Corporate & Commercial

Shareholder oppression and order to make dividend payouts (Supreme Court Judgment of 11 January 2023)

This paper analyses the recent ruling of the Supreme Court, of 11 January 2023, ordering a company to pay out dividends in the context of shareholder oppression.

FERNANDO MARÍN DE LA BÁRCENA
Associate Professor of Corporate & Commercial Law, Universidad Complutense de Madrid
Academic Counsel, Gómez-Acebo & Pombo

1. Introduction

Company courts are increasingly aware of the implications of conflicts between shareholders of closely held companies and are able to identify the typical signs of a shareholder oppression strategy: removal from management, notice of rescission or breach of employment or service contracts with the payor company, abusive share capital increases, extraction of value through related-party transactions and remuneration of directors and implementation of measures that hinder the exercise of rights related to governance or scrutiny, among others.

In addition to the above measures, there is usually an unjustified and continuous refusal to distribute the company's profits over time by systematically allocating the profit for the financial year to the creation of reserves (known as *profit-retention resolutions*), all with the aim of "starving" the minority shareholder.

Spanish company law has a good set of preventive rules and some remedies specifically designed to protect the position of minority shareholders in a context of "shareholder oppression".

The main measure consists of the recognition of the abuse by a majority as grounds for challenging corporate resolutions (Art. 204(1) *in fine* of the Companies Act or LSC), which joins the legislation on related-party transactions

and directors' duties of loyalty - with its special features regarding the filing of liability claims for breach of the duty of loyalty (Arts. 227 et seq. LSC), the remuneration arrangement for directors and managing directors (Arts. 217 and 249 LSC and Supreme Court Judgment of 26 February 2018), the prohibition on voting on a shareholder-director's dispensation from such duties of loyalty (Art. 190(1) LSC) or the reversal of the burden of proof regarding the harm to the best interest of a company in litigation challenging corporate resolutions passed by majority shareholders involved in a non-situational conflict of interest (Art. 190(3) LSC). With regard to profit-retention resolutions, the most important and controversial measure consisted of recognising the shareholder's right of exit for failure to pay dividends (Art. 348 *bis* LSC).

However, it must be recognised that the practical usefulness of exercising such rights or filing such claims to protect the position of minority shareholders is sometimes very limited.

It is common knowledge that a declaration of invalidity of a resolution for abuse by a majority is usually followed by the passage of further abusive resolutions that must be challenged at a considerable financial and, often, personal cost.

As for the filing of liability claims against directors for payment of excessive remuneration or breach of duties of loyalty, although they can result in an order to redress the harm caused to the company, this solution is of little use when the assets remain under the control of the same majority of shareholders-directors who acted abusively and without loyalty. There are hardly any precedents for the expulsion of the shareholder-director of a private limited company ordered to compensate the company (Art. 350 LSC).

On the other hand, the right of exit for failure to pay dividends will not arise if the company's operating expenses are overburdened by payments that merely transfer value from the company to the majority shareholder(s) (*e.g.* with directors' generous remuneration and other related-party transactions). Moreover, this may not be an acceptable solution in many cases, as the independent expert appointed by the Registry of Companies may be unable to determine the fair value of the shareholding, either because of the very nature of the company's business or because of obstacles to valuation that the majority shareholders directing the company place in the way of the valuation.

It is true that the situation described above can be avoided by concluding, at the time of incorporation, shareholders' agreements aimed at protecting the position of minority shareholders (and vice versa) in a context of conflict, and that good lawyers are very insistent on this point with their clients. However, the practical reality of closely held companies shows that they are set up (or inherited) on the basis of family or friendship ties and because of this agreements reached by shareholders at the time of incorporation, despite existing, are not usually documented.

2. Shareholders' legitimate expectations and the reason (*causa*) at the root of a company's formation

Direct participation in the governance of the company, with direct access to information, documentation and decision-making, in many cases on a paid basis, or the provision to the company of services, also on a paid basis, is in many cases the result of agreements reached by all shareholders at the time of the company's formation and is at the root of the incorporation of companies where labour and capital relations are substantially connected.

Removal from the position of director and the unilateral termination of these agreements for no other reason than the will of the majority shareholder(s), together with the refusal to pay company dividends, entails the termination of the means available to the minority shareholder to participate in the profits generated by the company. The adoption of this type of decision by the controlling shareholders constitutes an infringement of the essential bases of the company's formation and frustrates the legitimate expectations of minority shareholders who, far from being merely investor shareholders, expect a return on their investment in the company through the provision of remunerated services to the company.

U.S. case law and some U.S. state laws have long recognised the possibility of instigating actions or remedies of different types aimed at protecting these expectations against oppressive or abusive strategies of the majority, which may consist of ordering the majority shareholder to buy out his or her stake in the company by means of a valuation of the shares by an independent expert. Along the same lines, the UK Companies Act 2006, among other UK legislation, allows minority shareholders who suffer from a strategy of oppression to legally request their exit or compulsory purchase and sale by the majority shareholder of the shares or holdings owned by the minority shareholder in closely held companies (sections 994 and 996).

The judgments of the Fourth Chamber of the Provincial Court of La Coruña of 25 June 2019 and of the Supreme Court of 11 January 2023 that we analyse in this paper should be framed in this context.

This is not a case of a company being ordered to pay out a dividend which the majority shareholders did not wish to pay, nor is it a case of the Spanish courts interfering in the self-financing decisions of companies. This is a case of unjustified deprivation, with regard to the minority shareholder, of any involvement in the management of the company and of remuneration for his work as warehouse manager, accompanied by an extraction of the company's liquidity through financing contracts with the majority shareholder and an abusive withholding of company profits, unjustifiably preventing the payment of dividends for two consecutive financial years. This is important to note when identifying the basis and, consequently, the possible evolution of this case law.

3. A case of shareholder oppression

The company in dispute is a company limited by shares (a corporation) on an *intuitu personae* basis. The only two shareholders are a company (holding 51 % of the capital) and a non-corporate shareholder (holding the remaining 49 %). In turn, the controlling company is controlled by two natural persons linked by family ties (father and son) who hold paid positions on its board of directors.

As the judgment of the Provincial Court recounts, for fourteen consecutive years (between 2000 and 2014) the minority shareholder participated in the management as a joint and several director and received a remuneration of approximately five thousand euros per month (in reality, for carrying out activities ancillary to directorship, such as the "management of a warehouse"). For its part, the majority shareholder has "service and financing relations" with its subsidiary that provide it with the necessary liquidity to pay a considerable amount of remuneration to the members of its board of directors (father and son).

In this context of corporate peace and direct or indirect remuneration of all shareholders,

the company did not pay dividends, with the sole exception of the payment made in 2011, when it was unanimously agreed to pay out 75% of the profit for the year.

In June 2014, a conflict arose between the shareholders, which followed the normal path for this type of situation. The minority shareholder is removed as joint and several director (and as "warehouse manager"), so that he no longer receives the corresponding monthly remuneration and is removed from the management, which is taken over exclusively by the controlling shareholder as sole director.

The service and financing relation between the company in conflict and its majority shareholder undergo changes (conversion of the balance of the credit line into a participating loan, subsequent termination, signing of a group financing agreement that prevents the payment of dividends to some companies but not to others, etc.). In addition, while the parent company continues to finance itself from the subsidiary in conflict and provides it with remunerated services, the tap on dividends is turned off: the payment of corporate profits obtained in 2014 and 2015 is denied, despite the fact that the company has accumulated reserves of significant amounts in all previous years.

In this situation of shareholder oppression, the minority shareholder challenged the resolutions on the creation of reserves as abusive and, characteristically in this case, brought an action against the company for the distribution of the entire profit for both financial years.

The Provincial Court of La Coruña agreed with the claimant because there was a change in the relationship between the shareholders that prevented the minority shareholder from obtaining the return on his initial investment in the company, while the majority shareholder did receive it (bold and italics added):

> 21. Having said that, in our opinion, the contested resolutions are abusive because, although they do not cause harm to the company, they are passed for the benefit of the majority shareholder - to *whom the reserves that GSS Atlántico accumulates flow by way of financing, without guarantees or any pressure for repayment, even in part* - and to the detriment of the minority shareholder. *Since Mr. Ángel Jesús was removed as joint and several director* and *lost his remuneration as administrator or manager of the A Coruña workplace, his position has changed completely, and with it the assessment to be made of the continuity of the practice that the company had been following regarding the allocation of profits. The claimant no longer enjoys the benefit that he obtained, in exchange for his work, by way of remuneration* - only in one financial year, 2011, had he received dividends - *and this places him in a new scenario that the majority shareholder, who is the one who has caused it, cannot be unaware of*; a situation in which the duty of loyalty of the majority shareholder towards the minority shareholder is activated and takes on special significance, the necessary recognition that the continuity of the same dividend policy that had been followed until then can only benefit GSS Line and be detrimental to Mr. Ángel Jesús, *who receives nothing*

> *from the profits generated by the company's business and who also cannot realise his investment to his advantage - if that were his intention - because he is trapped in a closely held company which does not pay dividends and which uses its profits to finance the controlling company, that is to say, the majority shareholder himself.*

The Supreme Court judgment highlights not only the abusive nature of the profit-retention resolution, but the whole situation as a typical strategy of shareholder oppression, and emphasises the frustration of the legitimate expectations of the minority shareholder to participate in the profits derived from the company's business activities by means of remuneration for services rendered to the company, while the majority shareholder receives financial assistance that allows it to pay remuneration to its board of directors:

> At the end of 2014, the company had reserves of 2,128,630 euros. With those reserves, it was no longer a 'reasonable necessity' not to distribute the profits obtained in the financial years 2014 and 2015, but an 'unjustified' excuse for the majority to impose that resolution not to distribute profits, which, in the light of the background set out in the first legal basis, *was detrimental to the minority shareholder who had a 49 % shareholding and had ceased to obtain economic returns from the company, while those who controlled the parent company (majority shareholder) continued to benefit from the earnings provided by their remuneration as directors of the parent company, thanks also to the financial assistance provided to them by the subsidiary.*
>
> As the Provincial Court rightly concluded, we are dealing with a clear case of a resolution imposed with abuse by the majority, to the clear detriment of the minority, *as it aims to deprive it of the logical economic return derived from the profits made by the company*, without there being a reasonable need to justify it.

The conclusion to be drawn from the foregoing is that it is not a question of the Provincial Court of La Coruña or the Supreme Court interfering in the self-financing decisions of the companies, but of reversing the effects of an abusive strategy of oppression consisting of depriving the minority shareholder - without just cause - of the revenue he received in return for his work as warehouse manager and, at the same time, preventing him from having any access to company profits, which he does receive through the lines of credit set up with the subsidiary in dispute 'without guarantees or any pressure for repayment, even in part', which in the end 'accrue' to the natural persons controlling the parent company in the form of remuneration to its board of directors.

Whether the correct basis for this judgment is the duty of loyalty between shareholders (as the Provincial Court holds), the prohibition of abuse of rights (as the Supreme Court reasons) - or whether it would be preferable to speak of the existence of a basic contract or agreement in a situation of business collusion with the agreement to incorporate the company, but subordinate to it - is a question that cannot be addressed in this paper.

4. Analysis of the judgments

The strongest criticism of these rulings is rather theoretical and stems from the idea that, while it is permissible to declare an unjustified reserve resolution to be abusive, the court cannot declare the "reverse" dividend payment resolution to be approved, since there is no *single* alternative to the abusively passed reserve resolution. Thus, ordering a company limited by shares to pay out as dividends *precisely* the sum that the majority shareholder decided to allocate to reserves constitutes undue interference in a decision of a business nature, such as that relating to the financing of the company's business activity by means of equity or debt capital.

From this point of view, the only possible remedy against an abusive resolution to apply the profit for the year to the formation of reserves would be to hold it void and the general meeting would have to be reconvened to decide freely on the allocation of the profit for the year, presumably with the sole limit of not agreeing again to allocate the entire profit to the formation of reserves. If the new resolution is also considered abusive for the minority, since the company always benefits from the creation of reserves, it could be cancelled again, and so on until a distribution is reached that cannot be considered abusive. In fact, this is the solution normally offered by authors and courts in legal systems around us, such as Germany and Italy.

In our opinion, the decision adopted by the Provincial Court of La Coruña and ratified by the Supreme Court is substantially comparable, but it is important to highlight two issues, one of substance and the other of a formal nature:

— Once again, the issue of substance is that the justification for these judgments lies not only in the lack of dividend payouts, but also in the termination of the remunerated relationship of the work for hire agreement that allowed the minority shareholder to obtain an economic return from the company, while the majority shareholder receives it through lines of credit, effectively without guarantees or terms of repayment. If the minority shareholder had been a mere investor, the lawsuit would have been dismissed, and the same if this strategy of shareholder oppression had not been claimed (and proven). What these courts have done is to re-establish the effectiveness of the agreements reached by the shareholders at the very moment of the incorporation of the company and it is therefore coherent that the distribution has been agreed with the figure that the shareholders themselves considered appropriate at a time prior to the conflict. This is the Spanish version of the *Legitimate Expectations Approach* of U.S. courts.

— The formal issue concerns the need to respect the decision-making procedure in a corporate organisation such as a company limited by shares, even when it is a company on an *intuitu personae* basis.

The shareholder's right to dividends can only arise from a resolution of the general meeting, which in turn requires a proposal to be submitted for deliberation and voting at the general meeting. When that proposal is rejected (explicitly or implicitly), it is appropriate to join the action challenging the positive resolution (profit retention) with an action declaring positive the result of the vote (to pay out dividends), accompanied by a claim for voidance of the votes against the proposal to allocate the profits, laid

before the general meeting by one or more shareholders, on the grounds that they were abusive.

This type of action, subject to the same procedural and material requirements as actions challenging corporate resolutions, must be directed against the company and against the shareholders whose votes are to be voided, and the right of the remaining shareholders to appear in the proceedings as intervenors must be ensured so that they can all raise, as defences, the grounds of voidness or voidability that may apply, seeking a declaratory judgment from the court in this respect, with the support of the votes cast in favour of the proposal ("the resolution is in the votes"). The judgement rendered shall have the effect of res judicata against all shareholders and shall determine the establishment of the legal situation resulting from the adoption of the proposal with retroactive effect and without the possibility of further challenge. The shareholder's right to the dividend will have arisen as a consequence of the declaration (which is not the same as a direct judgment ordering performance from the company) and the holder may demand payment from the company, which must pay it out of its distributable reserves (273 LSC).

The case decided by the aforementioned judgment meets the above requirements, as it is a company comprising only two shareholders. The minority shareholder made a request for the payment of dividends in the plea of the claim. The reasons for which it was considered that the payment requested by the claimant would be contrary to the company's interests were debated in the proceedings, reasons which were rejected by the court (*e.g.* breach of a financing agreement which envisages the payment of dividends as an early termination event).

5. Conclusions

a) The Judgment of the Supreme Court of 11 January 2023 resolves a very particular factual case where there is a strategy of shareholder oppression consisting not only of the resolutions that denied the payment of dividends, but also of a set of behaviour of the majority shareholder or controlling shareholder that deny the minority shareholder his legitimate expectations of obtaining an economic return from his shareholding in the form of dividends, or the provision of services or work in a remunerated manner.

b) In our opinion, the case would not have been resolved in the same way if the claimant had been a mere investor or if the majority shareholder had not benefited from the financing which it does not repay and which allows it to remunerate the natural persons who make up its board of directors in the terms indicated by the judgments. We believe that the court decision handed down at first instance is implicitly based on the affirmation of the existence of an agreement between the shareholders that serves as the basis for the very incorporation of the company, which would have been infringed by the majority shareholder.

c) A company limited by shares cannot be ordered to pay dividends to its shareholders, since such payment requires the passage of a resolution by the general meeting of shareholders. However, it is possible to join to the action challenging

the positive resolution on the creation of reserves an action declaring the approval of the proposal for the allocation of the profits by voiding the votes cast against it. Once the result of the vote has been declared, the shareholder's entitlement to the dividend arises and payment of the dividend is payable by the shareholder if the company has sufficient reserves to cover it.

Disclaimer: This paper is provided for general information purposes only and nothing expressed herein should be construed as legal advice or recommendation.