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Welfare, Fairness and the Role of Courts in a Simple and Flexible Private Company Law*

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Abstract
The author highlights the pivotal role of justice in flexible and simple corporate law. He focuses on the significance of the notion of reasonableness and fairness in corporate law and on the way in which the fundamental rights embodied in the European Convention on Human Rights influence the relations between the shareholders within a company. He is of the opinion that reasonableness, fairness and fundamental rights will remain lasting elements of Dutch company law. A consequence of this trend is that courts will play a pivotal role in corporate law.

Keywords: flexibilisation of private company legislation, reasonableness and fairness, fundamental rights, minority shareholders and exit rights.

> To put it simply, I watch like others for signs that the leadership of civilisation by economics … is working in some satisfactory way. After all, leading society through a prism of economics has been an experiment never tried before.[1]

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[1] John Ralston Saul, *The Collapse of Globalism and the Reinvention of the World* (London, Atlantic 2006) p. xi.

1. INTRODUCTION

Over the last few decades, one of the most noticeable traits of Dutch corporate law is the fact that the legislator uses corporate law to realise certain political goals. In the 1960s, for example, one of the key policymaking goals was to establish employee participation in the corporate decision-making process. In the Netherlands, the pursuit of this idea – or better yet ideal – has been rather successful. By the 1970s, a supervisory board with a complicated system of workers' representation was introduced in Dutch corporate law.[2] This arrangement remains in force, despite having been modified by amendment. Today, these provisions cause us some trouble, because we have for several reasons lost faith in the effectiveness of the participation of Dutch employees in the corporate decision-making process. Thus, our concern nowadays is how to abolish these complicated rules on worker participation in a decent way. We have relatively little experience with such matters.

About a decade ago, it occurred to the Dutch legislator and many other legislators that corporate law could be used to enhance economic activity and entrepreneurship. Not only did this view lead to an endeavour to restrict the possibility of using anti-takeover measures for a company when faced with a hostile bidder, but, even more importantly, it has given rise to reform of Dutch corporate law, which seeks, among other things, to make Dutch private company law more simple and flexible.[3]

Ultimately, I expect the result of such an economically inspired approach to corporate law reform to lead to improved shareholders' rights, especially for minority investors, and more freedom of contract, and that our legislator will to a certain extent retreat from the corporate law domain.[4] In effect, the company will become a less regulated entity with more autonomy for its shareholders, especially the majority shareholder. In my opinion, this result can be traced back to the influence of neo-classical economic thinking. Indeed, this highly abstract theory still dominates economic thinking. From this perspective, the point of departure is the autonomy of shareholders and faith in market efficiency. The bottom line, then, is that the autonomy of the shareholders and market efficiency create a stronger demand for as much freedom of contract in company law as possible.

In my view, few objections can be raised against the use of corporate law for the realisation of political or economic goals that the legislator deems appropriate

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[2] Sections 152-164 and sections 262-274 of Book 2 of the Dutch Civil Code.

[3] I refer to the various drafts which have been published by the Ministry of Justice, available at: <http://www.minjus.nl>.

[4] On this topic, see Kenneth Dau-Schmidt and Carman L. Brun, 'Lost in Translation: The Economic Analysis of Law in the United States and Europe', 44 *Columbia Journal of Transnational Law* (2006) p. 606.

at a certain time for the general well-being of our society. In the longer run, such a use of company law seems unavoidable in a democratic society, particularly where economic considerations have become more and more important in many fields, including healthcare and education. So what is the result? The cost of this trend could be that corporate law will lose some of its original sacredness and timelessness and that the law-making process becomes a tool for social engineering. Although sceptics may doubt the wisdom of this new direction in the corporate law-making process, I do not think this is wrong in itself.

In addition to the above considerations, it is worth remembering that companies traditionally function in an environment that requires management to act efficiently. Predictably, this makes it necessary for companies to be efficiently organised. This explains why, around the globe, the corporate lawyers who produced the legal framework for companies created certain features in order to make the company form more attractive for use in business. Some of these features were developed in the nineteenth century. In the twentieth century, others were eventually added. The main features include: the concept of legal personality, limited liability for shareholders, the transferability of shares, centralised and autonomous management, profit rights for shareholders, a certain say for shareholders in the company, the admission of the concept of groups of companies and the freedom to reorganise companies, *inter alia*, by means of mergers, split-ups and conversion. It is widely acknowledged that these features have contributed greatly to promoting economic activity in the form of a company.[5] The success of the company around the globe during the last 150 years can be traced back to these features of the company.

2. BEYOND ECONOMIC EFFICIENCY

Although corporate law may function as an instrument to enhance economic activity, it should in my view always guarantee an acceptable level of integrity. This would effectively establish the idea of justice in corporate law. Even though this may seem self-evident, however, I doubt whether this is really the case. Let me quote the first sentence of an American book that has recently been published:

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[5] See, for instance, John Micklethwait and Adrian Wooldridge, *The Company: A Short History of a Revolutionary Idea* (London, Phoenix 2005) at p. xv: 'The most important organization in the world is the company: the basis of the prosperity of the West and the best hope for the future of the rest of the world', and at p. xxi: 'The limited liability corporation is the greatest single discovery of modern times.' For an older book in which the importance of the company was underlined, see G. Ripert, *Aspects juridiques du capitalisme moderne* (Paris, Librairie Générale de Droit et de Jurisprudence 1946). See especially chapter II: l'ère des sociétés par actions.

> Our thesis is that social decisions should be based exclusively on the welfare of individuals – and, accordingly, should not depend on notions of fairness, justice or cognate notions.[6]

It may not be surprising that, as an old fashioned Dutch – or worse European – corporate lawyer with a predilection for a systematically practised law, I do not agree with this thesis. On that basis, we need a corporate law regime that is more than just economically efficient. There is not one universal model of corporate law, particularly where the interests and visions of people differ greatly within our society and from society to society. Clearly, the interests of a majority shareholder will not be the same as the interests of minority shareholders, and these differences must consequently be taken into account, for example, when structuring best practice codes. Irrespective of how economically sound and efficient certain decisions may be, it is precisely this wide diversity of interests and visions which demands that the decisions of a corporation should be subject to a test of fairness and carefulness. Hence, corporate law should, in my view, be based on a pluralistic approach, embracing the overarching principles of economic efficiency and justice. In addition to this, I would like to argue that our type of society, with its emphasis on efficiency and individualism, requires binding notions such as the general interest, the interest of the company and justice in order to continue to function satisfactorily.[7]

In this essay, I would like to highlight the pivotal role of justice in corporate law. I would like to focus on two legal concepts in order to draw attention to the significance of the notion of justice in Dutch corporate law. The first is the notion of reasonableness and fairness in corporate law, and the second notion refers to the way in which the fundamental rights embodied in the European Convention on Human Rights influence the relations between the shareholders within the company. Both notions (reasonableness and fairness as well as the fundamental rights) concern doctrines that continue to be highly relevant despite today's strong focus on the economic basis of corporate law. Should the principles of 'reasonableness and fairness' and 'fundamental rights' find an important place in a newly deregulated Dutch corporate law – and I expect that they will – I predict that the courts and judges generally will play an important role in Dutch corporate

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[6] See Louis Kaplow and Steven Shavell, *Fairness versus Welfare* (Cambridge, MA, Harvard University Press 2002). A well-known comparative law book – Reinier Kraakman's *The Anatomy of Corporate Law: A Comparative and Functional Approach* (New York, Oxford University Press 2004) – seems to take the same approach: 'more particularly, the appropriate goal of corporate law is to advance corporate welfare of a firm's shareholders, employees, suppliers and customers…' (p. 18).

[7] On this theme, see the excellent essay by the American historian James C. Kennedy, *De deugden van een gidsland, burgerschap en democratie in Nederland* (Amsterdam, Bakker 2005).

governance and law. I expect that a stronger orientation of corporate law on economic efficiency will underline the significance of concepts such as 'reasonableness and fairness' and 'fundamental rights'. Concepts like 'reasonableness' and 'fairness' can correct 'economic outcomes', the result being that parties, in particular minority shareholders, will seek recourse to the courts to determine whether 'reasonableness and fairness' and 'fundamental rights' have been violated in a particular case. Only the courts can fill in concepts like 'reasonableness and fairness' and 'fundamental rights' on a case-by-case basis.

In making these points, it is necessary to state that one of the ideas of which I am convinced is that, with the legislator retreating, the judge will have to take over its role in upholding notions of 'reasonableness and fairness' and 'fundamental rights' as boundaries of what is allowed in corporate law.

It is important to highlight another point as well. With a more liberal corporate law, disputes between shareholders and management in closed corporations will be less frequent. The powers of the management board will be reduced to the extent that the shareholders' meeting will gain powers. Naturally, disputes between management and shareholders are typical under 'old' Dutch corporate law. However, I expect that conflicts between minority and majority shareholders will become more frequent under the 'new' legislative regime. This is likely to be the case, as shareholders will become more powerful. This will lead to conflicts regarding the division of the newly acquired power. Thus, minority shareholders will appeal to the courts more frequently, invoking concepts such as reasonableness and fairness and fundamental rights. Now, I shall illustrate my expectations with examples taken from the current project to make the legislation applicable to Dutch closed companies more simple and flexible.

3. REASONABLENESS AND FAIRNESS

Our company law provisions are located in Book 2 of the Dutch Civil Code. A key provision of this part of our Civil Code (paragraph 8) reads as follows: 'Everyone who is involved in the organisation of a company by virtue of the legislation or the articles of association should, in acting towards one another, observe the requirements of reasonableness and fairness.' In addition to this, paragraph 8 also states that a court may deviate from a statute or the articles of association if the observance of the statute or the articles of association would be unacceptable according to the requirements of reasonableness and fairness. Dutch corporate lawyers consider these paragraphs important, because a private company may have a long existence. As a consequence, the company is often viewed as an 'incomplete contract', as there are few or no adequate provisions to address all kinds of unexpected events or developments, such as misconduct of the majority shareholder. Thus, provisions in the articles of association or the shareholders' agreement that were once fair may through a change in the circumstances

and the passing of time become unfair. In turn, judges in the Netherlands may in such cases disregard these contractual or statutory provisions, and in practice they sometimes make such decisions. Because Dutch courts take the principles of reasonableness and fairness seriously, we find that articles of association and shareholders' agreements tend to be much shorter in the Netherlands compared to their Anglo-American equivalents.

In order to fully grasp the importance of the concept of reasonableness and fairness in Dutch corporate law, I should note that, in several of its decisions, the Dutch Supreme Court has stressed that the concept of reasonableness and fairness should not be applied extensively in professional relations. Thus, it should be stressed that something must go seriously wrong before a paragraph of a contractual agreement or the articles of association will be disregarded by a Dutch court.[8]

The Dutch law reform project designed to make Dutch corporate law more simple and flexible currently has no plans to abolish paragraph 8, which establishes reasonableness and fairness as fundamental concepts. In my view, that is also not really possible. The Companies and Business Court in Amsterdam is an important court for Dutch corporate law matters. It adopts decisions that may often be viewed as guiding. Very often these decisions are ultimately inspired by or based directly on the principles of reasonableness and fairness. In this sense, the Companies and Business Court plays a role that is comparable to that of the Chancery Court. Clearly, Dutch corporate law is not able to function well without the concept of reasonableness and fairness as laid down in paragraph 8.[9]

When considering ways to make Dutch corporate law more simple and flexible, it may help to acknowledge that a distinction exists between welfare and economic efficiency, on the one hand, and fairness, on the other hand. I would like to defend the view that ample consideration should be given to this contrast in the proposals. Let me offer an example to support this view. Current Dutch corporate law requires a private company to always include a restriction on the free transferability of shares in its articles of association. At present, the Dutch Civil Code allows a private company two options for such a compulsory blocking clause, of which one should be implemented in the articles of association.

The Ministry of Justice proposes to remove the current obligation to restrict the transfer of shares. This seems to be a good idea. Shareholders may of course still include a restriction on the transfer of shares in the articles of association. For that situation, the Ministry of Justice proposes certain rules as well. The most important of those rules concerns the case in which a shareholder may not transfer

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[8] See, for instance, Hoge Raad 28 May 2004, *Jurisprudentie Onderneming en Recht* (2004) p. 342.

[9] On this subject, see Maarten J. Kroeze, 'The Companies and Business Court as a specialized court', *Ondernemingsrecht* (2007) pp. 86-91; and Jack B. Jacobs, 'The role of specialized courts in resolving corporate governance disputes in the United States and the EU: an American's perspective', *Ondernemingsrecht* (2007) pp. 80-85.

his shares to a party of his choice because the articles of association stipulate that he must transfer them to another party. For this situation, the Ministry of Justice proposes an arrangement that is based on a combination of welfare, party autonomy and fairness. Thus, under this proposal, parties may agree in advance on a certain fixed price. According to this approach, this price should be the price for which the shareholder must transfer his shares to a party designated in the articles of association. In addition to this, the Ministry of Justice proposes that, in the case where the shareholder can show that this fixed price is unacceptable according to the principle of reasonableness and fairness, he may request that a court appoint a third-party expert in order to determine a price for the shares. In such a case, the shareholder will be entitled to the market value of his shares. Naturally, the unfairness of the fixed price in the articles of association will not be easy to show. In this light, it is important to recall the decisions of the Dutch Supreme Court in which it decided to apply reasonableness and fairness only in the exceptional circumstances in which a serious violation had occurred. In my view, such an arrangement does do justice to the combination of party autonomy and fairness.

Another important component of the proposals of the Ministry of Justice involves enhancing the exit rights of minority shareholders. I would like to emphasise that it is generally felt that there is a need to improve these sections of our Civil Code.[10] A significant implication of the current proposal of the Ministry of Justice is that majority shareholders will become more powerful compared to the other players within the company, such as the managing directors and the minority shareholders. In cases where a majority shareholder takes a firm stand against disagreeing minority shareholders, the only option for the minority shareholders is to exit the firm. The new Dutch rules for a simplified private company have to provide shareholders with adequate protection in such cases.

It has been particularly difficult for the Ministry of Justice to draft new sections determining the value of shares in the case of an exit of a minority shareholder. The new corporate rules provide that the value of the shares should be calculated as stipulated in the articles of association or the shareholders' agreement. Only in cases where the articles of association or the shareholders' agreement do not contain provisions in this regard or the minority shareholder is able to show that the price resulting from the calculation as set forth in the articles of association or shareholders' agreement is evidently unfair in view of all the relevant circumstances, may a judge appoint experts in order to determine the market value of the shares. In such cases, these experts should be paid by the majority shareholder.

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[10] The current exit right for a minority shareholder can be found in section 343 of Book 2 of the Dutch Civil Code.

4. FUNDAMENTAL RIGHTS

The European Court of Human Rights ruled in 2002 that shares in a company fall under the protection of ownership guaranteed by Article 1 of the First Protocol to the European Convention on Human Rights.[11] According to the Court, shares are an economic position worthy of the protection offered by Article 1 of the First Protocol. As a result, a decision taken by the company to weaken certain powers attached to shares or to weaken other rights, such as financial rights, constitutes a deterioration of title in the share.

Traditionally, the Dutch legislator seeks to protect the shares in a company against dilution. The traditional protection is offered by the statutory pre-emption right. Under flexible corporate law, shareholders may be denied a pre-emption right on the basis of, for instance, a clause to that effect in the articles of association or a resolution of the shareholders' meeting. The protection offered by the traditional pre-emption right may then become rather weak. Will that create problems under Article 1 of the First Protocol? I do not expect so in the case of the Netherlands. Our Civil Code prescribes as a compulsory rule the principle of equal treatment of the shareholders by the company. This principle of equal treatment is nothing more and nothing less than reasonableness and fairness. The Dutch Supreme Court decided in a famous judgment[12] that a selective allotment of shares in principle contravened the statutory equality principle in spite of the fact that the shareholders' meeting had explicitly decided to bypass the pre-emption right. Shareholders holding the same class of shares have to be treated in the same way by the company. When our Supreme Court confirms this decision under a new simple and flexible regime, Article 1 of the First Protocol will not come into view.

Still, there are other questions for which Article 1 of the First Protocol may become of importance. I again refer to the minority shareholder who wishes to exit. The reason for his wish to leave the company may be that the majority shareholder has prejudiced the company's assets, for instance by undertaking competing activities that harm the company. As a result, the shares of the minority shareholder may have decreased in value. Under our present exit rules, the exiting shareholder will obtain compensation for the transfer of his shares that is to be determined as close as possible to the moment at which the shares are transferred to the majority shareholder. This means that the shareholder will not be compensated for the shares' loss of value which was the reason for the minority shareholder to leave and was due to the conduct of the majority shareholder. In

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[11] European Court of Human Rights, 25 July 2002, *Jurisprudentie Onderneming en Recht* (2003) p. 111; and European Court of Human Rights, 7 November 2002, *Jurisprudentie Onderneming en Recht* (2002) p. 112.

[12] Hoge Raad 31 December 1993, *Nederlandse Jurisprudentie* (1994) p. 436.

my opinion, this outcome is unreasonable, especially if one acknowledges that the majority shareholder can prevent the company from instituting legal proceedings against him. Does Article 1 of the First Protocol any relevance for the solution of this problem?

In 1995, the European Court of Human Rights passed judgment in the *Agrotexim* case.[13] The case concerned expropriation without compensation by Greece of certain assets owned by an English company, called Fixed Brewery. The shareholders of the company, which had been wound up in the meantime, protested against this, alleging that expropriation of any of the company's property resulted in a decrease in the value of shares in contravention of the protection guaranteed by Article 1 of the First Protocol. The European Court of Human Rights did not share this view and decided that only a direct infringement of the title incorporated in a share could constitute an infringement of the right of ownership within the meaning of Article 1 of the First Protocol. It regarded expropriation as a measure related to the possessions of the company and not those of the individual shareholders. According to the Court, the company – not the shareholders – had to take action against the expropriation.

If a majority shareholder harms the company, there can be no question of direct damage to the shares. Accordingly, Article 1 does not seem to be relevant. I doubt whether this is really correct, however. Should the *Agrotexim* judgment apply if the minority shareholder is about to leave the company? In that case, he will no longer be able to benefit from the action taken by the board of the company against the majority shareholder who has prejudiced the company's interest. The decision in the *Agrotexim* case was not about shareholders who wished to leave the company. In addition to this, there is something else. In the case I described above, the majority shareholder prevented the board from functioning properly by preventing the board from taking action against him (as the majority shareholder). In such a case, the majority shareholder is likely to abuse his position as a majority shareholder against the minority shareholder. In my opinion, the Dutch legislator should provide that a minority shareholder who leaves the company can be compensated for the decrease in the value of his shares that has been caused by the majority shareholder (because this is reasonable and in order to prevent problems with Article 1 of the First Protocol). Thus, it gives me some pleasure that the Dutch legislator intends to insert such a clause in our Civil Code.

5. CONCLUDING REMARKS

In conclusion, welfare and fairness are notions that can clarify and direct the Dutch project to make the private company more simple and flexible. It is my

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[13] European Court of Human Rights, 24 October 1995, *Nederlandse Jurisprudentie* (1996) p. 375.

view that reasonableness, fairness and fundamental rights will remain lasting elements of Dutch corporate law. These concepts are becoming increasingly important in the practice of company law. In upholding reasonableness, fairness and fundamental rights, the courts will play a pivotal role, especially in the context of a more simple and flexible private company law.