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BEHIND CLOSE DOORS: GOVERNANCE ISSUES IN PRIVATE EQUITY DRIVEN INDUSTRIES – THE CLOSE CORPORATION PARADOX AND ITS IMPACT ON PRIVATE EQUITY IN THE US AND SWEDEN.

*Kristian Hermanrud **

Publicly traded companies make up only a small fraction of the vast number of corporations operating in the US today. Only about 10,000 companies are traded publicly while there are roughly 20 million corporations doing business in the US.¹ Likewise, over 245 private corporations' annual revenues exceed \$ 1 billion. Among these, more than twelve employ more than 50,000 employees.² Despite the influence on vast amounts of people and capital legislature has, to a large degree, focused on publicly traded companies. The reasons for this stem, in large, back to the years of the market crash in the early thirties and has since given rise to a multitude of regulatory and legislative actions. The recent scandals giving rise to the Sarbanes Oxley Act and, most likely, new regulation pertaining to the recent credit crisis impacts the governance of companies across the globe. Different regulatory schemes have evolved to remedy situations arising in an ever more complex corporate market. In the US, a system of enabling legislation has arisen. The basic principle is that freedom of contract will create a more efficient market. Choosing in which state and how to incorporate will allow for decisions regarding form, taxes, liabilities and contractual rights. In Europe, regulation has instead focused in part on safeguarding rights by enacting regulations to limit certain actions and the restrictions imposed are based on which nation you start your enterprise in. The paradox of whether to enable efficient markets by creating freedom or safeguarding against venture capital vultures becomes strikingly apparent in the close corporation. This article aims to compare elements of the regulatory policies in the largest per capita private equity market in the world, the United States, and the third

* J.D. Uppsala University faculty of Law, LLM-candidate Suffolk University Law School; For comments, revisions and conversations on Swedish law I am indebted to Jonas Ljungberg and Niklas Elofsson, Uppsala Faculty of Law. For grammatical expertise and careful scrutiny I am very thankful to my colleague Luigi Tollis at Suffolk University Law School. For discussions, comments and ideas I am thankful to Professor Polito and Professor Gibson at Suffolk University Law School. Lastly I want to thank my wonderful wife Christina for your continued support on these endeavors.

¹ IRS statistical service.

² Forbes Nov 2000.

largest, Sweden. After I describe how approaches to corporate governance in the US might impact the private equity market (by imposing fiduciary duties and how those duties can be circumnavigated ex ante) I will describe the Swedish corporate regulatory environment. Special focus will be given to differences in capital requirements and how fiduciary duties play a role in maintaining shareholder rights. By describing the different approaches to regulating corporate governance a picture starts to emerge which shows that despite differences in governance techniques and risk allocation devices employed, an effective market seems to have emerged in both countries.

US REGULATION IN LARGE

Stemming from a climate where state legislatures try to appeal to corporate interests, some say the development of corporate law in the US is a “race to the bottom”³. Others proclaim the law is a process of evolution and as such is a “race to the top” where the best corporate solutions will prevail.⁴ Both premises are warranted and it is quite possible that they can coexist. Providing an attractive environment for incorporation has several advantages to both the corporation and the host state. For the corporation, modern corporate codes provide market efficiency coupled with reduced costs should a litigious situation arise. For the host state, the potential revenue streams provide a much needed source of income. On the other hand, in their race to maintain an attractive breeding ground for corporations, states will undoubtedly make use of the most attractive corporate statutes. Such statutes are often those providing corporate law which mimics the principals found in contract law. The basic premise being one where the parties are allowed to contract as they please providing for greater freedom and flexibility. The downside, as has been expressed by an increasing number of oppositional researchers, is that this could diminish the actual remedies available to exploited parties. Given the particular nature of the corporate environment a regulatory scheme which too heavily relies on contractual principals could have a detrimental impact on the willingness to invest if stakeholders perceive that systemic risks in the market outweigh the expected return on capital.

³ Subraminian G., *The influence of antitakeover statutes on incorporation choice: Evidence on the “race” debate and antitakeover overreaching*, 150 UPALR 1795, 2002.

⁴ Id.

The “race to the bottom” hypothesis is premised on the notion that states focus their efforts to attract corporations by providing attractive venues for incorporation by allowing greater freedom. By relaxing corporate law states have been described as providing a legislative agenda which;

*“Was not one of diligence but one of laxity”*⁵

States wishing to provide an investor friendly environment could, for example, provide statutes allowing for comprehensive protection from shareholder actions in the corporate bylaws thereby diminishing minority protection against incompetent boards. Similarly, allowing corporations to be formed where the articles of incorporation allow for de facto freeze-outs of minorities would perhaps be attractive to some, but would not serve to heighten the markets confidence in such a state’s corporate laws and would perhaps provide a breeding ground for new corporate scandals.⁶ The potential impact on the private equity market, which is particularly sensitive to correct risk assessment, becomes apparent.

Another area of debate is that of takeover statutes. States may wish to provide for extensive prohibitions on takeover defenses to provide a deterrent for dysfunctional boards thereby allowing the market for corporate control to function effectively. This trend is offset by some states, such as California, which provide for extensive shareholder and minority protection in their corporate laws. Whether the federal government should be allowed to intervene by passing federal regulations protecting societal and minority interest is a much contested issue. Currently there exists a difference of opinion where scholars, like Mark Roe, interpret regulation such as the Sarbanes Oxley Act (SOX) as proof of the federal systems power and that states, especially Delaware, are simply a venue which mimic federal regulations.⁷ In contrast, scholars like Roberta Romano

⁵ Ligget v. Lee, 288 U.S. 517.

⁶ For an excellent discussion about the fallacies in said theory see Reza Dibadj, *Delaying Corporate Law*, Hofstra Law Review, 34 HOFLR 469 2005.

⁷ Roe Mark J., *The Creeping Federalization of Corporate Law, Delaware's Competition*, 117 Harv. L. Rev. 588 (2003).at 26.

proclaim that SOX is simply an exception to the general rule that states regulate fiduciary duties and the distribution of powers between boards and shareholders.⁸

STATUTORY IMPACT ON CORPORATE GOVERNANCE

In any public company the way in which the board of directors and managers utilize their knowledge and competence will be directly reflected in share price, at least, that's the theory. Problems pertaining to the age old paradox of control versus ownership therefore seldom arise in a well functioning corporation but are all the more plentiful when dispersed shareholders are subject to economic loss due to the actions of the management. Questions as to the effectiveness of the systems in place to safeguard minorities against abuse and the effectiveness of the disciplinary functions of the market have also recently become topics of debate.⁹ Though the market undeniably plays an important role in functioning as the best indicator of a company's financial status and position, it says little about the internal workings of the company. In theory ineffective management will be sanctioned as the company will perform worse, thereby driving down share prices – the Efficient Capital Market Hypothesis.¹⁰ This however is premised on transparency of corporate governance. We need only look at the recent crisis in the capital markets to realize that perhaps there are issues of effectiveness which have not been remedied. A problem arising with US regulation of corporate affairs seems to be that these codes reflect little more than the explicit demands of contracting investors and managers.¹¹ In other words, state regulations governing corporations could be little more than an image of the prevailing idea of what a contract binding the parties should be. A problem with such a system is that it might contribute to ineffective shareholder protection and increase the willingness of managers to underestimate risks to increase short term yields. In essence, the “contract” reflected in the state corporate legislation might not reflect the needs of the oppressed or the market at large. First, there is no

⁸ Romano Roberta, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?* Yale Univ. Int'l Ctr. For Fin., Working Paper No. 05-02, 2005. at 39f.

⁹ Dibadj Reza, *Delaying Corporate Law*, Hofstra Law Review, 34 HOFLR 469, 2005. at 483.

¹⁰ Pinto A., Branson D., *Understanding Corporate Law*, Second edition, Lexis Nexis 2004 at 92.

¹¹ Roe, Mark J., *Corporate Law's Limits*. Journal of Legal Studies, Vol. 31. Delaware's Politics, supra note 5 at 2496.

contract between shareholders and managers. Second, the shareholders are seldom aware of internal dealings within a company and many think it safe to presume that disgruntled shareholders would rather pursue managers with federal antifraud and state corporate law than on theories of contract.¹² Despite this, many states have developed corporate law which is little more than a wish list for managers, all in an effort to attract corporate capital. Some have gone so far as to describe Delaware as “the brothel of corporate law”.¹³ The general principle, protecting shareholders and others from the malicious acts of a menacing crew of managers or directors is, apart from state corporate statutes, instead manifested in the concept of fiduciary duties.

GOVERNANCE BY IMPOSING FIDUCIARY DUTIES

Fiduciaries are generally created when one is given power that carries with it a duty to use that power to benefit another.¹⁴ This relationship can be ascribed to a number of different situations and can include partnerships, trustees, or other agents and principles. There is no clear cut definition of fiduciaries and this ambiguity provides a potentially wide area of application. Fiduciary duties are generally considered to consist of two duties; the duty of care and the duty of loyalty. They are owed to the company by the directors in public corporations. As will be discussed later, the situation differs in closely held corporations where fiduciary duties can be imposed even between the shareholders and not only towards the company but towards each other.¹⁵

The Model Act provides a baseline standard for a director’s fiduciary duties; he or she must discharge their duties of loyalty “in good faith” and “in a manner the director reasonably believes to be in the best interests of the corporation”.¹⁶ The duty of care is described as requiring directors to perform their duties with the diligence of a reasonable person in similar circumstances. The somewhat ambiguous language ascribes to the terms used certain values. Acting in good faith means acting honestly and fairly and has primar-

¹² Dibadj Reza, *Delaying Corporate Law*, Hofstra Law Review, 34 HOFLR 469, 2005. at 469.

¹³ Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?* 48 *Vill. L. Rev.* 1189, 2003

¹⁴ Pinto A., Branson D., *Understanding Corporate Law*, Second edition, Lexis Nexis 2004.at 199.

¹⁵ see SEC v Chanery Corp., 318 U.S. 80, 85-86.

¹⁶ ABA, (American Bar Association), *Managing Closely Held Corporations*, A Legal Guidebook, Committee on Corporate Laws, 2003. At 32.

ily an evidentiary function. Lacking good faith is often a clear signal that the given action is a form of self dealing or other motive unlinked to the furtherance of the business.¹⁷ An objective standard can be described as “reasonably believes” (what a rational analysis by others would deduce as being true). This is furthered by “person in a like position” and implicates a test of common sense. “Care” is of vital importance in this context as it clearly stipulates the need to make an informed decision. Ignorance is never an excuse for making a poor business decision. However, having made sufficient enquiries, evaluating the results and then making a poor decision is not considered a breach of care given it could have been made by others under similar circumstances. Testing breach of care is done by relating it to an inner safe harbor called the business judgment rule (BJR). This standard of judicial review states a presumption in favor of the director and enforces a presumption that the decision in question was informed and made in good faith.¹⁸ Bad business decisions are usually allowed if they are informed. Under this doctrine, the court will focus on the decision making process, not the decision and the BJR therefore acts upon a presumption about the decision. *“In making a business decision the directors of a corporation acted on an informed basis . . . and in the honest belief that the action taken was in the best interests of the company”*¹⁹ The duty of loyalty requires a fiduciary to act for the best interests of the corporation and in good faith. This is generally an issue when a director or manager stands to make a decision from which he or she can personally benefit. This duty is tested using the entire fairness doctrine. To test the fairness of a transaction is no menial task and state Courts have developed intricate systems to derive at answers to these problems.

Recent debates have begun probing the effectiveness of said principles. In a recent study of Delaware corporate law and the application of common law doctrine of fiduciary duties the author, Reza, describes the fiduciary duties as “little more than eloquent rhetorical flourish”.²⁰ The duty of care seems to require gross negligence to be

¹⁷ ABA, (American Bar Association), *Managing Closely Held Corporations*, A Legal Guidebook, Committee on Corporate Laws, 2003, At 34f.

¹⁸ *Id.*, At 41.

¹⁹ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

²⁰ Dibadj Reza, *Delaying Corporate Law*, Hofstra Law Review, 34 HOF LR 469, 2005., note 80 at 8., see also Kahn M., Rock E., *Symbiotic Federalism and the structure of corporate law*, Vanderbilt Law Review, Oktober 2005, supra note 66, at 13.

breached and the duty of loyalty imposes only upon the directors to not engage in apparent self dealing. Reza makes a statement in his article to the affect that;

Seeing as how the safe harbor of BJR calls for not only negligence, but “gross negligence” and violators are found only when there is “reckless indifference to or a deliberate disregard of the interests of the whole body of stockholders”²¹ or “actions which are without the bounds of reason.”²²

In an a critical article another author expresses the implications of the BJR in Delaware as;

“Is not, functionally speaking, a standard of review at all. Rather, it is an expression of a policy of non-review of a board of directors' decision when a judge has already performed the crucial task of determining that certain conditions exist.”²³

FIDUCIARY DUTIES IN CLOSELY HELD CORPORATIONS

President Obama, in a recent speech, claimed small business alone provide for half of the private sector employment in the US and create seventy percent of all new jobs.²⁴ The closely held corporation, which dominates this sector, can be described as an incorporated partnership.²⁵ Though many statues which stated a limit on the number of shareholders have now been amended there is a general acceptance to the idea that a close corporation has few shareholders.²⁶ Lacking a market where the shares can be freely traded this is perhaps the most prevalent characteristic of a close corporation. Most companies start as small corporations and, as the success of the venture becomes a reality, investors seek to capitalize on the venture by going public or cashing out. As will

²¹ Allaun v. Consol. Oil Co., 147 A. 257, 261 (Del. Ch. 1929).

²² Gimbel v. Signal Cos., 316 A.2d 599, 615 (Del. Ch. 1974).

²³ Allen William T ., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 Del. J. Corp. L. 859, 870 (2001).at 870.

²⁴ Address by President Obama on the 16th of March, 2009
<http://www.msnbc.msn.com/id/21134540/vp/29722440#29722440>.

²⁵ Pinto A., Branson D., *Understanding Corporate Law*, Second edition, Lexis Nexis 2004. at 287.

²⁶ In a recently published article the Massachusetts State Government surmised the position of the closely held corporation as follows: A “closely held” corporation is a corporation “typified by: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation. The important characteristic for the purposes of this article is that the management and ownership of a close corporation is in the hands of a few, often only two, individuals. www.ma.gov.

be described later these perceptual stages in development are especially important given the fact that close corporation shareholders owe each other a heightened duty of care and the relationship has the characteristics of an equal partnership. As such the duties owed necessarily impact the investors risk assessment. The effect is also that any sale of shares or mergers with other companies comes under the control of the few owners which might tempt controlling parties to cut corners in order to effectuate a profit. Many close corporations maintain agreements limiting minority shareholder influence which has the effect of sometimes causing conflicts within the company as minorities are subject to a “freeze-out”. Lacking a public arena to liquidate investments, stockholders are often forced into bargaining with controlling shareholders. The scenario gives rise to a number of issues such as that of loyalty, risk management, and business ethics. Absent clear mechanisms of minority protection the closely held corporation would be an arena where the strong survive at the expense of the weak. Since controlling shareholders often hold positions as board or company directors, conflicts of interest easily arise.

Exploitation can take many forms such as salaries, bonuses, or other forms of wealth transfer effectively distributing dividends but doing so in a matter so as not to give all shareholders equal parts thereof. Sweden, in contrast to the US, imposes penalties to remedy undercapitalization problems by stipulating stringent demands on corporate capital. The rules in Sweden are primarily in place to protect creditors but, as will be discussed, could even impact the investor incentive by limiting options to secure dividend payments (on preferred shares for example). In the US a different approach has been favored. In Delaware, along with approximately 15 other jurisdictions, the close corporation special statutory provisions only apply to corporations which are incorporated as close corporations.²⁷ The implications being that lacking such incorporation an “unregistered” close corporation falls under the general provision of the Delaware Corporate Code. The general statutes, in turn, are perhaps less useful to a minority suffering from exploitation.²⁸ The problem was addressed in *Nixon v Blackwell*,²⁹ where it was held that there are no special judge-made rules for closely held

²⁷ Pinto A., Branson D., *Understanding Corporate Law*, Second edition, Lexis Nexis 2004. at 314.

²⁸ New York Law Review, A plea for Separate Statutory Treatment of the Close Corporation, 33 N.Y.U. L. Rev. 700 (1958).

²⁹ *Nixon v Blackwell*, 626 A.2d 1366 (1993).

corporations in Delaware. Protection is instead achieved through definitive shareholder agreements.

“The tools of good corporate practice are designed to give a purchasing minority shareholder the opportunity to bargain for protection before parting with consideration”.

Anyone wishing to invest in a close corporation in Delaware should therefore do so under the advisement of an attorney as the courts might be hesitant to provide remedies ex post.³⁰ More often than not however, small business entities lack funding or knowledge to form investment contracts. It is often the case that a shareholder enters into a commitment based on personal knowledge or relationship to the corporation or its founders. Many times family members are shareholders and naturally trust each other. When the company experiences illiquidity or a party exploits their position the issue of fiduciary duties arises. In these cases, lacking sufficient statutory protection and not having previously formed adequate agreements to manage these disputes, the parties might find themselves at the mercy of the courts and it becomes important to understand how these duties are employed in a close corporation setting.

As a shareholder in a US closely held corporation, one becomes subject to an intricate web of duties and opportunities and shareholders can have fiduciary duties to each other.³¹ Taking part in the management or even control of the business brings about many opportunities which might favor not only the company as a whole, but the shareholder individually. This could be construed as a breach of duty under the corporate opportunity doctrine. The doctrine of heightened fiduciary duties in closely held corporations stem from a Massachusetts case, *Donahue v Rodd*.³² In *Donahue*, the Court stated that in a close corporation, the fiduciary duty owed is not only the same as that of a partnership but is subject to the same standard.³³

³⁰ Pinto A., Branson D., *Understanding Corporate Law*, Second edition, Lexis Nexis 2004.

³¹ *Donahue v. Rodd Electrottype Co.*, 328 N.E.2d 505 (Mass. 1975).

³² Id.

³³ *“We have defined the standard of duty owed by partners to one another as the “utmost good faith and loyalty.” Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They may not out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation. ...The controlling group may not, consistent with its strict duty to the minority utilize its control of the corporation to obtain special advantages and disproportionate benefit from its share ownership.”* Ibid

Special caution needs to be taken when the shareholder is a director or manager, as then the insight into corporate affairs is even greater. Though no precedent clearly spells out such a rule, it seems reasonable that greater insight should call for greater care not to take advantage of corporate opportunities. Similarly, other dealings which might disadvantage shareholders lacking insight into corporate affairs could be scrutinized under this doctrine. Fact specific circumstances should therefore lay the foundation for determining the scope of duties.

Acting as a director or manager also calls for greater levels of care as it gives rise not only to duty of loyalty to the other shareholders, but also duties of care. Taking care to execute only informed decisions, when they negatively impact other shareholders, becomes vital in maintaining a reasonable level of diligence as set forth by the business judgment rule. Recent debates have however raised questions as to the boundaries of the business judgment rule. It is claimed that the scope of the business judgment rule has become significantly expanded providing greater protection as the task of proving a decision was not informed becomes increasingly difficult. The most efficient constructions to prevent claims for breaches of care are therefore ex ante. By providing clear guidelines through shareholder agreements and maintaining a high level of care when partaking in business decisions, the shareholder acting either as a director or independently should be fairly well informed on the limitations of his or her duties and liabilities. As was mentioned however, lacking funds for procuring adequate council, the founders might be disadvantaged if savvy investors employ schemes to limit their duties. The impact of said principles on the private equity market are unclear but what can safely be stated is that with such large amounts of capital in the market and the apparent lack of remedies being afforded to exploited parties perhaps the regulatory scheme will require a new approach in the near future.³⁴

³⁴ Beyond the remedies for breach of duty lie more drastic measures. In the case of oppression the remedy may be as severe as involuntary dissolution of the company. In my opinion this is a drastic measure which should not be used unless it has been proven to a point of certainty that it is the only way to allow for remedy of the oppression. On the other hand, when the corporation is subject to a merger or sale of assets, the appraisal remedy has become a common solution in many states. Depending on the type of merger (cash or statutory) it is in my opinion appropriate to take this middle ground between imposing duties and dissolution; the appraisal remedy can provide objective relief. This is, however, a complex issue and the valuation of nonpublic stock is topic of much debate. In his thesis on appraisal rights Gustaf Sjöberg expresses the view that appraisal rights should be seen in the context of the corporate setting and emphasis

EVOLUTION OF CONTRACTUAL RIGHTS AND THEIR IMPLICATIONS

Investors and creditors alike must manage their risk in order to accurately determine premiums. For many investors the closely held corporation is the first stage in corporate development. Many times a closely held corporation will be taken public in the foreseeable future and thereby provide dividends or return on investment after a sale of the shares. Given these premises, investors regularly employ tactics to minimize the risk of said investments. In the close corporation setting, regulating the transference of shares, dividend payments, seats on the board of directors, or power of veto, are commonly employed tactics. Given these premises it becomes easy to see how such an investor quickly becomes subject to the duties imposed under *Donahue*. The principles providing protection to shareholders and the company are not always in line with the ideas of the investor. The investor wishes to maximize return on investment, and this may call for large dividend payments on preferred shares, liquidation of assets, mergers, or other corporate transactions which might not benefit the shareholders at large. If, for example, the corporation fails to meet the turnover required to provide adequate dividends, the investor might have to choose between lowering dividend requirements or taking action on the board by vetoing new investments or proposing a sale of assets. Either action might constitute a business decision which disadvantages other shareholders if the investor has preferred stock or similar standing giving the investors first right to profits. To combat this situation the investor might choose an ex ante solution; a “fiduciary out” clause in the investor contract. This makes possible the taking of actions which would otherwise constitute a breach of fiduciary duties, but limiting liability thereby preserving investor incentives. Whether such provisions hold up in court is a difficult question to answer. Given the situation in Delaware, where contracts entered into by willing parties who have filed as a close corporation are enforced, the contract will, by my determination, be enforced in such a state. In other jurisdictions, where perhaps the duties

is put on establishing the type of corporation, i.e. close or public, before determining the proper remedy. The approach seems to fair well with the general presumption of determining duties depending on the corporate environment in each specific case as opposed to establishing new tests for when shareholders have been oppressed as it is clear that in a close corporation these tests are subject to such a severe degree of variability that the foreseeability of applicable law might be jeopardized. See Sjöberg G. *Tvångsinlösen*, Jure Förlag AB, 2007, At 445f.

of loyalty are more strictly enforced, the situation might be seen as one of self dealing. In cases where the investor has both a seat on the board and maintains a standing as a controlling shareholder it seems reasonable to view clear examples of oppression as breaches of fiduciary duties. By imposing strong fiduciary duties courts could create an atmosphere of accountability. History has proven, again and again, that there exist no moral deterrent strong enough to act as an inhibitor in the corporate setting. Contrary to this, the contractual freedom provided for in many state statutes have widened the applicable field of “out” clauses available to investors unwilling to commit to the duties otherwise imposed. The viability of such contracts became apparent in the recent *Walt Disney*³⁵ case. In *Disney*, because the party was very careful in the way that they structured the transaction, the Chancery court did not find the duties of care, loyalty, or good faith were violated. It seems, in other words, that as far as the law in Delaware is concerned, a wary investor, paying careful attention to the language in a contract, can create a very favorable environment for doing business, perhaps at the expense of the less-well-funded minority shareholders.

The business judgment rule has also evolved into a standard which calls upon the exploited parties to prove something akin to gross negligence. Furthering this dilution of protection is the fact that the Court of Chancery in Delaware has allowed for extensive contractual provisions to circumnavigate the impact of the business judgment rule.³⁶ The situation has been described as “anemic at best”.³⁷ Similarly, the duty of loyalty provides little by means of imposing duties as investors are savvy in creating safeguards. This can be done by establishing special committees or boards of independent shareholders. This is problematic as it is doubtful that an independent board is truly independent when the

³⁵ *In re Walt Disney Co.*, No. 15452, 2005 Del. Ch. LEXIS 113 (Del. Ch. Aug. 9, 2005).

³⁶ See Del. Code Ann. tit. 8, § 102(b)(7) (2004); see also Roe, Mark J., *Corporate Law's Limits*. Journal of Legal Studies, Vol. 31., note 14, at 243 “One does not exaggerate much by saying that American corporate law has produced only one major instance in which nonconflicted managers were held liable to pay for their mismanagement: *Smith v. Van Gorkum*, a decision excoriated by managers and their lawyers, and one promptly overturned.”

³⁷ Dibadj Reza, *Delayering Corporate Law*, Hofstra Law Review, 34 HOF LR 469, 2005 at 9. *A director is only liable if he or she is grossly negligent, and the rule presumes that the director acted with due care If the company has an exculpatory provision in its articles of incorporation, as nearly all publicly-held corporations do, the plaintiff-shareholder must prove that the director failed to act in good faith or intentionally harmed the corporation. As if these legal standards were not enough to reduce a director's incentives to act with care, directors invariably have indemnification rights and insurance, and courts have limited the ability of shareholders to obtain discovery in derivative actions alleging director misconduct.”*

heavy weight of corporate control, posed by investors or the employers of the special committee, are hovering above like a tiger ready to pounce. Different from an independent court, the special committee is subject to the control and influence of the corporation. It is therefore doubtful if such a solution is preferable to a court mediated settlement. One need only look at recent discoveries as to the influence on credit rating agencies and accounting firms to see why “independent” is perhaps more of a utopia than a reality.

Summarily, the tactics of contracting around fiduciary duties have become more commonplace. In jurisdictions such as Delaware these types of contracts have been upheld despite being fairly obvious cases of self dealing.³⁸ It becomes of gravest importance for an investor to carefully scrutinize where a closely held corporation is incorporated. In states providing strong minority protection, actions viewed as self dealing will probably be deemed as such in court voiding the clause or contract. Contrarily if a closely held corporation is incorporated in Delaware the contractual provisions of an investor contract will, to a much larger extent, be enforced. The discrepancy is problematic as it provides an area of uncertainty and therefore might impact the market for venture capital negatively.

EUROPE AND SWEDEN

Today a corporation is but one of many types of business entities and its wide area of applicability has become its trademark. Courts today are also finding ever wider ranges in the application of corporate law. Many countries are also working towards finding new forms corporations to allow for greater flexibility and availability to those wishing to incorporate a business idea. Small and medium-sized enterprises (SMEs) have, over the past decades, become increasingly important as they attract large amounts of venture capital and often provide the stepping stone for corporations wishing to go public at a later stage. The large impact of venture capital backed firms have been the topic of much debate as they have been found to have significant impact on the product and labor markets. Private equity and the private equity backed securities now impact countries

³⁸ Dibadj Reza, *Delaying Corporate Law*, Hofstra Law Review, 34 HOF LR 469, 2005 specifically on *Disney*.

around the world and in the US alone private equity and hedge funds were believed contain over a trillion dollars in assets as recently as 2006.³⁹ In short the impact of the flow of capital is enormous and governance of said markets should be a priority.

The wide array of business associations available in the US cannot be directly translated to the Swedish market. Generally a corporation will be formed as a limited liability company, or Aktiebolag; AB.⁴⁰ The possibility to elect to incorporate and be taxed as a partnership (pass through taxation) is therefore generally not available. Two forms of companies, the kommanditbolag and the handelsbolag, mimic rules for partnerships with similar rules for loyalty and taxation. These corporate forms however, lock the investor into other regulations which govern loyalty and profit sharing. The rules are similar to those of partnership laws in the handelsbolag, but differ on the options available to issue stock. The kommanditbolag is similar, but where the kommandit is individually liable. Since neither can issue stock however, the passive investor has little to gain from this arrangement.

When incorporating, there is also a minimum capital requirement of approximately 12,000 USD for private and 60,000 USD for public companies.⁴¹ This is tied to another limitation on the distribution and use of contributed or generated capital. A corporation's initial issuance of stock, given that stocks are not issued at a premium, form the company's contributed capital. This capital cannot be used for dividends and the investors and stakeholders are therefore prohibited from emptying the corporation from funds. Similar provisions can be seen in accounting standards in the US, but in Sweden, the regulations are directly sanctioned in the corporate code. The assets in the company, minus liabilities, must always maintain this level of capital and the directors can become personally liable for using said assets, regardless of the cause, if certain criteria are met. The rules are primarily in place to protect creditors. This seems to be a somewhat awkward arrangement as creditors usually demand mortgage backed securities to be issued and in the case of a lending institute, such as a bank, they should be sophisticated

³⁹ Stattin, Uppsala University Faculty of Law, *Reglering av Private Equity bolag och hedgefonder – internationella och europesiska trender*, 2009 citing Christopher Cox in senate hearing on July 25th 2006.

⁴⁰ The definition of closely held company is in some respects. A company is required as closely held where four or less individual hold shares representing more than 50 % of the votes. Also non-resident legal entities are covered by the definition. <http://www.abanet.org/tax/groups/flf/nr00/nr01sweden.pdf>.

⁴¹ Swedish Companies Act (Sw. aktiebolagslag, SFS 2005:551).

enough to evaluate risk. The demands on capital instead impact shareholders whom will maintain a level of protection from dilution or distribution on their initial investment. The amount of capital can be revised with shareholder approval (each individual shareholder and class has veto power under certain conditions). If the contributed capital falls below half of the stated capital however, the company can be forced into liquidation. Capital requirements in Swedish companies contrast them starkly from US corporations where, under extreme circumstances, the equity can have negative value if there are no assets and only debt.

The differences described should create variances in risk assessment and hence impact the demand of return on invested capital; higher risk should mean higher demand and vice versa. As was stated initially however, the US and Swedish private equity markets seem to be equally efficient if per capita investment is used to measure willingness to invest. The answer seems to lie in other tools employed in the Swedish regulatory system which allow for an attractive balance to be struck between the investors demand for return and the legislator's intentions to protect the market at large.

The unwillingness of the regulatory bodies in Sweden to introduce new types of corporate forms, and whether to do away with a minimum capital requirement in corporations, was the subject of a governmental study as recently as 2008.⁴² The consensus seems to be that the system in place provides for ample incentives while safeguarding creditor and shareholder interests. The reasons lie, in part, with the systems impositions of liabilities.

In the US, as has been described, the liabilities in closely held corporations are often of a fiduciary nature. Sweden, on the other hand, has stringent statutory demands for finding breaches of fiduciary duties. As a civil law country the case law provides little guidance when trying to determine the particulars of a given situation regarding fiduciary duties. Directors, according to the Swedish Corporate Code, have a fiduciary duty to act in good faith and in the best interests of the company. Any member of the board of directors, or the managing director, may be liable for damages towards the company where, in the performance of his duties, he willfully or negligently causes the company to suffer damage. In order for liability to the shareholders to arise, the act must be in vio-

⁴² SOU 2008:49.

lation of the Swedish Companies Act, the Swedish Annual Report's Act, or the articles of association.⁴³ The heightened fiduciary duty owed by shareholders to other shareholders in a close corporation in some US jurisdictions is not limited to closely held corporations in Sweden. The code creates liability not only to the company but to other shareholders or "others".⁴⁴ The broadness of this liability should not be overstated. Though such liability exists as a feasible tort claim, few cases provide insight into when such a liability might actually be imposed. The reason for this might lie in the courts unwillingness to adapt a more stringent standard of review.

Sweden, as a civil law country, employs a method of statutory and contractual interpretation which differs from the US. The method in which corporate contracts are formed and interpreted is, in practice, wholly different. The courts are given ample room to subjectively interpret contracts and claims resembling equity are not uncommon in contract situations. In essence, the court will view what is fair and just and was in the reasonable expectations of the parties upon entering the contract. Opposite this modus of interpretation are the statutory provisions; which are generally interpreted very restrictively. The result of these two factors is that "unfair" contracts can be amended or voided and if you are not in violation of a specific provision – chances are good no liability will be imposed absent obvious and ascertainable damages.

Cumulatively, the regulatory regime and operation of law set a high burden on a disgruntled party to prove damage to the corporation or their interests. The regulations in place therefore differ to the duty of care and loyalty as is the case in the US. As was mentioned earlier however, the system in the US is perhaps not as strict as it would first seem, given the options available to contract around such duties; options not available in Sweden. There also seems to be an unwillingness to engage in litigation in Sweden. This could be due to the fact that usually the loser is given the honor of paying the litigation costs. Coupled with the fact that there are much fewer corporations, and people (approximately nine million), the case law which would otherwise have outlined the boundaries for fiduciary duties is not abundant. As a result, the litigious tradition seen in

⁴³ SFS 2005:551 29:1, see also http://www.vinge.se/upload/juridisk_info/Doing_Business_in_Sweden_2008.pdf.

⁴⁴ SFS 2005:551, 29:3.

the US is not present in Sweden, and ex ante solutions by means of regulation seem to be the favored mode of governance.

These somewhat limited fiduciary duties are, however, coupled with a wholly different regulatory tool; the duty to treat all shareholders equally.⁴⁵ This regulation provides that all shareholders must receive the same benefit or detriment and as such complements the fiduciary rules described. The end result seems to be that shareholders, regardless of class, can find adequate protection from oppression. The “fiduciary out” tactic seen in the US is less common in Sweden as the rule is statutorily mandated and cannot be contracted away. A final tool in providing security to investors is the variance in merger and takeover provisions. In large, Sweden mimics the European standards and as such do not allow a statutory merger to dilute rights of certain classes of shares. An interesting development however, is the case stemming from the EU, which now supersedes national law in many cases. In the *SEVIC* case⁴⁶ the court concluded that the EC Treaty⁴⁷ establishes a right for transnational mergers. This coupled with the *Centros* case,⁴⁸ which establishes a right for registration of a corporation formed legally in another member state, creates a new area of law which could impact certain of the Swedish Corporate rules. As Danelius discusses in his article, the result could be that companies wishing to avoid the capital requirements in Sweden could incorporate in the UK and then simply set up shop in Sweden.⁴⁹ The impact on the private equity market of these decisions is largely unknown, in part because the cases are fairly recent, but it is feasible that investors looking to take advantage of both systems could do so.

In Europe, revisiting old and outdated regulations have long been contested subjects. As recently as 2006 words such as “regulatory fatigue” and “enabling legislation” were used to describe the shift in policy.⁵⁰ Sweden has long held its ground as these winds of change swept across Europe while at the same time being sensitive to progressive reform. As late as 2005, Sweden passed a new Corporate code which revisited many of the old dogmas long perceived as redundant. One issue where the regulatory will of the EU and

⁴⁵SFS 2005:551, 4:1.

⁴⁶ C-411/03 *SEVIC Systems AG*, ECR 2005 p. I-10805.

⁴⁷ European Community (EC) Treaty.

⁴⁸ C-212/97 *Centros Ltd mot Erhvervs- og Selskabsstyrelsen*, ECR 1999 s. I-1459.

⁴⁹ Danelius, SvJT 2006, s 919.

⁵⁰ Id at 921.

Sweden have not been able to agree is on that of voting rights on separate issues of shares. The prevailing principle in the EU seems to be that of “one share one vote” while in Sweden there has been a long tradition of separate voting rights for different issues of stock within the same class.⁵¹ Naturally a shift in policy in Sweden could impact potential investors risk assessments but the effect of a shift is largely a speculative one.

CONCLUSIONS

If a relaxation of rules governing corporations provide a marketplace where parties can contract freely; at least in theory, there exists an efficient market for corporate control. The efficient market hypothesis mandates that share price premiums would provide incentives to contract in ways beneficial to the longstanding goals of the corporation. The approach in the US, where protection of corporate capital are remedied by bankruptcy, accounting, and property laws, the fiduciary duties play a vital role in maintaining a level of accountability for the management and controlling shareholders. The market seems to have adopted an approach to investor contracts which therefore provide incentives premised on equity growth. If the return on investment is realized – the company is prosperous. Demands on capital and other regulatory techniques imposed on corporate entities in Sweden instead mandate protection statutorily and impose duties of faith by eliminating temptations to divert funds. By also providing courts with the discretion necessary to remedy injustices, the system seems to have found a balance between control and ownership which allows for an efficient market.

Both systems seem to have evolved to allow for efficient markets, but the question of whether a regulatory scheme demanding stringent control of the governing parties is superior remains to be seen. If the private equity market in the US survives the recent credit crisis, it will be a testament to the resilience of the system. On the other hand, large costs of labor and heavy tax burdens in Sweden have not deterred investors from placing capital in the Scandinavian markets. Future studies might determine how large the demanded return on capital is in each country respectively. This could might shed some light on the apparent paradox created when two different approaches to regulating corporate governance seem to produce very similar results; an efficient market. In sum,

⁵¹ Danelius, SvJT 2006, s 919.

the Swedish capital market provides proof that regulation has not, despite higher taxes and labor costs, discouraged investors to make Sweden the third largest private equity market per capita in the world.