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Conflict Resolution and the Role of Corporate Law Courts: An Empirical Study

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Abstract

We study private enforcement of corporate law in a civil law jurisdiction that has a relatively weak company law regime. First, we develop a benchmark for how effective the court is in resolving conflicts in a speedy and decisive manner. We base our findings on a hand-collected database of filings of legal actions brought against companies between 2002-2008. The main conclusion is that the grant of injunctive relief provides an incentive for the parties to the lawsuit to seek out settlements and thereby prevent further costly and unwanted litigation. Our results emphasize the importance of the private enforcement of intra-firm disputes and the effectiveness of a specialized court in providing protection to minority shareholders.

Keywords: legal procedure, private enforcement, corporate law, derivative actions
JEL Classifications: K22, K4, K41

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Conflict Resolution and the Role of Corporate Law Courts: An Empirical Study

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1. Introduction

The contemporary corporate governance debate is concerned primarily with the design of a legal, institutional and regulatory framework that helps protect weak and widely dispersed shareholders against self-interested managers. Since the relationship between managers and shareholders is characterized as a 'principal-agent' relationship, solving this managerial-shareholder agency problem appears to be corporate governance policymakers' long-standing dilemma for publicly listed companies. It is recognized that the equity investors in publicly held companies may encounter many complex and costly problems of shirking and opportunism on the part of directors and management. Information and collective action problems prevent close monitoring of management performance and enable directors and managers to develop a variety of techniques to tunnel assets and extract profits and private benefits from the company for their own interests.

At the beginning of the decade, corporate governance reforms dominated the policy agenda due to the wave of accounting fraud in Europe and the US. Arguably the most fundamental objective of these reforms has been to create value to the primary stakeholders of the publicly held company, i.e., the shareholders.[3] That is not to say that other stakeholders are neglected. No company ever survived that ignored the interests of employees, customers and suppliers. Until the recent financial crisis, public debate focused generally on the internal elements of the corporate governance framework that mediate in the relationship between self-interested management and weak, dispersed shareholders. This is hardly surprising since provocative comparative studies during the late 1990s argued that the greater effectiveness of the legal rules covering protection of company shareholders in common law countries compared to the rules originating in their civil law counterparts, explains the out-performance of the financial systems and equity markets in Anglo-American countries.[4]

The 'best practice' rules and principles that arise from the burgeoning corporate governance literature and reforms specifically cover the protection of shareholders in listed companies. Whilst it is well-know that the corporate governance principles specifically cover publicly held

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[3] It is widely understood that there are significant differences in the two main systems of corporate governance. See, e.g., *E. Berglöf* , Reforming Corporate Governance: Redirecting the European Agenda, 24 Economic Policy, 1997, p. 93: The market-oriented corporate model and the relationship-based (or network-oriented) corporate system. It is argued that relationship-based systems recognize the claims of non-shareholders (stakeholders) in the process of corporate governance and consequently provide a comparatively weak governance structure for monitoring and enforcement of minority shareholder rights. In contrast, the Anglo-American governance system (market-oriented model) is more attuned to the norms of shareholder wealth maximization, stringent financial disclosure and investor protection.

[4] See *R. La Porta, F. Lopez-de-Silanes, A Shleifer and R.W. Vishny*, Legal Determinants of External Finance, 52 Journal of Finance, 1997, p. 1131; *R. La Porta, F. Lopez-de-Silanes, A Shleifer and R.W. Vishny*, Law and Finance, 106 Journal of Political Economy, 1998, p. 1113; *R. La Porta, F. Lopez-de-Silanes, A Shleifer and R.W. Vishny*, Investor Protection and Corporate Governance, 58 Journal of Financial Economics, 2000, p. 3.

firms, it might be argued that they indirectly affect non-listed companies. Despite the limited market for and the restricted transferability of interests in non-listed companies, business participants, however, should be engaged in bargaining for contractual provisions that deal with the protection of a company's stakeholders. Still these contractual mechanisms are often very costly solutions due to technological limitations, private information and strategic behaviour. That is not to say that economic actors do not use contractual mechanisms to deal with the possibility of opportunistic behaviour, but the incomplete contracts paradigm asserts that business participants may not be able to contract their way into governance structures that deal with every contingency *ex ante*. Moreover, the costs of designing a contractual corporate governance structure that minimizes the expected risks of opportunism and can be enforced by judicial process is prohibitively high.

We can see that policymakers, in practice, typically assume that non-listed companies will adopt many of the 'best practice' rules and principles for publicly listed companies. They tend to leave the special needs of closely held, non-listed companies as more of a backwater. It is certainly reasonable to infer that rules and principles that ensure 1) the basis for an effective corporate governance framework; 2) define the rights of shareholders and the responsibilities of management; and 3) set out norms for enhanced disclosure and transparency, could also improve the governance of closely held companies. This leads, however, to the question of whether such a 'one-size-fits-all' approach to corporate governance regulation is justified in economic and social terms.

Indeed, non-listed companies do not always seem to benefit from the spillover effect. For instance, the compliance costs could be exorbitantly high. This is especially true of corporate governance provisions that are still being dodged by publicly held companies due to their cumbersome and time-consuming nature. Moreover, the increased information costs and uncertainty about the application of the terms by courts may have a detrimental effect on the performance of non-listed companies. It is therefore suggested that the typical organizational structure of these companies demand an approach different from publicly held firms. This is implicitly acknowledged with the financial reporting requirements for non-listed firms. An alternative approach implies varying levels of control and commitment that help firms tailor the organization of the firm to their particular needs. A distinct corporate governance framework not only helps to define the internal and external stakeholders' expectations *ex ante*, but also, and more importantly, assists judiciaries and arbitrators in solving problems *ex post*. The legal environment and civil procedures are key factors in determining the quality of the jurisdiction in which companies operate.[5]

Since these larger non-listed companies are regarded as the backbone of a robust economy, policymakers should become more aware that neglecting the governance needs of these firms will stunt productivity growth and job creation. The rapid pace of technological change and the decreasing international barriers to trade over the past decade have not only created new strategic and organizational opportunities for firms, but have also made them more vulnerable to risks. Hence, it is submitted that in order to help these companies fully exploit the new opportunities and adjust more easily to immediate uncertainty, policymakers at both a national and international level should endeavour to devise the most efficient corporate governance framework as part of their long-term strategy to foster investment, innovation and entrepreneurship. Although corporate governance reforms around the world are generally inappropriate for non-listed companies, a shift in the focus from listed companies to non-listed companies is arguably important since the preponderance of firms are not listed and ownership and control are typically not completely severed.

The purpose of this paper is to address the main corporate governance issues for non-listed companies. It will examine the diverse economic arguments for and against the importance of corporate governance of non-listed companies, thereby placing corporate governance analysis

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[5] See *A. Balas, R. La Porta, F. Lopez de Silanes, and A. Shleifer*, The Divergence of Legal Procedure, 2008. Available at SSRN: http://ssrn.com/abstract=1091232.

on a new footing. By using economic theories of the firm to identify the main problems that non-listed firms typically encounter, it is possible to identify a wide range of internal and external mechanisms that can be employed to solve the complex and costly contracting and governance problems of the firm. It is important to note that the economic models do not completely dispel or neglect the role of the law. Rather than emphasizing that a firm can emerge spontaneously without a legal governance structure, they point to the role of the law in supporting corporate governance arrangements that preserve the extra-legal mechanisms that help to lessen the costs of the bargain constraints. In this context, the incomplete contracts concept of the firm holds out several important lessons for the discussion on corporate governance of non-listed companies. In general, the influence of this concept on the discussion is twofold. First, it helps to understand the function of corporate governance in non-listed companies. Second, and more significantly in the context of this paper, it advocates which corporate governance mechanisms should be implemented in order to reduce transaction costs and solve post-contractual opportunism, such as moral hazard and hold-up problems.

This paper presents the role of the corporate governance framework of closely held companies as an incentive system and considers the variety of institutions and rules for dealing with conflicts between controlling shareholders and minority investors. We identify a wide range of mechanisms that can be employed to solve the complex and costly contracting and governance problems of the firm. These mechanisms are typically contractual in nature and include ownership structure, the board representation, financial transparency, and adequate information disclosure. Moreover, recent empirical work has pointed out that in an environment that moves towards protecting the minority shareholders' interests, the judiciary plays an important role in enforcing and further developing the corporate governance mechanisms. At first sight, the intervention of the judiciary appears to be conducive for furthering an efficient corporate governance framework for non-listed firms. Because specialized business courts can respond faster and more easily to economic and social change than legislatures, it could be argued that courts continuously develop innovative interpretations of the corporate governance rules and principles, thereby giving recommendations on how firms should implement these norms. If economic and social changes render accepted rules and standards obsolete, courts would thus be able to adjust these norms to economic and social change.[6] While previous empirical studies have shown that private enforcement of company law conflicts in civil law countries is unlikely to be popular, we hypothesize that enforcement actions commenced within the context of the Netherlands inquiry procedure will be popular since it offers parties an additional round after the fact bargaining, which enables them to negotiate their way out of the dispute.[7]

To test our hypothesis, we examine cases filed under the Dutch inquiry procedure ('*enquêterecht*') as set out in Artt. 2:344-359 of Book 2 of the *Burgerlijk Wetboek* (Dutch Civil Code, hereafter 'BW'). This involved 972 reported decisions in 323 inquiry procedure requests during the period of 1 January 2002 through 31 December 2008.[8] We point out that private enforcement is common for non-listed companies to resolve deadlock situations and minority squeeze-outs. This view is surprising since Dutch company law also offers a special procedure for facilitating buy-outs and squeeze-outs for non-listed companies. We argue that investors,

[6] See *G. Calabresi*, A Common Law for the Age of Statutes, Harvard University Press, 1982. See also *E.P.M. Vermeulen*, The Evolution of Legal Business Forms in Europe and the United States, Venture Capital, Joint Venture and Partnership Structures, Kluwer Law International, 2003.

[7] See *L.E. Strine*, "Mediation Only" Filings in the Delaware Court of Chancery: Can New Value Be Added By One of America's Business Courts?, 53 Duke Law Journal, 2003, p. 585. In this essay, Strine argues that courts should ideally assist business parties in resolving their differences by an additional round of after-the-fact bargaining initiated by the process of judge-conducted mediation.

[8] This dataset is also used by *E.P.M. Vermeulen and D.A. Zetzsche*, The Use and Abuse of Investor Suits: An Inquiry into the Dark Side of Shareholder Activism, 2009. Available at SSRN: http://ssrn.com/abstract=1428901.

despite being relatively underprotected by statutory rules, benefit from easy and affordable access to dispute resolution procedures, such as those provided by the Dutch specialized business court.

The paper is divided into 5 parts. The next part analyzes the significance of the diverse patterns of ownership and control in non-listed firms. The economic theories of the firm are taken as a starting point for identifying the set of problems that internal business participants – controlling shareholders, minority shareholders and managers – need to solve when structuring their company. It is submitted that an economic analysis sheds light on the role that a legal corporate governance framework plays in facilitating or in interfering with the internal relationship between the participants. Part 3 continues to explore the arguments for and against the importance of a legal framework for non-listed companies. Although the general view is that corporate governance is of utmost importance, the question remains of which legal mechanisms promote economic and social welfare and boost economic growth. This part identifies legal mechanisms that could be employed by policymakers, lawmakers, the judiciary and other economic actors in solving corporate governance problems. Part 4 outlines the main features of the Dutch inquiry procedure, and explains the factors giving rise to its increased use by non-listed companies. Part 5 concludes.

2. The theory of the – closely held, non-listed – firm[9]

2.1 Why should one care about the theory of the firm?

This part of the paper introduces economic concepts fundamental to the analysis of corporate governance structures that are best suited to meet the needs of non-listed companies. Understanding these concepts will enable policymakers to identify the potential tensions between the participants in these companies and assist in their resolution. In pursuing this objective, this part builds on the best available theories from law and economics. For instance, theories of the firm, which dominate the thinking of economically oriented policymakers, focus on the question of why business people either place a transaction in the market or locate it inside a firm, and what are the boundaries of the firm. More importantly, they help understand the key problems that business participants encounter and indicate what the core features of a corporate governance framework ought to be if economic and social welfare is to be promoted. Indeed, an economic analysis of closely held firms reveals the role the law must play in facilitating solutions for the corporate governance problems.

This paper focuses on the middle group of non-listed companies, such as family-owned companies, group-owned companies, private-investor-owned companies and joint ventures. These firms are deemed to be typified by: 1) a smaller number of shareholders; 2) no ready market for the corporate stock; and 3) substantial (majority) shareholder participation in the management, direction and operation of the company.

2.2 Contractual theory of the firm

Companies are generally viewed as a nexus-of-contracts. The nexus-of-contracts theory treats firms as entities that serve as a nexus for a set of relational contracts among its participants.[10] In this respect, a corporate governance framework should be viewed merely as a 'standard form contract' that represents the different points on the continuum of types of firms. This theory is arguably an appropriate and socially desirable concept, since it draws attention to the variety of

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[9] In this paper, the terms 'closely held company' and 'non-listed company' are used interchangeably. In this respect, a closely held company is a company whose shares are not generally traded in the securities market.

[10] See *C. Jensen and W.H. Meckling*, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 Journal of Financial Economics, 1976, p. 3.

needs, i.e., rights and duties, of participants involved in different companies.[11] Nonetheless, the nexus-of-contracts theory of the firm does not explain why firms require a particular type of corporate governance structure. Moreover, the theory's narrowly conceptualized assumptions – i.e., that 1) the firm is best viewed as a set of incentive contracts; 2) the function of the legal system is to supply rules and standards that are *ex ante* efficient; 3) rationally informed firm participants will bargain themselves into efficient governance structures; and 4) the firm's contracts are self-enforcing and do not require judicial enforcement – are successfully challenged.[12] In general, the complaint against the nexus-of-contracts theory is not that relational contracts are irrelevant to understanding the internal organization of the firm, but that it is difficult and costly for firm participants to write *ex ante* complete contracts inside the firm. For one thing, people intend to act rationally, but they are simply not able to foresee and describe all future contingencies in a contract. Economists claim that people are 'boundedly rational'.[13] More importantly, even if contingencies can be dealt with contractually, information asymmetries and strategic bargaining often prevent efficient and complete contracts from emerging.[14] In short, relational contracts are often incomplete due to the difficulties for the participants to 1) foresee some contingencies at the outset of the relationship; 2) specify all contingencies in the contract; 3) monitor the performance of the other participants; and 4) enforce the relational contracts.[15]

2.3 Incomplete contracts theory of the firm

Viewing the firm as an incomplete contract provides a broader understanding of the legal and non-legal mechanisms required for the optimal design of corporate governance frameworks, and, more significantly, of the importance of having corporate governance frameworks in general. Incomplete contract theories, which in many ways build on and formalize the concepts and ideas of transaction costs economics, attempt to explain how structuring as a particular type of firm deals with opportunistic behaviour.[16] Indeed, when parties can simply write a complete contract, they specify in full detail what each party must do in each state of the world and how the surplus should be shared. In practice, bounded rationality and private information inevitably entail contractual incompleteness. Consequently, firm participants may have to renegotiate the contract to react to unforeseen contingencies, which may lead to an opportunistic attempt by one of them to obtain more of the *ex post* return on investment.

The transaction cost theory of the firm essentially assumes that firm participants have less scope to act opportunistically if the transaction takes place within a firm rather than in the market.[17] However, it does not explicitly describe the mechanisms through which organizing as

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[11] See *O. Hart*, An Economist's Perspective on the Theory of the Firm, 89 Columbia Law Review, 1989. P. 1757.

[12] See *W.W. Bratton, M. Hviid and J.A. McCahery*, Repeated Games, Social Norms and Incomplete Corporate Contracts, In Ch. Willet (ed.), Aspects of Fairness in Contracts, Blackstone Press, 1996.

[13] See *O.E. Williamson*, The Economic Institutions of Capitalism, The Free Press, 1985.

[14] See *P.R. Milgrom and J. Roberts*, Economic Theories of the Firm: Past, Present, and Future, 21 Canadian Journal of Economics, 1988, p. 444.

[15] See *O. Hart*, Firms, Contracts, and Financial Structure, Clarendon Press, 1995; *B. Klein, R.G. Crawford and A.A. Alchian*, Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 Journal of Law and Economics, p. 297. Because opportunistic behaviour is often observable to the parties involved, but not verifiable by courts, relational contracts are inherently incomplete.

[16] Two forms of opportunistic behaviour should be distinguished: moral hazard and hold-up problems.

[17] *O.E. Williamson* (The Economic Institutions of Capitalism, The Free Press, 1985) argues that the combination of asset specificity, environmental and behavioural uncertainties, and transaction frequency explains the existence and boundaries of the firm. If transactions are repeated more frequently, levels of uncertainties are high and the relationship-specific investments are made, parties are better off organizing as a firm, which in Williamson's view solves the hold-up problem by mitigating opportunistic behaviour and improving investment incentives.

a firm could lead to more efficient investments. The incomplete contracts theory of the firm, on the other hand, explains in more detail which mechanisms inside the firm mitigate moral hazard and hold-up problems. The most influential theory is the Grossman-Hart-Moore framework of property rights.[18] This theory emphasizes the importance of economic ownership of physical or non-human assets in a firm. Carrying out transactions in firms solves moral hazard and hold-up problems, because the owner of the firm enjoys the 'residual right of control' over the firm's physical assets. This means that the owner has 'the right to decide all usages of the assets in any way not inconsistent with a prior contract, custom, or law'.[19] In this view, ownership is a source of power *ex post*, which fosters and protects investments and so prevents a non-owner from appropriating rents and business opportunities. Unified control over the physical assets of the firm automatically leads to control over human assets, since employees, including management teams, can be denied continuous access to the assets in which they have made human capital investments.

A basic understanding of the property rights theory makes it relatively easy to explain what the function of corporate governance is in the context of publicly held companies. A corporate governance framework determines, among other things, how control over the firm's resources is allocated, and how hierarchy is created within the firm. It acts as a facilitator, enabling managers and the widely dispersed shareholders to move towards the optimal governance equilibrium within a firm. To see this, let us consider some of the key features of company law, which is the main source of legal corporate governance mechanisms: 1) a company is a legal entity that holds the firm's assets; 2) the limited liability feature allows shareholders, many of whom are wealth constrained and risk-averse, to diversify their risks; and 3) company law creates centralized management, to which the shareholders delegate important control rights. These principles facilitate the separation of residual control from residual risk-bearing – usually referred to as the separation of ownership and control. In a publicly held company the shareholders are simply too small and numerous to exercise the residual rights of control.[20] It would be too costly if all of them were involved in decision management. Moreover, the shareholders, who are only interested in the company's share price, lack the expertise and competency to take part in the decision-making process. As a consequence, the property rights theory of the firm recognizes that delegating residual control rights is necessary to facilitate management's participation in the firm and to give management sufficient incentives to undertake relationship-specific investments.[21]

The relationship between the widely-dispersed shareholders and the managers is characterized as an 'agency relationship' in which the managers are the agents and the shareholders are the principals. From this perspective, the shareholders may encounter many complex and costly problems that need to be addressed by legal mechanisms. The delegation of control leads to substantial monitoring costs, as opportunistic managers often exploit the collective action problem barrier to effective monitoring by dispersed shareholders.[22] It is recognized that this principal-agent problem is due to managers having superior information on investment policies and the firm's prospects. Managers tend to be better informed, which allows

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[18] See *S.J. Grosmann and O.D. Hart*, The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration, 94 Journal of Political Economy, 1986, p. 691; *O. Hart and J. Moore*, Property Rights and the Nature of the Firm, 98 Journal of Political Economy, 1990, p. 1119; *O. Hart*, Firms, Contracts, and Financial Structure, Clarendon Press, 1995.

[19] See *O. Hart*, Firms, Contracts, and Financial Structure, Clarendon Press, 1995. The residual claimant receives the net income that the firm produces, i.e., whatever remains after all revenues have been collected and all debts, expenses and other contractual obligations have been paid.

[20] See *H. Hansmann*, The Ownership of Enterprise, The Belknap Press of Harvard University Press, 1996.

[21] See *P. Aghion and J. Tirole*, Formal and Real Authority in Organizations, 105 Journal of Political Economy, 1997, p. 1.

[22] Rational shareholders have incentives to free-ride on the costly monitoring efforts of other shareholders. Attempts to engage in collective monitoring will therefore fail if a few shareholders bear the entire cost, but receive only a portion of the benefits.

them to pursue their own goals without risk. Consequently, shareholders find it difficult, due to their own limitations and priorities, to prompt managers to pursue the objectives of the owners. Dispersed shareholders that are unable to solve their collective action problem assist opportunistic managers to extract private benefits of control through self-dealing. Herein lies the most important role of developing an effective corporate governance framework that provides proper incentives for the board and management to act in the interest of the company and its shareholders, and furnishes these shareholders with sufficient monitoring information.[23]

2.4 Multi owners in closely held companies

Whilst the incomplete contracts theory of the firm provides a powerful insight into how publicly held companies are organized and what the main focus of the corporate governance debate should be, it does not, correspondingly, offer a clear explanation of the problem of multi-owner closely held companies in which the identity of the shareholder is the most important characteristic. The preceding discussion suggests that multi-owner closely held companies are sub-optimal due to the sharing of residual control rights. Information asymmetries induce controlling shareholders to divert corporate opportunities for their own interests. There are a number of mechanisms that allow controlling shareholders to be able to obtain greater premium for their shares. For example, the most widely-used mechanism to accumulate control power with a limited investment are ownership pyramids or cascades which can enable shareholders to maintain control throughout multiple layers of ownership while at the same time sharing the investment with other (minority) shareholders at each intermediate ownership tier. A pyramidal structure of share holdings is a highly effective mechanism that reduces the liquidity constraints of large shareholders while it allows those shareholders to retain substantial voting power. Whereas pyramids of share stakes require smaller investment of capital (smaller cash flow rights), the large shareholder can still control his target company. In a similar vein, the issuance of dual class voting shares to separate ownership and control allows a large shareholder to transfer resources from the company. The private benefits of control are non-transferable benefits beyond the financial return on investment. Given significant holdings, the large shareholder is usually allowed a seat on the board of directors and will thus receive non-public information on the firm’s cost structure or on supply contracts of the competitors. Such a blockholder could, for example, after obtaining such strategic information, renew negotiations about the subcontractor’s price. Consequently, such transactions can lead to the creation of another kind of agency conflict, namely the oppression of minority shareholders rights. As shown above, sharing ownership rights is consequently inefficient in that the anticipation of opportunistic behaviour severely inhibits shareholders’ investments. Indeed, from an incomplete contracting perspective, ownership by more than one party is only reasonable under very restrictive conditions. For instance, a multi-owner structure may be optimal if parties merely invest physical capital (rather than human capital).

The fact that, in the real world, firms are usually structured as closely held companies casts doubt on the robustness of the Grossman-Hart-Moore conception of the firm. Indeed, parties often choose joint ownership structures deliberately to reduce hold-up and moral hazard problems.[24] The question, then, is of why business participants prefer joint ownership of the firm and its assets. First, complete integration of ownership and control may be too costly and

[23] Clearly, good corporate governance does more than regulate the ownership and control arrangements inside the firm. A corporate governance framework would not be credible if it did not affect outsiders. Not only does corporate governance provide rules and institutions that enforce the internal ownership and control arrangements, but it also contains rules that protect other stakeholders, like employees and creditors, against externalities that may arise from the opportunistic behaviour of insiders. Again, it must be noted that this paper focuses on the internal elements of corporate governance.

[24] See *B. Klein, R.G. Crawford and A.A. Alchian*, Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 Journal of Law and Economics, p. 297.

difficult. For instance, firms that are largely dependent on intellectual research and human capital and own few (if any) specific physical assets, such as professional firms and software houses, arguably do not thrive well on vertical integration. In addition, given the uncertain output and high monitoring costs within these firms, self-monitoring by team members will be a better remedy for preventing moral hazard problems.[25] Second, rather than protection against opportunism, firm participants may choose a governance structure that offers more individual adaptability – that is, a structure that gives parties the ability to adapt to changed circumstances in a more self-interested manner. Third, national laws may require that at least one of the two or more shareholders in closely held companies is a local resident. This could obviously hamper a foreign owner's preference for the integration of ownership. Fourth, minority shareholders may remain in closely held companies after delisting. Fifth, family companies in which the integration of ownership and control, which may have existed initially, has dissipated spouses and members of the second and third generations of the founding family receive ownership interests, but do not participate actively in management and leave the operations of the company to another controlling shareholder. Sixth, and perhaps most importantly, other mechanisms than integrated ownership of physical assets may protect business parties against opportunistic behaviour.

When the residual rights of control are not allocated to one owner – or, as in publicly held companies, to a homogenous and monolithic group – parties tend to rely more on implicit contracts and non-legally enforceable norms.[26] Reputation concerns and fear of retaliation and of the breakdown of the business relationship induce parties to adhere to these implicit contracts and norms.[27] Parties are sometimes inclined to abide by certain norms that encourage cooperation, because their relationship is built on trust or because acting unselfishly is embedded in the relationship. In family business, for instance, firm participants have often internalized strict norms of family loyalty, which may result in the parties reflexively making relationship-specific investments and performing satisfactorily, thereby maximizing the owners' welfare and profit.[28] In this view, the more expensive legal, monitoring and ownership, mechanisms are of secondary importance in family firms.[29] They may even have a counterproductive effect. Although trustworthy business parties may have natural preferences to act honestly, incentive mechanisms could crowd out these preferences, replacing trust in the relationship with trust in the particular legal mechanisms. They may invite initially trustworthy parties to change their attitude towards each other. Yet, the economic theories of the firm also acknowledge that legal mechanisms and institutions could help business parties limit opportunism by offering an adequate framework that provides incentives for the parties to make continuously specific, in particular human capital, investments. To illustrate this, the next part of the paper will discuss specific issues regarding the role and design of the legal framework without neglecting the function of non-legal mechanisms.

[25] See *A.A. Alchian and H. Demsetz*, Production, Information, and Economic Organization, 62 American Economic Review, 1972, p. 777.
[26] See *G. Baker, R. Gibbons, and K.J. Murphy*, Relational Contracts and the Theory of the Firm, 1997; *E.B. Rock and M.L. Wachter*, Corporate Law as a Facilitator of Self Governance, 34 Georgia Law Review, 2000, p. 529.
[27] See *R. Cooter and M.A. Eisenberg*, Fairness, Character, and Efficiency in Firms, 149 University of Pennsylvania Law Review, 2000, p. 1717.
[28] Internalized norms become part of the firm participants' characters. Violating such a norm may provoke self-criticism and guilt, thereby acting as a self-enforcing mechanism (Cooter and Eisenberg 2001).
[29] See *E.A. Posner*, Law, Economics, and Inefficient Norms, 144 University of Pennsylvania Law Review, 1996, p. 1697.

3. The Legal Framework of Corporate Governance of Non-Listed Companies

Recognition of the conflicts between controlling and minority shareholders draws attention to the need for a variety of institutions and rules for dealing with these issues. The previous part of the paper identified a wide range of non-legal mechanisms that can be employed to solve the complex and costly contracting and governance problems of the firm. However, the incomplete contracts paradigm of the firm implies that non-legal mechanisms only offer a partial solution to the corporate governance problems. To be sure, in circumstances where legal regulation would otherwise be justified, non-legal mechanisms can be of considerable practical significance in imposing costs on opportunistic behaviour. This is not to say, however, that these mechanisms are the most important factor in curtailing conflicts of interest between the controlling and minority shareholders. This part of the paper describes a legal framework that helps to define and determine the legal mechanisms of corporate governance. Business statutes and corporate governance best practices could not only provide a sound legal framework that protect stakeholders' participation and information rights, but also furnish business participants with 'off-the-rack' arrangements upon which they can fall back when establishing the distribution and allocation of powers and responsibilities within the company.

Company law, for instance, serves to facilitate the separation of ownership and control. It gives the general meeting of shareholders an *ex ante* incentive to make investments of financial capital, and delegates the residual control rights to management. In a publicly held company the shareholders are, as discussed earlier, usually too small and numerous to exercise control and be involved in the company's day-to-day decision-making process. Although company law typically limits the shareholders' ability to intervene in management's decision-making power, it would be erroneous to conclude that shareholders are deprived of every control right within the firm. In order to mitigate shareholder hold-up by management, shareholders are given, among other things, the right to elect and remove managers and the right to information and dividend. In addition, shareholders have the legal power to veto substantial asset purchases or sales initiated by the managers, such as mergers and acquisitions. Finally, company law and the extended corporate governance regulations set the internal rules for each of the participating groups within the company. How do they work? How can decisions be made? How are they represented? How can they react to unforeseen problems that are looming over the company due to bounded rationality and asymmetric information? Any set of policy recommendations should take account of the role company plays in dealing with governance needs and anticipating future conflicts within the company.

3.1 The legal source of corporate governance of non listed companies

The first part of the paper showed that, since future contingencies are uncertain and the parties' activities are practically impossible to specify or observe, these relational contracts are inherently incomplete. In order to solve the problems associated with contractual incompleteness, the firm participants can choose among different governance structures that rely more or less on 'softer' mechanisms. Obviously, integrating the ownership of the crucial assets can protect investments from post-contractual opportunism. In this case, ownership and power is allocated to the party that has the largest firm specific investment and is most crucial to the generation of surplus. The owner then has control and primary monitoring authority. Norms and implicit contracts help to ensure that both the owner of the firm and other participants inside the firm act diligently and honestly.

Multi-ownership structures prove to be very robust when relationship-specific investments are sufficiently complementary,[30] the parties are indispensable to each other, they both depend on unique resources, and sharing ownership rights is necessary due to time and wealth

[30] See *R. Hauswald and U. Hege*, Ownership and Control in Joint Ventures: Theory and Evidence, 2002.

constraints, and regulations. For instance, joint ventures often result in a synergy that can be very productive, especially when financially constrained parties seek to share risks.[31]

Multi-ownership structures are typically organized in an egalitarian rather than a hierarchical fashion. Each party usually has equal control rights over the physical assets, and share equally in profits and losses.[32] Ostensibly, multi-ownership structures work best when they involve participants of similar talents and propensities and who make similar investments.[33] However, as we have seen in the first part of this paper, parties of different productivity and capital levels use this very popular structure. The asymmetry between the owners of the company gives participants an incentive to engage in opportunistic behaviour.[34] To be sure, the participants and their legal advisors could attempt to deal with the high potential of opportunism contractually, but again these contractual mechanisms are often very costly solutions due to technological limitations, private information and strategic behaviour. That is not to say that contractual mechanisms are not used to deal with the possibility of opportunism and self-dealing transactions. However, the incomplete contracts paradigm asserts that the participants may not be able to contract their way into governance structures that deal with every contingency *ex ante*.

Accordingly, the business participants usually prefer to use a legal organizational form that defines and sets forth the ownership structure, provides important contractual provisions in advance, supports the enforcement of implicit contracts and internalized norms, and gives the business relationship legal entity status. This makes the law governing the organizational form the key for the corporate governance framework for non-listed firms.[35] The question then is: Which legal organizational form to focus on when analyzing the persistent legal features that serve to protect participants from the misconduct by fellow participants? Publicly held firms are predominantly organized as joint stock companies or corporations. The limited liability company is, however, the prevalent business form around the world.[36]

Although the development has been quite different depending on the legal system, the private company or limited liability company has been adopted in almost all countries of the world. In the United Kingdom, the private company has a single legislative base. It was initially developed in practice and later recognized by the legislature, which furnished it with certain distinct features.[37] Most countries that once belonged to the British Empire included the private company into their own company laws, as they were already familiar with basic legal principles of the donor jurisdiction. The second strand of development is the enactment of a separate statute for the limited liability company. Germany is renowned for its limited liability company (*Gesellschaft mit Beschränkter Haftung*), which was the precursor of separate limited liability company legislations throughout the European continent, Latin-American jurisdictions, Asia,

[31] See *S.A. Johnson and M.B. Houston*, A Reexamination of the Motives and Gains in Joint Ventures, 35 Journal of Financial and Quantitative Analysis, 2000, p. 67.

[32] See *E.F. Fama and M.C. Jensen*, Separation of Ownership and Control, 26 Journal of Law & Economics, 1983, p. 301.

[33] See *J. Bleeke and D. Ernst*, Is Your Strategic Alliance Really a Sale?, Harvard Business Review, 1995, p. 97.

[34] For instance, in many economic situations, business participants of different productivity and capital levels use a multi-owner structure (*K. Sherstyuk*, Efficiency in Partnership Structures, 36 Journal of Economic Behavior & Organization, 1998, p. 331). If one of the participants is more productive or makes larger investments than other, the less productive participants have an incentive to shirk, free-ride or engage in other opportunistic behaviour.

[35] Since the shares of non-listed companies are not generally traded in the securities market and share transfer deals take place outside the official exchanges, securities regulations have a minor or no role to play in providing the corporate governance framework of these firms.

[36] See Doing Business in 2009, A Publication of the World Bank and the International Finance Corporation. Available at www.doingbusiness.org.

[37] See *J.A. McCahery and E.P.M. Vermeulen*, Corporate Governance of Non-Listed Companies, Oxford University Press, 2008.

and former Socialist countries. The United States offers only a single corporate form which can be contractually tailored to the needs and wishes of closely held firms.[38]

Regardless of whether they are governed by a separate statute (the 'free-standing approach') or viewed as factual variations on or sub-type of the general corporation (the 'integrated approach'), the private company and limited liability company have developed in the image of the joint stock company with its capital-oriented structure. Since the joint stock company is designed to attract substantial amounts of capital into the firm from passive investors and, consequently, to regulate the rich and intricate principal – agency problem, this structure is poorly tailored to fit the governance needs of non-listed firms, in which ownership and control are typically not completely severed. Despite the sometimes inappropriate structure, the private company and limited liability company have nevertheless become the preferred vehicle for closely held firms.

In order to meet the needs of the specialized and idiosyncratic relationships in non-listed firms, legislative and judicial adjustments have been made in a piecemeal fashion across jurisdictions through the years. Two sets of problems have been arisen repeatedly due to the publicly held character of the limited liability company forms. The first revolved around the enforceability of contractual attempts by participants to modify and sidestep rigid rules tailored to the needs of publicly held companies. Today, most jurisdictions either provide more flexible company laws or allow non-listed firms to contract around the rules provided by the company law statute.[39] The second set of problems falls under the caption of 'protection of minority shareholders'. Case law sometimes assumes that limited liability companies and partnerships are functionally equivalent business forms with the same organizational needs. This approach is based on the assumption that business participants choose the limited liability company form over the partnership form only to take advantage of limited liability and tax benefits. Advocates often propose modifications of the exit rules of non-listed companies so that business participants would enjoy the same exit options as partners in a partnership. Moreover, they argue that shareholders in a closely held firm setting may owe each other a strict fiduciary duty of good faith and loyalty.[40]

Because it is not clear when and to what extent the partnership principles should be applied to limited liability companies, the 'partnership law' analogy may be inappropriate in this context. For instance, the judicial discretion to meddle in the internal affairs of limited liability companies might entail deficiencies and inconsistencies, in that it could limit the law's certainty and its value for larger non-listed firms. Moreover, it appears that once partnership-type doctrines are accepted in the limited liability company law, these doctrines are difficult to opt out of. Especially, inexperienced judges tend to rely on established precedents. Finally, because these doctrines are vague and open-ended, they may create confusion, thereby preventing participation of international investors.

The next section makes a fundamental break with the traditional legal treatment of the problem of 'minority oppression' in limited liability companies by rejecting the partnership analogy and will discuss in more detail which organizational and legal structures are favourable

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[38] The shortcomings of this method have been solved recently by the promulgation of highly flexible legal organizational forms, such as the Limited Liability Company and the Limited Liability Partnership.

[39] Since the European Court of Justice's judgments recently encouraged the introduction of competitive lawmaking within the European Union, the European member states increasingly allow contractual deviations from the company law statutes. See *W.W. Bratton, J.A. McCahery and E.P.M. Vermeulen*, How Does Corporate Mobility Affect Lawmaking? A Comparative Analysis, 57 American Journal of Comparative Law, 2009, p. 347.

[40] For instance, in the United States and Germany, the judiciary has viewed the private company as a 'quasi-partnership'. See *Donahue v Rodd Electrotype Co.*, 328 N.E.2d 505 (Mass. 1975) and, to a lesser extent, *Wilkes v Springside Nursing Home, Inc.*, 353 N.E.2d 657, 663 (Mass. 1976). In Germany, the German Supreme Court imposed a broad fiduciary duty on controlling shareholders of the German close corporation – *Gesellschaft mit beschränkter Haftung (GmbH)* – in the ITT case (BGH 5 June 1975, BGHZ 65, 15 (ITT).

for the development of non-listed companies in general. It is suggested that a legal framework, in which contractual, legal and non-legal mechanisms interrelate, is crucial to further stimulate the development of a good corporate governance framework for non-listed companies.

3.2 The role of company law in establishing a corporate governance framework for non-listed firms

3.2.1 Internal governance structure/board and management

Although the controlling shareholders in non-listed companies are often closely involved in management, a company law rule that provides for decentralized management directly by the controlling and minority shareholders is not optimal for larger non-listed firms that wish to attract external capital and attempt to limit their exposure to risk and opportunism through a combination of contractual measures and the active monitoring of management. The principal-agent literature shows that the failure to legally separate ownership from control will limit the benefits of specialization in the firm's decision-making. For example, if minority shareholders are prepared to undertake the financial risk for the firm's ventures, it does not necessarily follow that these members will be equally suited and talented to make appropriate management decisions about the allocation of firm resources. Second, the full integration of ownership and control means undifferentiated management decision-making, which entails a more cumbersome, costly, and restricted process. Finally, a complete shareholder dominated firm will suffer higher costs due to the absence of monitoring and intervention devices to intervene on behalf of investors. The transfer of effective control to a management team, which may be directly or indirectly related to the controlling shareholder, avoids the bureaucratic costs of collective decision-making.

Thus seen, the limited liability company can be considered as a legal organizational form providing a differentiated management and control structure in which shareholders elect directors and participate in certain fundamental decisions, and directors establish policy, select managers, perform monitoring functions, and act as the firm's agents. Because the controlling, majority shareholder elects the directors and, hence, is able to control the management of the corporation, minority shareholders are particularly vulnerable to opportunistic acts by the controlling shareholders.

Indeed, there are reasons to believe that managers who are directly or indirectly controlled by the controlling shareholder, will not always take the minority shareholders' best interests into account. Company law can help to discourage divergence from the minority shareholders' interests by providing rules that limit the managers' power to act solely on the directions and instructions of the controlling shareholder.[41] For instance, a legal rule could instruct director-managers to take into account the interest of minority shareholders and other stakeholders in exercising their powers. Moreover, shareholder approval may be required when weak management intends to enter into substantial property dealings on behalf of the company.

The safest way to ensure that the interests of minority shareholders are represented on the board of directors is the use of different classes of shares that have identical financial rights but are entitled to vote separately as classes for the election of specified numbers of board members. Another option is cumulative voting: a voting system that gives minority shareholders more power, by allowing them to cast all of their board of director votes for a single candidate. Cumulative voting, however, may easily be eliminated or minimized by the controlling shareholder. For instance, he may alter the articles of association or remove the minority

[41] It is argued that broad actual agency authority creates additional risk of opportunism, in that it fails to fully appreciate the benefits of specializing decision management and decision control The decision process could be divided into four steps: (1) initiation, (2) ratification, (3) implementation, and (4) monitoring. Steps (1) and (3) are typically allocated to the same actors and, therefore, conveniently called decision management. Steps (2) and (4) are called decision control. See *E.F. Fama and M.C. Jensen*, Separation of Ownership and Control, 26 Journal of Law & Economics, 1983, p. 301.

shareholders' director without cause and replace him or her with a more congenial person. Fact is that controlling shareholders are reluctant to adopt cumulative voting.[42] Exit rules and fiduciary duties toward the different shareholder groups appear to be better mechanisms to diminish opportunistic behaviour.

3.2.2 Exit rules

Company law default rules traditionally 'lock in' the participants by giving them only a very limited right to dissociate. This is not surprising in view of the fact that corporate laws were originally designed to reflect the needs of publicly held corporations where the public market for shares provides shareholders with an optimal escape route. The lack of a liquid market in limited liability company shares deprives the participants in such a company of an effective exit mechanism. This lock-in effect may help to prevent an abusive use of a buyout right, thereby furthering (at least to some extent) the stability of the firm. Yet both legislatures and judges have recognized that intimate and idiosyncratic relationships, which are also often organized as limited liability companies to take advantage of limited liability and tax benefits, require an investment to be less permanent. Nevertheless, this argument ignores the fact that limited liability companies are often formed by business participants that have no familial relationship.[43] A variety of legal strategies have been developed in different jurisdictions to solve disturbances among members of limited liability companies: dissolution, withdrawal and expulsion.

Corporate legislation responded by supplying a narrow dissolution and/or buyout right in the event of shareholder deadlock or illegal or oppressive conduct. For instance, the Dutch Civil Code provides special rules to resolve disputes among shareholders in non-listed companies.[44] In the Netherlands, a shareholder may institute a legal procedure resulting in a buyout against the other shareholders if his or her rights or interests are prejudiced by the conduct of the other shareholders. Shareholders may also request the expulsion of a shareholder that act opportunistically towards the company. Another example is Section 994 of the Companies Act 2006 in the United Kingdom, which states that a member of a company may file a petition for a buyout remedy on the ground that the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of some part of the members or that any actual or proposed act or omission of the company is or would be so prejudicial. Case law has gone even further by sometimes deploying a version of the partnership analogy. In this view, the corporate norms of centralized management and the principle of majority rule are conducive to minority oppression, in which case the minority may face an indefinite future. Thus, in order to protect the minority against the so-called 'squeeze-outs', judicial efforts have moved the exit rules of limited liability companies more in the direction of traditional partnership law.[45]

These highly discretionary remedies present tremendous potential for judges to err in construing the scope of the exit rules.[46] Judges and arbitrators should act with care when conferring a partnership-type right to withdraw capital from the firm to minority shareholders who bring a cause of action for oppression. Because the dissatisfied minority shareholder has an incentive to obscure the nature of the business arrangement, it is often difficult to determine the exact underlying bargaining arrangement. As judges often lack business expertise, they rely

[42] Cumulative voting allows shareholders to multiply the number of share owned by the number of board of director positions to be voted on, and then cast that number for one or more directors.

[43] See *M.M. Blair and L.A. Stout*, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law, 149 University of Pennsylvania Law Review, 2001, p. 1735.

[44] See sections 335-343 of Book 2 of the Dutch Civil Code.

[45] A squeeze-out can be defined as an action of the majority to cut the minority off from any say in management and any significant distribution of the business earnings.

[46] See *S.K. Miller*, Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem", 30 Cornell International Law Journal, 1997, p. 381.

often on notions of fairness that protect the minority interests. That is not to argue that minority shareholders can be certain that their interests will always prevail, even if the majority ignore the minority's concerns. Litigation is often too costly and time-consuming.

The absence of statutory guidance, which could be adopted *ex ante*, may have a detrimental effect on both the firm and its participants. When end-period terms are prohibitively costly to arrange *ex ante* by the participants themselves and are not easily verifiable by courts and arbitrators *ex post*, legislatures appear better suited to supplying the default rules for endgame settings. As such, the logic of providing these rules is to lower costs for the parties and to create a degree of predictability that could operate as a sanction against opportunism. Because exit mechanisms provide safety nets to ensure the parties' control rights and authority over the firm's assets, the question of which 'default exit rule' is socially efficient is crucial. The default rule must act both as an incentive instrument and as a tool to discipline possible opportunistic abuse. These rules must be designed to contribute to the optimal governance equilibrium in the firm.

What should the statutory standard form provide? Upon first inspection, two categories of default exit rule could be contemplated. First, shareholders may have the right to compel the dissolution of the firm and liquidation of its assets. Second, shareholders may withdraw and/or be expelled from the firm and receive the 'fair' value of their ownership interests. To be sure, both the dissolution and dissociation concepts may be subject to several conditions, which severely limit the voluntary and involuntary exit of participants. However, commentators have argued that in limited liability companies both the majority and minority shareholder should be locked into the business and judicial intervention should be limited.[47] The minority shareholders could use easy exit rules opportunistically. When the limited liability company lacks the liquidity to pay the leaving party the buyout price or holds specific assets that cannot easily be unbundled without significant loss of value, the minority shareholders could threaten to use the exit rules and, by doing so, force the majority shareholder to satisfy their demands. It is therefore argued that exit rights must be curbed in limited liability companies.

That is not to say that, given the limited market for and often restricted transferability of interests in limited liability companies,[48] business participants must always be locked into a very unpleasant investment in which hold-up problems abound. Obviously, the problem that arises in endgame settings can have a particularly heavy impact on both the firm and its participants. For instance, internal strife often encourages opportunistic behaviour not only by the controlling shareholder, but also by the minority shareholders. Although limited liability companies are characterized by the majority rule and statutory norms of centralized management, dissatisfied minority shareholders could attempt to obstruct a successful operation of the firm by playing havoc with decision-making processes. In order to help parties solve dissension and deadlocks, legislators could define specific rules that comprise the different involuntary and voluntary exit provisions. By providing clear rules litigation costs could be reduced, since disputes could more easily be solved at a preliminary stage before trial. For instance, the law could provide that a majority shareholder, holding more than 90% of the company's shares, has the right to expel the remaining shareholders by the payment of a reasonable price. However, these dissociation provisions are not entirely without difficulties. Thorny calculation issues, particularly concerning the valuation of interest and whether payment should be deferred, abound in these endgame settings, since it is also difficult for courts and arbitrators to verify the 'fair value' of interests. Consequently, it is submitted that statutory *ex ante* rules are also best equipped to provide guidance in relation to valuation issues. For instance, the rule could provide that dissociating shareholders receive the same amount in a buyout as they would receive if the

[47] See *E.B. Rock and M.L. Wachter*, Waiting for the Omelet to Set: Match-specific Assets and Minority Oppression in Close Corporations, 24 Journal of Corporation Law, 1999, p. 913.
[48] In closely held firms, one often finds restrictions on interest transferability. Three basic types of restrictions are commonly employed: first refusals, first options and consent restraints. See *W.L. Cary and M.A. Eisenberg*, Corporations, Cases and Materials, The Foundation Press, 1988.

company were dissolved. Goodwill will be taken into account when the buyout price is equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern.[49]

In light of the foregoing discussion, the limited liability company is best served by rules that lock-in the majority and minority participants by giving them a limited right to dissociate. This view relies on contractual arrangements by the participants themselves and on extra-legal mechanisms, such as self-enforcing norms of trust and loss of reputation, to constrain opportunistic behaviour. However, extra-legal mechanisms can lessen but not eliminate the inefficient subtraction of private benefits from the firm. It is submitted that when gains of opportunism can be very large, legal rules are needed to prevent firm participants from engaging in opportunistic behaviour.[50] As prerequisites for these legal norms of performance, minority and majority opportunism must be discouraged, and the self-enforcing character of the relationship must be preserved. In this respect, legal scholars usually point to the function of fiduciary duties.

3.2.3 Fiduciary duties

Fiduciary duties have evolved differently across a range of contexts involving different types of parties and consensual relationships. For instance, traditional partnership law has developed broad and strict fiduciary duties. Partners expect honesty, fair dealing and mutuality of effort from each other. In this view, even though partnerships can be described as contractual in the broad sense that the partners have entered the relationship voluntarily, fiduciary duties are moral concepts of the highest order, and are not contractually modifiable. These duties are necessarily open-ended standards of performance that can be separated into (1) a duty of care and loyalty, (2) a duty to disclose information, (3) a duty to preclude from self-dealing transactions, personal use of partnership assets, usurpation of partnership opportunities, and competition with the partnership, and (4) a duty of good faith and fair dealing.

Because fiduciary duties are open-ended and vague, it might be argued that a breach of fiduciary duty is often hard for an outside party such as a court to verify, and consequently will only assist in preventing opportunism to a limited extent.[51] For instance, fiduciary duties are only brought into play when the trust-based relationship breaks down and *ex post* renegotiation is cumbersome. Yet proponents of strict and broad fiduciary duties suggest that these high standards of performance have a distinct function that supplements the remedial actions provided by statute. Fiduciary duties help to foster the development and internalization of trust and norms in a particular business relationship. In this respect, fiduciary duties have a prophylactic function.

Traditionally, the broad scope of the fiduciary duties distinguishes partnerships from limited liability companies. While managers stand in a fiduciary relationship to the company and its shareholders, managers of companies appear to have a more relaxed set of fiduciary duties. In limited liability companies, the legal concept of fiduciary duty has two quite different functions. First, managers are generally expected to perform their duties with the care of a prudent person who manages his own affairs of equal gravity. Second, the managers owe the company a duty of loyalty that limits the possibility of self-dealing transactions, prohibits managers from usurping corporate opportunities and forbids unfair competition with the company. In short, fiduciary duties offer protection against the managers' pursuit of personal interest and excessively negligent behaviour. They cannot be used to discipline directors in the performance of their official duties, thereby second-guessing managers' business judgements.

[49] This example is derived from the Revised Uniform Partnership Act in the United States (§701).
[50] See *E.B. Rock and M.L. Wachter*, Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation, 149 University of Pennsylvania Law Review, 2001, p. 1619.
[51] See *F.H. Easterbrook and D.R. Fischel*, Close Corporations and Agency Costs, 38 Stanford Law Review, 1986, p. 271.

In terms of the fiduciary duties law concerning transactions with a dominant shareholder, managers are generally exposed to few risks. For instance, in the United States, courts have typically been reluctant to allow interested transactions with shareholders holding 50% or more ownership stake or exercising explicit control over the company.[52] Nevertheless, business transactions with a controlling shareholder can be justified. Arguably, clever directors and officers, given weak fiduciary duties, will initiate many of their business transactions with favoured shareholders.

It is not quite clear whether shareholders in limited liability companies owe each other a fiduciary duty. As noted earlier, in some jurisdictions courts increasingly extend the application of strict partnership-type fiduciary duties to shareholders of these companies. Because there are no capital market forces that help to constrain opportunistic behaviour, there really is something to the partnership metaphor. It might be argued that in limited liability companies, where management functions are (at least to some extent) transferred from directors to shareholders, strict fiduciary duties are justified to prevent the greater threat of opportunistic behaviour.[53] However, the convergence of fiduciary duties in partnerships and limited liability companies also seems to have its limitations. Some law and economics scholars argue that strict and broad fiduciary duties at all levels of closely held firms could be counterproductive. In this view, broad fiduciary duties could encourage parties to engage in over-monitoring at the expense of productivity.[54]

For instance, joint venture partners rely more on renegotiation and reputational incentives than vague and open-ended fiduciary duties to overcome the consequences of incomplete contracts. Moreover, they often prefer to specify their rights and duties in an agreement.[55] For instance, they usually draft explicit buyout options in the joint venture contract. Vague fiduciary duty concepts may increase the transaction costs of negotiating the terms of the agreement and even foreclose potentially productive ventures. This is especially true of joint ventures between rival enterprises that want to deal at arm's length outside the scope of the jointly held firm. These venturers normally do not want to be hampered by broad.

In light of this discussion, many legal scholars believe that fiduciary duties should vary across the type of business form. They question whether broad fiduciary duties are optimal under different circumstances and recognize that opportunism in closely held relationships is not always best addressed by imposing broad and vague fiduciary duties. They conjecture that if fiduciary duties are varied to suit various relationships, the parties' *ex ante* adoption of a particular business form sends a signal about their organizational preferences. When limited liability companies are best served by rules that lock-in majority and minority shareholders, the question arises: where does this leave the judicial role on minority protection? A possible answer to this question will be discussed in the part four of this paper.

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[52] Kahn v. Lynch Communication Systems, 638 A2d 1110 (Del 1994).

[53] This threat is perfectly described by *F,H, Easterbrook and D.R. Fischel*, The Economic Structure of Corporate Law, Harvard University Press, 1991, p. 238) ('[d]rafters of the organizing documents of a closely held corporation cannot avoid a trade-off. On the one hand, they must provide some protection to minority investors to ensure that they receive an adequate return on the minority shareholder's investment if the venture succeeds. On the other hand, they cannot give the minority too many rights, for the minority might exercise their rights in an opportunistic fashion to divert returns.').

[54] See E. Talley, Taking the "I" Out of "Team": Intra-Firm Monitoring and the Content of Fiduciary Duties, 24 Journal of Corporation Law, 1999, p. 1001. He argues that broad fiduciary duties might be inefficient as they create incentives for the business participants to spend resources on monitoring each other rather than on productive activities.

[55] See *J.A. McCahery and E.P.M. Vermeulen* (eds.), Law, Economics and Organization of Alliances and Joint Ventures, Cambridge University Press, forthcoming Fall 2009.

3.2.4 Duty of loyalty

The advantages of being locked-in do not, of course, apply across the board. For instance, judicial intervention is justified to prevent so-called non pro rata distributions that are not based on any agreement among the business participants. In so far as this principle is crucial to the strategy of allowing controlling shareholders to manage the company in the general shareholder interest, it is necessary to strictly enforce this principle. Indeed, the 'non pro rata distribution' principle corresponds with important features of limited liability company law that help to prevent the opportunistic transfer of wealth from the minority shareholders to the controlling shareholder.

Company law can play an interesting role in solving problems involving non pro rata distributions. First, it can provide the participants with a rule stating that all shareholders share in the profit in proportion to their stake in the company, unless otherwise agreed upon. In the event of dissolution, the law can provide that the residual assets of the firm – anything left after creditors are paid and other obligations fulfilled – will be divided pro rata among the shareholders. Moreover, shareholders in limited liability companies can be bestowed with a legal mechanism that give them a statutory pre-emptive right to subscribe for newly issued shares proportional to their existing shares in the capital of the company.[56] Thus seen, company law rules help to align the interests of the controlling and minority shareholders. Indeed, when non pro rata distributions are prevented, the controlling shareholder, in maximizing the value of his stake, likewise maximizes the value of the minority shares.

The duty of loyalty provides a safety valve against harmful evasion of the rules of 'non pro rata' distributions. The duty of loyalty establishes that a controlling shareholder may not profit from his position at the expense of the welfare of the minority shareholders. The duty of loyalty can operate in tandem with non-legal mechanisms, such as self-enforcing norms of trust and reputation, to curb shareholder opportunism. Apart from the unusual situations, the duty of loyalty could function well to protect investors against one-time acts of substantial self-dealing. To be sure, it has been argued that judicial gap filling is prone to error. However, it is submitted that courts can more easily determine whether financial distributions are made correctly than decide in cases involving the protection of minority shareholders' employment and decision-making rights in the firm. Practice learns that judicial intervention in the latter conflicts is usually far too complex due to unverifiable factors and could undermine the self-regulatory mechanisms required for stable, cooperative business relationships.[57]

3.2.5 Information rights

In order for the duty of loyalty to operate effectively, minority shareholders must have means to detect opportunistic behaviour by the controlling shareholder. Herein lies a second reason for intervention by the judiciary. Like the enforcement of the non pro rata distribution principle, the protection of the information rights of minority shareholders must be another important feature of limited liability company law.

Minority shareholders may gather public information and limited liability information. The main source of public information is the periodical publication of the company's annual reports. In Europe, larger limited liability companies are obliged to publish audited annual reports under law. For instance, the Fourth European Companies Directive extended disclosure requirements in general to all limited liability companies.[58] The Fourth Directive contains detailed requirements for the preparation of balance sheets, profit and loss statements, and annual reports. Moreover, the Directive requires the disclosure of transactions with related parties, such

[56] Dominant shareholders may use the issuance of new shares to expropriate private benefits from the minority shareholders. See Sang-Woo Nam and Il Chong Nam (2004) (stating that the pre-emptive rights were not well protected in the East Asian countries until very recently).

[57] See *E.B. Rock and M.L. Wachter*, Waiting for the Omelet to Set: Match-specific Assets and Minority Oppression in Close Corporations, 24 Journal of Corporation Law, 1999, p. 913.

[58] Some smaller enterprises are exempted from the publication of certain information.

as key management members and spouses of board members, if these transactions are material and not carried out at arm's length.[59] Although the Directive demands that the accounts give a true and fair view of the assets, liabilities, financial position and results of the company, the information is not always accurate. For instance, in the Netherlands, the annual accounts must be adopted by the shareholders within five months following the end of the financial year. But companies may extend this period to 13 months, which, obviously, will severely diminish the reliability of the disclosed information. Moreover, annual reports do not fully disclose information about the possible expropriation of the company's benefits. Direct and indirect transactions between the company and the controlling shareholder can affect the accuracy of the financial reports.

The inaccuracy of public information is less pressing if a minority shareholder is also a director in a company. In that case, he will be able to influence and monitor the management decisions directly.[60] Legally required shareholder approval may have the same effect. However, if minority shareholders are not in a managerial capacity or involved in the decision-making process, they are unlikely to gather the information without relying on a legal mandate. In the US, an individual shareholder is entitled to substantial information.[61]

3.2.6 Derivative actions

The enforcement of minority shareholder informational rights and the norm against non pro rata distributions are clearly important in the context of non-listed companies. Unlike their publicly held counterparts, there is generally no extensive gatekeeper system available that reduces the information asymmetry between the shareholders. Indeed, in publicly held companies, so-called reputational agents, such as investment bankers, financial media, investment advisors, corporate governance analysts, improve the monitoring and the detection of opportunistic behaviour within firms. Shareholders in non-listed companies must more rely on judicial gap-filling to ensure that their rights are protected. In order to bring an action for the controlling shareholder's breach of fiduciary duty, some jurisdictions provide for what are known as derivative suits. From the standpoint of the defendant, the incentives to bring these actions depend on the nature and character of the litigation and the size of the award. These derivative suits are brought by one or more shareholders in the name of the company and for the benefit of the company as a whole, and are an exception to the usual rule that a company's board of directors manages the company affairs. A non pro rata distribution claim falls within the realm of the derivative actions. It goes without saying that these actions are often necessary to block the attempts of controlling shareholders to profit from self-dealing transactions with the company, since the managers are often largely controlled by majority shareholders.

As derivative suits cause high litigation costs and great uncertainty, restrictions to prevent a dissatisfied minority shareholder to obstruct the successful operation of a company by acting in his own personal interest are in place in many jurisdictions. For instance, the minority shareholder is required to own stock at the time of the challenged action and throughout the suit. Moreover, although derivative suits create incentives for companies to settle the matter, settlements are often subject to judicial review. Finally, recoveries go to the company and will not benefit shareholders directly. In response, plaintiffs have sought to institute direct actions. However, since the guiding principle in limited liability companies is preserving the beneficial

[59] See Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings. This Directive entered into force on 5 September 2006 and should be transposed in the member states on 5 September 2008.

[60] It goes without saying that all members of a company's board of directors (including minority directors elected through cumulative voting) should have the right to inspect the company's accounts and books.

[61] Del. Code. Ann. tit. 8, §220(b).

lock-in effect, then it is correct to require a derivative suit in lieu of a direct suit by the minority shareholder. Under this principle, any recovery must be paid into the company's treasury and remain there until some sort of pro rata distribution is made. Courts must of course permit shareholders to bring a direct individual action to enforce shareholders' rights to inspect corporate books, pre-emptive rights, and to compel dividends. In this respect, the combination of direct individual actions and derivative suits, although costly, could enhance the protection of minority shareholders rights.

This part discussed legal mechanisms to address the problem of misconduct by controlling shareholders in non-listed companies. It is argued that when the gains of opportunism are very large, legal rules and norms are needed to prevent parties from engaging in opportunistic behaviour. As prerequisites for these standards of performance, majority opportunism must be discouraged, and the self-enforcing character of the relationship must be preserved. In this regard, we examined the function of fiduciary duties, particularly the duty of loyalty. The duty of loyalty helps to foster the development of trust and norms in a particular business relationship. It is argued that statutory rules and case law must prevent non pro rata distributions and facilitate information gathering by minority shareholders. In this respect, it is important to note that the effectiveness of courts in providing an efficient deterrent depends both on the ability of parties to bring actions and the quality of courts to resolve matters. Presumably many of the protections available to shareholders are, in practice, outside the reach of business participants due to the lack of courts' residual lawmaking powers and the substantial procedural barriers that discourage litigation.

For private companies, a fundamental issue involves how to resolve disputes among the members of the firm. For example, that the traditional derivative suit designed originally for corporations has been extended to limited liability companies without concern for its application or whether it will yield adequate results. Arguably, the remedy is unlikely to provide a good fit for closely held firms where members serve as management. Not only is there doctrinal incoherence, but some question whether this technique is too costly given the other legal remedies available to the firm.[62] In the next section, we evaluate an alternative remedy that has proven to be successful in solving conflicts among shareholders in listed, but above all, non-listed companies.

4. An Effective Court Procedure: The Dutch Inquiry Procedure ('enquêterecht')

In this section, we focus on the unique system of dispute resolution in the Netherlands which provides parties with a speedy, predictable and low-cost procedure for obtaining relief from intra-company conflicts. Unlike most civil law countries, corporate law enforcement plays an important role in constraining the oppression of shareholders in Dutch firms. For years, the Netherlands ranked consistently behind leading countries, such as the United Kingdom and the United States, with respect to corporate governance standards. This was reflected in much lower firm performance and increased cost of capital. In terms of the legal regime, the Netherlands ranked relatively low in investor protection and, in the context of listed companies, Dutch companies were seen to make takeovers very difficult to achieve.

Through institutional and legal reforms, the Netherlands has in this decade taken steps to provide better legal protection for minority shareholders and mechanisms to monitor management's actions. Starting with the introduction of the code of conduct in 2003 and amendments to the Dutch Civil Code in 2004, Dutch companies have been committed to the adoption and implementation of higher standards of governance which has impacted their performance. It could therefore be argued that the regulatory changes have significantly eroded

[62] See *L.E. Ribstein*, Litigating in LLCs, Business Lawyer, 2009. He argues that the derivative suit remedy is an inappropriate default for many non-listed companies.

the "Dutch discount" which refers to the fact that companies traded lower than their competitors abroad, due to low standards of corporate governance. Moreover, the interventions by activist investors, facilitated by the 2004 changes to the Code, have probably also served to eliminate further poor governance practices as well as lower the discount.

However, the real story here is that the Dutch Enterprise Chamber, a division of the Amsterdam Court of Appeals, and the inquiry procedure played an important role in clarifying these higher standards. After all, the improvement of the corporate governance norms comes partly from the increased recognition that, without the possibility to enforce these norms, Dutch companies would continue to suffer from poor management performance that could not be easily eliminated due to a system of weak shareholder rights and anti-takeover devices. In this context, the Enterprise Chamber's decision in the ABN-AMRO case has sent shock waves throughout the Dutch corporate community by sending a strong message by not only confirming, but also extending the 2004 legislative changes that shareholder approval is needed for major decisions of the company.[63] The Enterprise Chamber ruled that the shareholders of ABN AMRO Holding should approve the sale of its La Salle subsidiary to the Bank of America in a court-ordered shareholder vote despite the fact that the Dutch Civil Code did not explicitly require shareholder approval for a deal of that size. The Enterprise Chamber based its decision on a clarification of the open norm as defined in Art. 8 of Book 2 of the Dutch Civil Code which states that shareholders and managers should conduct themselves in relation to each other in accordance with the dictates of reasonableness and fairness.

Even though the judgment of the Enterprise Chamber was reversed by the Dutch Supreme Court on grounds that the Dutch principles of reasonableness and fairness should be interpreted strictly, it is generally accepted that the Enterprise Chamber has improved the corporate structure and governance of both listed and non-listed companies in the Netherlands. The next section will highlight the growing importance of this specialized court in resolving corporate governance related disputes in the Netherlands.

4.1 The Inquiry Procedure pursuant to ss. 344 et seq. of Book 2 of the Dutch Civil Code

4.1.1 The two-stage proceeding

The Enterprise Chamber is a specialized court which has jurisdiction when: 1) doubts arise as to whether a company is properly managed (the inquiry procedure);[64] 2) shareholders are dissatisfied with financial reporting and challenge the annual account;[65] 3) there are conflicts regarding the removal of a company's Supervisory Board organized under the Structure Regime;[66] or 5) a shareholder that owns at least 95% of the outstanding share capital seeks to freeze-out the remaining shareholders.[67] As noted above, the court has probably exerted most influence on the development of Dutch corporate law and the protection of minority shareholders in the inquiry procedure. Upon request, the court has the ability to initiate an inquiry into the policy, management and conduct of business in a company when there are well-founded reasons to believe that a company is or has been managed improperly and incorrectly. The inquiry procedure, which was first introduced in 1928 to strengthen the position of minority shareholders in Dutch listed companies, had no practical use until 1971, when an overhaul of Dutch company law laid the foundation for a popular dispute resolution mechanism.

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[63] Court of Appeal Amsterdam 451/2007 OK.
[64] See Art. 344 – 359 of Book 2 of the Dutch Civil Code.
[65] See Art. 447 – 453 of Book 2 of the Dutch Civil Code.
[66] See Art. 158 and 161a of Book 2 of the Dutch Civil Code. The Structure Regime applies to large companies in the Netherlands (roughly those with more than 100 employees and 16 million euros in capital). These companies are required to have a two-tier board structure. The directors are appointed by the supervisory board. The shareholders are only able to dismiss the entire supervisory board.
[67] See Art. 92a of Book 2 of the Dutch Civil Code.

Dutch corporate law mandates that only a narrow range of individuals are entitled to request an inquiry procedure.[68] Besides the public prosecutor (for reasons of public interest) and labor unions (for employees' interests), the most important constituency allowed to request an inquiry procedure are shareholders (or depository receipt holders) alone or collectively owning at least 10% of the outstanding shares (or depository receipts, respectively) of a company or shares with a nominal value of €225,000, or such lesser amount as is provided by the articles of association. The inquiry procedure contains two stages. In the first stage, a party may request an inquiry into the affairs of the corporation to determine whether the company has been mismanaged. If the Enterprise Chamber shares the applicant's concerns, it will appoint one or more individuals who will conduct an investigation and file a report with the court.[69] In the second stage, the Enterprise Chamber may be requested to take certain measures provided that improper conduct and mismanagement follows from the report.[70] The measures include 1) the suspension or dismissal of board members; 2) the nullification or suspension of board or shareholder resolutions; 3) the appointment of temporary board members; 4) the temporary transfer of shares; 5) the temporary deviation of provisions of the articles of association; and 6) the dissolution of the company.[71] The company or the applicants may appeal to the Supreme Court on legal grounds.[72] On appeal, the Supreme Court will not review the factual findings and background of the case. Table 1 summarizes the number of inquiry procedure requests and measures that have been brought by listed and non-listed companies to the Enterprise Chamber.

Table 1: Inquiry Requests and Measures (1971-2007)

	First stage		Second stage		
	Written request	Request sustained	Request to conclude mismanagement	Mismanagement	Final measures
Listed companies	31	22	15	9	6
Non-listed companies	479	294	92	71	61

Adapted from K. Cools, P.G.F.A. Geerts, M.J. Kroeze and A.C.W. Pijls, Het recht van enquête, een empirisch onderzoek, 2009.

Judging from the number of cases in the period 1971-1994, the inquiry procedure initially played a modest role in the development of company law and the reduction of managerial agency costs. Firstly, the lengthy and formalistic two-stage procedure rendered immediate responses to practical needs in a dynamic and ever-changing business environment impossible. Secondly, the limitation on the number of measures that the Enterprise Chamber could order constituted another reason for the initial caution in employing the inquiry procedure. If for instance a conflict between shareholders caused the mismanagement of a company, the court's discretion was limited to ordering the temporary transfer of shares to a nominee. This limit prevented the court from effectively resolving the dispute. Finally, the uncertainty about the

[68] Art. 345, 346 and 347 of Book 2 of the Dutch Civil Code.
[69] See Art. 350 of Book 2 of the Dutch Civil Code.
[70] Each case could generate several decisions, such as a preliminary measure, a final measure, the appointment of one or more persons to undertake an inquiry into the policy and conduct of the company, or the determination of the maximum amount of the costs of the inquiry.
[71] See Art. 356 of Book 2 of the Dutch Civil Code. Table 1 shows that only 6% of the requests in the context of listed companies (this is 13% in the context of non-listed companies) will result in a final measure. If we analyze our dataset for the period 2002 – 2008, we find that the appointment of temporary board members is the most popular measure (28%), followed by the suspension or dismissal of board members (23%), the temporary transfer of shares (18%), the nullification or suspension of board or shareholder resolutions (17%), the temporary deviation of provisions of the articles of association (11%), and the dissolution of the company (3%).
[72] See Art. 359 of Book 2 of the Dutch Civil Code.

application of the vague and open 'improper management' standard tempered the initial success rate of the inquiry procedure.

However, as case law expanded, the certainty, predictability and speed of the inquiry procedures increased (see Table 2). A close analysis of the decisions into the inquiry procedures show that the Enterprise Chamber defined a number of situations in which there are reasonable doubts whether a company is properly managed. A large percentage of these actions involve conflicts with minority shareholders in non-listed companies. Most actions arising in the Enterprise Chamber involve the following conflicts: (1) a deadlock in the decision-making process of the company; (2) if management fails to disclose vital information to the minority shareholders; (3) if conflicts of interest between managers and shareholders have arisen or where not properly countered by the company; (4) if the company does not comply with the disclosure and accounting requirements; (5) if the company has no or an unfair dividend policy; (6) if assets are being removed or reallocated to the detriment of the shareholders or other stakeholders of the company; and (7) if decisions of management are challenged as being inconsistent with the rules of the Dutch Corporate Governance Code.

Table 2: Length of the Inquiry Procedure

Period	Non-Listed Companies		Listed Companies	
	Number	Length	Number	Length
1971-1994	99	-	4	-
1994-1999	80	mean 704 median 490	4	mean 1858 median 2024
2000-2007	300	mean 440 median 265	23	mean 564 median 447

Adapted from K. Cools, P.G.F.A. Geerts, M.J. Kroeze and A.C.W. Pijls, Het recht van enquête, een empirisch onderzoek, 2009.

4.1.2 The Injunctive Relief

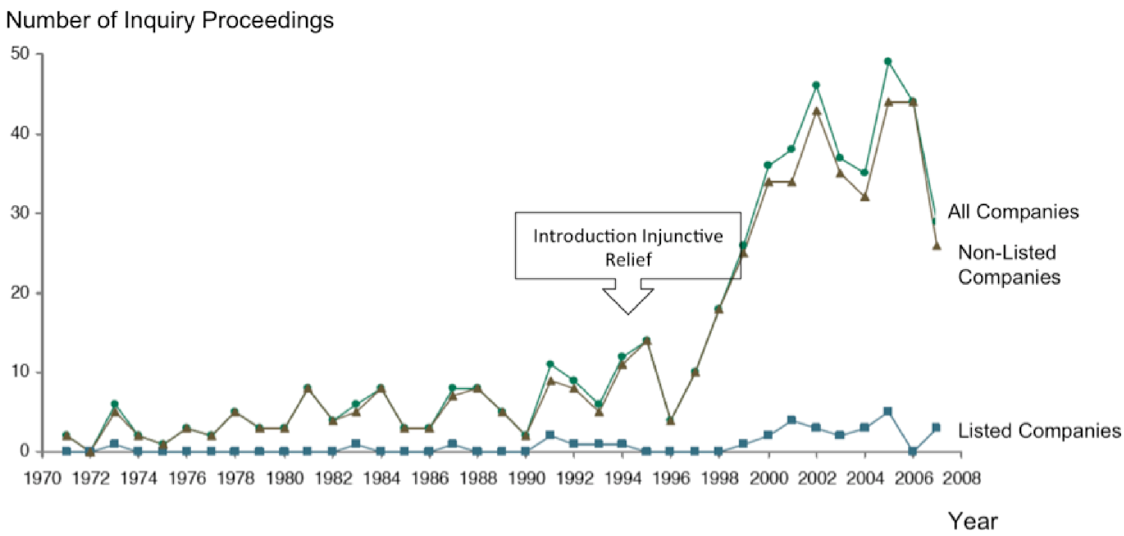
In 1994, the implementation of an injunctive relief in Art. 349a (2) BW gave rise to the current popularity of the Enterprise Chamber (see Figure 1). Pursuant to Art. 349a (2) BW, 'where an immediate remedy is required in connection with the condition of the company or in the interest of the inquiry, the Enterprise Chamber may at any stage of the proceedings, upon the application of the persons that requested the inquiry, order preliminary injunctions for the duration of the proceedings at most'. Since then, an application for an injunctive relief was the rule rather than the exception. In the period 2000-2007, out of 23 inquiry requests with respect to public companies, an injunctive relief was asked in 21 of these cases; a preliminary remedy was granted in 57% of these cases. In the context of close corporations, 234 injunctive reliefs were requested in 300 cases with a 'success rate' of 47%.

The 'fast-track' procedure under Art. 349a (2) BW is characterized by speed and informality. Even though the formalistic two-stage inquiry continues after the court has granted an injunctive relief, the preliminary nature of the decision furthered the judiciary's ability to assist in resolving the issues caused by the alleged improper management of the company. Data on the number of days before an injunctive relief bears this out. During the period of 2002-2008, the average number of days before injunctive relief is granted is 5 days for listed and 72 for non-listed (see Table 3). On both counts, the procedure offered is clearly efficient for shareholders. We speculate, moreover, that the process is much quicker for publicly listed companies due to the amount of media attention and greater pressure that can be exerted by institutional investors involved in the matter.

Table 3: **Number of days before an injunctive relief is granted: 2002-2208**

	Mean	Median
Listed Companies	5 days	4 days
Non-listed Companies	72 days	65 days

Figure 1: Popularity of the Dutch Inquiry Procedure



Adapted from K. Cools, P.G.F.A. Geerts, M.J. Kroeze and A.C.W. Pijls, Het recht van enquête, een empirisch onderzoek, 2009.

In terms of relief, the Enterprise Chamber has full discretion to order any preliminary remedy as it sees fit. The most popular remedies for publicly listed companies are: (1) the appointment of independent board members; (2) the prohibition of voting on particular agenda items; and (3) the deviation from the articles of association.[73] Conversely, the preliminary remedies which are most popular for non-listed companies include: (1) suspending directors; and (2) suspending shareholder resolutions.[74] These results confirm our hypothesis that the inquiry procedure is not limited to mere after-the-fact adjudication. The evidence, moreover, indicates that the Enterprise Chamber procedure assists the parties in overcoming their differences by promoting informal and supposedly efficient solutions. These non-formalistic remedies offer parties an additional round of after-the-fact bargaining either by themselves or under the supervision of independent observers. The principle of fast, informal and what we call judge-initiated 'mediation' or 'conciliation' appears to be very attractive to minority shareholders.[75] In many cases, after the injunctive relief, the company and its shareholders tend to follow the preliminary relief or settle their disputes amicably under the 'supervision' of the Enterprise Chamber. In the context of non-listed companies, 120 out of 309 disputes in the period 2002-2008 were settled and published by the Enterprise Chamber.

[73] The list is derived from our dataset including both listed and non-listed companies that were not involved in bankruptcy proceedings. In the period 2002-2008, the Enterprise Chamber granted more than 130 preliminary reliefs.

[74] Since the inquiry proceeding is often used in non-listed companies to resolve deadlock situations and minority squeeze-outs, the majority of resolutions that are either reverted or suspended include shareholder resolutions.

[75] This is true for both listed and non-listed companies, It appears that the inquiry proceeding is a very attractive mechanism to resolve deadlock situations in closely held corporations.

4.1.3 Discussion

The effectiveness of the Dutch inquiry procedure contrasts sharply with the dominant view of court intervention in intra-firm disputes. As discussed in part three of the paper, the common view is that ex post adjudication is not only costly and time-consuming, but may also be prone to error. Judicial intervention can create a potential judicial wild card that creates costly uncertainty. It is submitted that whilst intra-firm controversies are often observable to the exasperated parties, they may not be easily verified by a judge, and even less so when personal relationships in the family or between friends are involved. The difficulty in predicting the judicial outcome explains why in most jurisdictions relatively few disputes seem to end up in court.[76]

To see this, we can look to the special rules that the legislature in the Netherlands and the United Kingdom have introduced to resolve disputes among shareholders in non-listed companies. The Regulation of Disputes in the Netherlands, as discussed in section 3.2.2, is a lengthy procedure which leads to thorny valuation discussions. It should come as no surprise that since the introduction on 1 January 1989 only a small number of approximately 15 dispute resolution procedures have been brought to court. The same goes for the UK decisions on statutory petitions for relief from unfair prejudice. As discussed, under section 994 of the Companies Act 2006, a party may petition the court for relief in cases that the companies' affairs have been conducted in a manner is considered unfairly prejudicial to some of the interests of some members of the firm. This remedy has also provided a less than effective mechanism for firms to limit oppression in the context of non-listed companies (see Table 4).

Table 4: 'Unfair prejudice' decisions 1998-2006

Year	Unfair prejudice petitions in non-listed companies
1998	2
1999	11
2000	11
2001	13
2002	6
2003	14
2004	15
2005	10
2006	13

Adapted from *J. Armour*, Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment, 2008. Available at SSRN: http://ssrn.com/abstract=1133542.

Recall that the Company Law Review Steering Group earlier anticipated that judicial gap filling may create costly uncertainty and recommended that the 'unfair prejudice claim' under section 994 of the Companies Act 2006 (previously section 459 of the Companies Act 1985) should be limited in scope. Understandably, UK lawmakers chose to adopt a more restricted access to the adjudication of these conflicts. The relative success of the Enterprise Chamber in inquiry procedures – compared with the lower incidence of cases and success rate involving unfair prejudice in the UK – shows the potential difference in performance between specialized courts and a more general commercial law court regime.

The quality of the Netherlands Enterprise Chamber can be evaluated in terms of five key factors: (1) their integrity and speed; (2) their level of deference to insiders; (3) their ability to

[76] Cf. Easterbrook and Fischel (1986: 287) (noting that the available economic models of litigation indicate that the more trouble parties have in predicting how a judge will decide, the less likely they are to resolve their differences short of litigation, even when there are only two parties).

focus on the key underlying issues before them; (4) the degree of formalism in their decisions; and (5) the concern they have for the effect of their decisions on other corporate actors. In making an assessment, we observed that the very few courts are able to respond as effectively (in terms of time) to matters presented for adjudication. Not only do parties benefit – from a cost standpoint – from lower litigation costs, but they also benefit from the consistent quality of the decisions rendered by the Chamber and the inducement to settle matters in a more informal setting. As we have seen, this situation applies to both types of companies and has displaced the specialized squeeze procedure for non-listed companies as a consequence. Second, our results show, that with respect to the level of deference with respect to insiders that the risk that controlling insiders face – with regard to claims – is relatively high. Our evidence shows that with regard to non-listed companies, most inquiry procedures are heavily tilted against the interests of controlling majority shareholders. The Enterprise Chamber is highly focused and effective in responding to the requests of the parties involved. While we do not offer an optimal rate on the responsiveness of the court to requests, it is crucial to note that the appeal rate to the Netherland Supreme Court on legal error is low.[77] Fourth, the Enterprise Chamber is highly flexible, as noted above, in its use of remedies and procedure. This can be seen by virtue of the Court's reliance on the open norm of 'reasonableness and fairness.' Finally, while the Enterprise Chamber is an effective body in obtaining amicable settlements (suggesting that a case specific approach), its well-recorded practice of reaching out for more significant matters, such as in the ABN-AMBRO case, shows the concern for moving beyond the quotidian conflicts to precedential issues that will shape the corporate law landscape.

5. Conclusion

This paper has shown the importance of the major corporate governance techniques for non-listed companies. Minority shareholders' interests can be protected by rules that restrict managers' power to act in response to directions given by controlling shareholders. More effective lock-in rules and squeeze out regulation, for instance, are highly important for promoting share transfers and investment in these companies. To ensure, moreover, both continued investment and minority protection, it is desirable that the lawmakers devise clear and precise valuation methods and procedures that are un-cumbersome. At the same time, fiduciary duties can play a role in preventing non pro rata distributions. But, open-ended fiduciary duties in markets with less experienced courts and legal systems may prove less effective. Yet the duty of loyalty provides an important safety mechanism to protect investors against the abusive tactics of controlling shareholders. From the perspective of emerging and transition markets, however, these duties are not easily enforceable unless they are clearly enunciated as formal legal rules.

We also focused on disclosure and transparency which are fundamental elements in any corporate governance system. If these regimes are still in an early phase of development, it is vital to re-direct attention to individual shareholder rights and information rights. A very important way to ensure the ability of shareholders to employ legal techniques is to secure accurate and timely information on the financial affairs and performance of the company involved. To be sure, the strength of the shareholders' rights depends largely on the regular disclosure to authorities. However, the drawback of public disclosure is that it may not be able to inform investors of potential conflicts or company performance due to a variety of bottlenecks in its transmission. It is therefore necessary to enhance individual information rights, through a direct action, by ensuring the right of inspection of company ledger, books and other records.

Enforcement is another approach to protect investors in non-listed companies. Investors are likely to resort to this mechanism if other gatekeepers, like the reputational agents mentioned

[77] It appears from our dataset that in approximately 3% of the total requests in the period between 2002 and 2008 parties have appealed to the Supreme Court.

above, are insufficient. Given the limitation of direct actions by individual shareholders, it is important to enforce the principle of non pro rata distribution on behalf of the company. Derivative suits provide minority investors with the possibility of clawing back their investment appropriated by managers or controlling shareholders. The success of these actions depends on investors' access to information, the incentives provided to lawyers and the sophistication of the court system. Even where the court system is sophisticated and operates in a business friendly environment, we have shown that actions involving relief for minority investors are often frustrated due to costly and burdensome procedures and the tendency for general courts to become professional treadmills.

This paper points out the importance of a specialized business court, such as the Dutch Enterprise Chamber, in providing a high level of minority investor protection despite the relative weakness in the company law regime. By choosing to intervene in disputes to determine whether misconduct took place, and resolve in a speedy and decisive manner, the Enterprise Chamber has gradually increased its ability to improve the corporate governance environment in which firms operate. This conclusion is reinforced by our findings which show that the court, through its inquiry procedure, has become a leader in the resolution of disputes against controlling shareholders of non-listed companies. We show that the grant of injunctive relief may induce business parties to seek out settlements of conflicts that might otherwise end up in further expensive and unwanted litigation. During the period of 2002-2008, for example, we found that the Enterprise Chamber settled approximately one-third of the more than 300 disputes involving non-listed companies which came before it.

The effectiveness of the Dutch inquiry procedure contrasts sharply with conventional views of court intervention in intra-firm disputes. While most commentators point to the error-prone, costly and time-consuming aspects of ex post adjudication, we demonstrate, in contrast, that intra-firm controversies can be effectively resolved by a specialized court without the characteristic difficulties typically associated with legal disputes that seem to normally end up in courts.

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