sanction for breach of the

⁵³⁹ Communication from the Commission to the Council and the European Parliament. Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward. P. 22.

⁵⁴⁰ *Aktengesetz*, §327.

⁵⁴¹ See O'Kelley, Jr., C. R. (1992), op. cit., 218.

⁵⁴² See Frison-Roche, M.-A. (1996) op. cit., 19. The legitimacy of the notion of shareholder value maximization is handled below.

corporate contract. The aforementioned triggering events can be categorized depending on whether they result from intentional behaviour or not. For instance, the change of corporate purpose could either be part of diligent management or a manoeuvre to channel the company's business to another company linked to the majority shareholders. The same may be said of successive majority decisions not to distribute dividends. It therefore follows that the sell-out right procedure proposed here will encompass both subjective, *i.e.* intentional, and objective, *i.e.* non-intentional, breaches of the corporate contract.

The sell-out right will be triggered for valid reasons to be assessed by the courts, thereby echoing the procedure for the early winding-up of companies pursuant to French law⁵⁴³, which gives the following as examples of valid reasons for such early winding-up: failure by a shareholder to fulfil his obligations or a disagreement between the shareholders which paralyses the running of the company⁵⁴⁴. As these are intentional breaches of the corporate contract, both events would also qualify as valid reasons for triggering a sell-out right. In the case of an intentional breach of the corporate contract, the valid reasons will in fact often correspond to the definition of abuse of position by the majority. Symmetrically, if the minority abuses its power⁵⁴⁵ by opposing a corporate decision that is consistent with shareholder value maximisation with the sole aim of promoting its own particular interests, then it has intentionally breached the corporate contract.

Other sanctions of minority abuse currently include the cancellation of the decision of opposition, payment of damages or the appointment of an *ad hoc* director to resolve the issue. However, when the opposition deteriorates into deep-seated mistrust between the minority and majority within the company, these sanctions are no longer adequate and the squeeze-out of the minority becomes more appropriate. In the same way, the abuse of power by the majority is currently sanctioned by the payment of damages by the majority to the victims - the minority shareholders⁵⁴⁶. With the introduction of the sell-out right for valid reasons, in addition to this sanction, the majority could be compelled by the courts to buy the victims out. Under French case law, majority abuse of power is defined as a decision contradicting the company's general interest, taken with the sole purpose of favouring the majority shareholders to the

⁵⁴³ See Art. 1844-7 of the French Civil Code (*Code civil*) supra:
A firm comes to an end:
1° by the expiry of the time for which it was formed, except for an extension of duration decided in accordance with Art. 1844-6;
2° by the achievement or the extinction of its objects;
3° by annulment of the firm agreement;
4° by anticipated dissolution decided by the members;
5° by anticipated dissolution ordered by the court on application of a member for just reasons, notably in case of non-performance of his obligations by a member, or of disagreement between members which paralyses the running of the firm;
6° by anticipated dissolution ordered by the court in the case provided for in Art. 1844-5;
7° "by the effect of a judgment ordering the winding-up [...]" (Act no 88-15 of 5 Jan. 1988);
8° for any other reason specified in the memorandum or articles.

⁵⁴⁴ See Art. 1844-7 of the French Civil Code (*Code civil*).

⁵⁴⁵ See Boizard M., (1988) L'Abus de Minorité, *Revue des sociétés*, 366.

⁵⁴⁶ As is the case under French law.

detriment of the minority shareholders⁵⁴⁷. If the company is considered to be a nexus of contracts rather than a fictitious structure, the determining element of this definition is the reference to the breach of equality, *i.e.* furthering goals other than shareholder value maximisation, between shareholders rather than the reference to the interest of the company. The definition of the interest of the company remains unclear in French case law since, as explained in the introduction, the debate over the existence and the definition of a company interest distinct and separate from shareholder value maximisation has not yet been settled.

Subjective triggering events would centre around deviations from the goal of shareholder value maximisation and other consequences of intentional breaches of the corporate contract, whereas objective triggering events would focus on significant changes to the corporate contract. These objective events occur because corporate statutes governed by company law, operated under the majority principle, necessarily provide that the initially unanimously agreed articles of association can be changed according to certain conditions of majority and quorum⁵⁴⁸. The fundamental idea is that it is acceptable that some minority shareholders do not contribute to the decision-making process as long as this process remains consistent with the general “rules of the game” agreed by all of the shareholders.

In the event of a subjective or objective, *i.e.* deliberate or involuntary, breach of the corporate contract, the cost of the sell-out right shall be borne by the majority shareholder responsible for the triggering events. However, how should the price to be paid for the shares be determined? If the sell-out right is to fulfil its function as a remedy, the price must not be reduced as a consequence of the controversial action constituting the triggering event. The price should therefore reflect the value of the shares immediately prior to the breach, objective or subjective, of the corporate contract. So, in English law under section 994 of the Companies Act 2006, the courts⁵⁴⁹, when assessing the value of the shares, “will be influenced strongly by a desire to avoid the valuation reflecting the harm done to the company by the conduct of which the petitioner rightly complains”⁵⁵⁰. Neither English nor Belgian law provides clear guidance as to valuation methods and timetables. The valuation date could either be the judgment date⁵⁵¹ or the petition date⁵⁵². This assessment on a *pro-rata* basis is shared with the appraisal remedy

⁵⁴⁷ “[une résolution] prise contrairement à l'intérêt général de la société et dans l'unique dessein de favoriser les membres de la majorité au détriment de la minorité”, Cass. Civ. 18 April 1961, JCP 1961, II, 12164, note Bastian D.; Grands Arrêts de la Jurisprudence Commerciale, no. 69, p. 226, note Noirel J., D. 1961, p. 661; S. 1961, 2, 57, note Dalsace A..

⁵⁴⁸ See for instance under French law: Art. L. 225-96: “Only an extraordinary general shareholders’ meeting shall be empowered to amend all the provisions of the memorandum and articles of association. Any clause contravening this rule shall be deemed non-existent. The meeting may not, however, increase shareholders’ commitments, save as to operations resulting from a legally effected reorganisation of shares.

Its decisions shall be validly taken only if the shareholders present or represented at the first time of asking hold at least one quarter of the shares carrying voting rights or, at the second time of asking, one fifth of the shares carrying voting rights. If this latter quorum is not attained, the second meeting may be postponed to a date not more than two months after the date on which it was called.

It shall rule on a two thirds majority of votes cast by shareholders present or represented”.

⁵⁴⁹ But it could also result from an agreement between the parties outside the court.

⁵⁵⁰ Davies P. L. (1997) *op. cit.*, p. 749.

⁵⁵¹ For an illustration under UK law, see *Richards v. Lundy* [1999] B.C.C 786.

⁵⁵² For an illustration under UK law, see *Profinance Trust SA v. Gladstone* [2000] 2 B.C.L.C. 516.

applied by U.S. law which requires that the shares of the dissenter be bought “at the value immediately prior to the approval or announcement of such [extraordinary] matter”⁵⁵³, although U.S. courts seem recently to have liberalized valuation methods. In French law, the fair price of the sell-out mentioned in the *AMF* General Regulations may well result from an agreement between the parties under the control of the *AMF* if the majority, and not only the dissenting minority, is eager to part. Nevertheless, in most cases the parties will not be able to reach an agreement on such a contentious issue and the intervention of a third party will therefore be necessary. In the context of the stock market, two such third parties can be identified: the financial regulator or a financial expert who will deliver a fairness opinion regarding the purchase price. Outside of the stock market, in the event of a sell-out right in the private company, the third party responsible for this valuation could be a judge, assisted by a financial expert. This is the method applicable under Belgian law, as described in Part 4, and under French law pursuant to article 1843-4 of the French Civil Code (*Code civil*)⁵⁵⁴, according to which, when no agreement can be reached by the parties concerning the price of the shares transferred, an expert must be appointed by the parties or, failing agreement, by the courts. It seems logical in the private company that the role of the market watchdog should fall to the courts. One consequence of the intervention of a third party would be that the price would reflect the value of the shares rather than the respective bargaining power of the parties. Another option would be to require a fairness opinion from a financial expert when the price is negotiated at arm's length⁵⁵⁵.

Allowing dissenting shareholders to exit the company at the cost of the majority shareholders would act as an efficient counterbalance to the majority principle. However, the shareholders, both majority and minority, have formed (or subsequently accepted to join) a company which is run pursuant to the majority principle and not the unanimity principle. Therefore, it would be a breach of the initial commitment given by a minority shareholder, who founded or subsequently joined the company, to require a buy out of his shares simply because he finds himself in disagreement with how the company is run pursuant to majority decisions. In addition to this theoretical argument, we see three practical arguments why the sell-out right should be used with caution. One is that the creditors of the company rely on the corporate capital and were the shareholders able to withdraw their contributions in this way, this could increase the future costs of borrowing. The second practical argument is that innovation, which is a growth engine for the company, and risk-taking in general would be remarkably limited if dissenting shareholders could compel the majority shareholders to buy them out. This is why the circumstances under which this sell-out right could be triggered will have to be limited to legitimate reasons consisting of

⁵⁵³ Henn G. and Alexander J. R. (1995) op. cit., p. 997.

⁵⁵⁴ Art. 1843-4 of the French Civil Code (*Code civil*): “In all cases considering the assignment of a member’s rights in the firm, or the redemption of those rights by the firm, the value of those rights shall be determined, in case of dispute, by an expert appointed, either by the parties, or failing an agreement between them, by order of the president of the court who shall decide by way of interim relief proceedings and whose judgment shall be final”.

⁵⁵⁵ The fairness opinion would help ensure the majority shareholder does not abuse of the balance of power by proposing a purchase price that does not reflect the fair value of the shares.

a major change in or intentional breach of the corporate contract. In addition, and this addresses the third issue, the decision to grant the sell-out right should not be automatic but must remain at the discretion of a judge who will assess the legitimate reasons and also to take into consideration the situation of the majority, including its financial condition. The judge, when deciding on the sell-out right, should therefore hear both parties and the majority shareholders should be allowed to present counterarguments, *i.e.* their own legitimate reasons for refusing to buy out the minority. Such reasons would obviously have to be compelling in order to ensure that the sell-out right remains a sufficient incentive for the majority.

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