Regulation of Shareholder Exits in Closely Held Companies - Reflections from Sweden

Hanna Almlöf

LINKÖPING UNIVERSITY

Regulation of Shareholder Exits in Closely Held Companies – Reflections from Sweden

by

Hanna Almlöf*

The success of closely held companies largely depends on a well-functioning collaboration between the shareholders. Split ambitions, differenced targets and conflicts among owners can create a need to end the collaboration. The owners need a plan for a structural business partner divorce, i.e., regulation of shareholder exits. This study analyze full and partial shareholder exits with the aid of an interview study with eighteen legal advisors. Through a grounded approach to analysis, and with aid of the Nvivo software, different exit situations are identified and categorized. Exit strategies can be regulated in shareholders' agreements, in the articles of association, or by legislation. The later alternative, correctly constructed, could reduce transactions costs for the shareholders, as the legislation can serve as a standard contract. This study assesses to what extent the Swedish Companies Act functions as a standard contract for closely held firms on the topic of exit regulation. The study reveals that the Swedish Companies Act is of little help. Instead, the cost of contracting to regulate exits in shareholders' agreements is placed on the parties. This calls for legislative change.

Table of Contents ECFR 2022, 175–202

* LL.D. Assistant professor at Linköping University, Sweden. Research fellow at CeFEO — Centre for Family Entrepreneurship and Ownership and the Ratio Institute.
This study has been enabled through generous financial support by the Ragnar Söderberg Foundation, Jan Wallander and Tom Hedelius Foundation, and Tore Browaldh Foundation.
Note: Special thanks to Professor Hanne Søndergaard Birkmose who has given important and thoughtful comments to an earlier version of the manuscript and to my fellow team members of the Ownership Dynamics research project in Sweden and Denmark.

1. Introduction

Most limited liability companies in Europe are closely held. If the company is owned by more than one shareholder, some form of ownership management is needed. A key element in such management activities is the planning and regulation for ownership change. The success of a closely held business largely depends on a well-functioning collaboration among the shareholders. Unwanted transfers of shares, or other events that disrupt the balance of power, may have negative effects on the collaboration as well as on the business.

Free transferability of shares is a key feature in company law.[1] For closely held companies, however, the rule of free transferability is undesirable because shareholders want to preserve the delicate balance of power among them and avoid unwanted transfers of shares. In Sweden, free transferability is stated in chapter 4, Section 7 of the Companies Act (2005:551), and since Swedish company law uses a one-size-fits-all regulatory technique, i.e., only one corporate business form, this is a default rule.[2] Consequently, owners of closely held firms must regulate for unwanted transfers of shares in the articles of association or in a shareholders' agreement. Examples of such regulation are transfer restrictions in the form of the right-of-first-refusal or a post-sale purchase right clause.

The rule of free transferability of shares is also presented by the legislature as the ultimate shareholder protection rule, as it gives a dissatisfied shareholder

1 *John Armour/Henry Hansmann/Reinier H. Kraakman/Mariana Pargendler*, What is Corporate Law?, in: Reinier H. Kraakman/John Armour/Paul Davis/Luca Enriques/Henry Hansmann/Gerard Hertig/Klaus Hopt/Hideki Kanda/Mariana Pargendler/Wolf-Georg Ringe/Edward Rock (eds.), The Anatomy of Corporate Law: a comparative and functional approach, 2017, p. 1–28, 10.

2 After the U.K. model, Sweden has one business form limited by shares, the *aktiebolag*, but two types of the same: the private and the public company.

the right to sell his or her shares and leave the firm.[3] Such an exit opportunity is, however, limited in closely held firms for two reasons, which correspond to two important characteristics of closely held businesses. First, as just mentioned, the shares are often subject to transfer restrictions in the articles of association or in shareholders' agreements. Hence, any exit alternative is dependent on these agreements, which may, for example, set a time window for voluntary exits, or set the price in advance. Second, and maybe more importantly, there is no open market for shares in closely held businesses. Typically, the composition of owners is built on personal relationships, which limits the pool of potential buyers to those willing to enter that constellation, while also being accepted by current owners. This makes the market very limited or even non-existent.[4] Lack of exit opportunities for individual owners can lead to unwanted lock-in effects, which can create a conflict or aggravate an ongoing conflict among the owners.[5] Lock-in situations also mean that the owner's capital and competence is prevented from being used elsewhere, which must be seen as an ineffective use of resources that otherwise could be invested in new economic activity. Hence, in closely held firms, there is a need for owners to employ exit strategies.[6]

This study explores if and how exit opportunities are regulated in articles of association[7] and in shareholders' agreements in Swedish closely held firms, and investigates how legal advisors guide business owners on the topic. The results are analyzed in the context of the Swedish Companies Act, and reveal a clear

3 Government bill Prop. 2004/05:85, p. 250.

4 The two reasons can also be explained in terms of transactions costs, see e.g. *Susanne Kalss*, "The Transfer of Shares of Private Companies", European Company and Financial Law Review 3 (2004), 340, p. 347–349.

5 See e.g. *Klaus Ulrich Schmolke*, "Expulsion and Valuation Clauses – Freedom of Contract vs. Legal Paternalism in German Partnership and Close Corporation Law", European Company and Financial Law Review 9 (2012), 380, 388.

6 See e.g. *Jan Andersson*, Minority shareholder protection in SMEs: a question of information *ex post* and bargaining power *ex ante*?, in: Mette Neville/Karsten Engsig Sørensen (eds.), Company law and SMEs, 2010, p. 191–206; *Jan Andersson*, Redemption of Shareholders, in: Paul Krüger Andersen/Nis Jul Clausen/Rolf Skog (eds.), Shareholder Conflicts, 2006, p. 161–175; *Mette Neville*, Shareholders Conflicts in the European Private Company (SPE), in: Heribert Hirte/Christoph Teichmann (eds.), The European Private Company – Societas Privata Europaea (SPE), European Company and Financial Law Review – Special volume, 2013, p. 193–242; *Mette Neville*, A Statutory Buy-Out Right in SMEs – an Important Corporate Governance Mechanism and Minority Protection?, in: Mette Neville/Karsten Ensig Sørensen (eds.), Company law and SMEs, 2010, p. 247–293.

7 In some legislation, such as American state law, both the corporate charter and its bylaws govern the corporation. In Sweden, however, only one document regulates the firm, namely the articles of association.

mismatch between the need for regulation of exit strategies and the solutions offered by the legislation in the form of mandatory or default rules. A lack of court cases increases the problem. Even if the analysis and conclusions are based on the Swedish market and legislation, the theoretical framing of how company law can function as a standard contract to lower transaction costs, as well as the practical exit situations described and categorized in this article, ought to be universal.[8] Hence, the findings and conclusions can be translated to other national settings.

2. *Method*

This study of contractual and legislative regulation of exit strategies in closely held firms requires a dual approach. First, an inventory of the legal framework is needed to clarify which exit strategies have support in the legislation, in the form of mandatory or default rules. The point of departure is a legal analysis based on a Scandinavian dogmatic method with studies of the legal texts, preparatory works, case law and legal literature. In accordance with Swedish and Scandinavian legal theory, the sources of law are given priority in this order.[9] However, as will be shown, the Swedish Companies Act lacks general exit solutions. Consequently, the use of statutes and preparatory works is limited. Further, ownership issues are often kept away from the public light, which leads to a very limited access to case law. Moreover, as regulations of exits come in the form of shareholders' agreements, which are not available to the public, the legal analysis must be complemented by empirical data to fully understand the choices of business owners and their use of exit strategies. For this purpose, the legal analysis is supplemented by an interview study.

We have conducted in-depth interviews with eighteen legal advisors to understand the advisors' views of regulating exit opportunities in contracts, the attitudes of their clients[10], and common practices in drafting shareholders' agree-

8 For a short comparative overview, see e.g. *Kalss*, ECFR 2004, 340 (fn. 4), p. 352–353.

9 In accordance with Scandinavian legal method, preparatory works are considered as significant sources of law. Hence, the discussion on Swedish company law includes references to authoritative official documents, i.e., Government bills, abbreviated *Prop.* and Swedish Government Official Reports, abbreviated *SOU*.

10 Some advisors, mainly lawyers who are members of The Swedish Bar Association, refer to the business owners as "clients". Others, such as advisors working at accounting firms, use the term "customers". In this study, I make no distinction between these concepts, and use the term *client* for all business owners who seek professional advice.

ments.[11] Respondents were selected through purposeful sampling[12] based on their vast experience of providing legal advice to shareholders of SMEs on the topic of ownership regulation, i.e., the respondents are viewed as information-rich cases.[13] The advisors draw on their collective experience of advising closely held businesses, and together, they represent 350 years in the profession, with an average of 19.5 years of experience. A snowballing technique[14] was used to identify potential respondents. Most of the legal advisors were partners or employees at a law firm, but three of them worked in accounting firms, and one in another type of consultancy firm. This approach yielded a group of respondents in various parts of Sweden who represented a range of firm sizes from both urban and rural areas. The group consisted of twelve men and six women.

The interviews were semi-structured so that predefined aspects were covered, yet allowing new themes to emerge.[15] Interviews were conducted in parallel with data analysis until saturation was reached, i.e., when no substantial new exit situation or exit strategy was added with additional respondents.[16] The interviews were conducted in Swedish, recorded and transcribed *verbatim*. To systematically analyze the data, the transcribed interviews were processed with the aid of the NVivo software. The durations of the in-depth interviews ranged from 59 minutes to 119 minutes, with an average of 81 minutes.

3. The National Legal Framework

3.1 Free Transferability as the Starting Point

Adequate interpretations of the empirical findings require a profound understanding of the legal landscape. The starting point of such legal understanding is the rule of free transferability of shares. This rule is fundamental for a functional capital market. Since shareholders are subject to majority voting in the firm, there must be an offset to the capital investment. Consequently, a shareholder must be free to transfer the shares without the interference of other

11 These data are part of the research project *Ownership Dynamics* and have been collected by the author and Associate Professor Kajsa Haag.

12 *Janice M. Morse*, Sampling in Grounded Theory, in: Antony Bryant/Kathy Charmaz (eds.), The SAGE Handbook of Grounded Theory, 2007, p. 229–244, 237.

13 *Michael Quinn Patton*, Qualitative Research & Evaluation Methods, 2002, p. 230–234.

14 Ibid., p. 237–238.

15 *Kathleen M. Eisenhardt*, “Building Theories from Case Study Research”, Academy of Management Review 14 (1989), 532, 538–539.

16 *Kathy Charmaz*, Constructing Grounded Theory: A Practical Guide Through Qualitative Analysis, 2006, p. 113.

shareholders or the management, otherwise it would have a deterrent effect on investments and could hamper the company's ability to attract capital.[17]

The rule of free transferability is considered to include four aspects of freedom.[18]

- Right to transfer a share
- Right to *not* transfer a share
- Right to acquire a share
- Right to *not* acquire a share

Hence, the rule ensures that individual shareholders have an active right to acquire and transfer his or her property (the shares) at free will. The rule also ensures the passive right to not to be forced to either acquire or transfer shares. Nevertheless, the legislature recognizes that while the principle of free transferability is important for many companies, it is inconvenient for others. Therefore, free transferability of shares is the default rule, with three possible opt-in transfer restrictions that can be incorporated in the articles of association of a private limited company.[19] The advantage of including a transfer restriction in the articles of association is that it will be legally binding on any third party who acquires shares. The three opt-in alternatives are:

Consent clause – The articles of association of a company may include a clause stating that the validity of a voluntary transfer of shares is subject to the company's consent. Such a clause in the articles of association shall state whether the general meeting or the board of directors shall consider a request for consent.

Right-of-first-refusal clause – The articles of association of a company may include a clause pursuant to which a shareholder or other party shall be invited to purchase a share before it is voluntarily transferred to a new owner.

Post-sale purchase right clause – The articles of association may include a clause pursuant to which a shareholder, or any other person appointed in the articles of association, shall be entitled to purchase a share which has been voluntarily or by other means transferred to a new owner.

17 See *Armour/Hansmann, et al.*, in: Kraakman/Armour, et al. (eds.), Anatomy, (fn. 1), p. 10. The Swedish legislature shares the same view, see Government bill Prop. 2004/05:85, p. 249–250, or (possibly more clearly stated) Swedish Government Official Report SOU 1941:9, p. 262.

18 *Niklas Arvidsson*, Aktieägaravtal: särskilt om besluts- och överlåtelsebindningar, 2010, p. 138.

19 Government bill Prop. 2004/05:85, p. 250–251. In public limited companies, only post-sale purchase right clauses are allowed in the articles of association.

To avoid compromising the principle of free transferability, the list of opt-in alternatives is exhaustive, which means that any other transfer restrictions, or other regulations of ownership transfers, as a starting point cannot be included in the articles of association.[20] Instead, the owners must use shareholders' agreements for such ownership management issues. Of all registered companies in Sweden, 61 percent have some transfer restriction included in their articles of association. This is a very high number, given that many companies are singly owned. The most frequently used transfer restriction is the post-sale purchase right. Of those firms with transfer restrictions, 65 percent use only a post-sale purchase right clause, and another 24 percent use it in combination with a right of first refusal.[21] The main reason for these numbers is that post-sale purchase right clauses have an effect on all types of transfer, not only voluntary transfers such as sales or gifts, but also transfers due to inheritance, division of marital property, and execution of unpaid debts. However, there are no statistics on how common it is with shareholders' agreements and the frequency of specific clauses to regulate shareholder exits.[22] One contribution of this study is to provide some evidence of what exit situations shareholders' agreements include, and how advisors who draft these agreements perceive these contracts and the process with their clients.

3.2 Exit Situations in the Companies Act

As the principle of free transferability of shares includes both the right to transfer or acquire a share and the right *not to* transfer or acquire a share, any deviation from it must be supported by law. In this section, a general overview of the legal exemptions to the main rule of free transferability is presented.[23] Hence, without entering details, there are some exit situations that are supported by the Swedish Companies Act.

The most generally regulated exit situation is found in chapter 22 of the Companies Act.[24] It concerns the situations in which the ownership structure of a company is composed of one majority owner, who directly or indirectly holds

20 Government bill Prop. 2004/05:85, p. 251.

21 These data are not officially published by the authority, but have been collected in January 2021 by a Master's student for her thesis work.

22 *Cf. Neville*, in: Hirte/Teichmann (eds.), The European Private Company (fn. 6), p. 213–221.

23 Not mentioned here is the rule in chapter 29, Section 4, which states that a shareholder who has been sued for damages can be required to buy out the shares of the damaged party.

24 Corresponding rules are found in Norway, Lov om aksjeselskaper § 4–26 and in Denmark, Selskabsloven § 70.

more than 90 percent of the shares. The majority owner is then entitled at any time to buy the remaining shares of the company. In such a case, the minority owner(s) has a duty to transfer his or her shares to the majority owner. A mutual right is, however, also given to the minority shareholder(s) of such company. Thus, any person whose shares may be bought out shall be entitled to require the majority shareholder to acquire the shares. The main purpose of the rules is to ease mergers between a parent and daughter company.[25]

The second exit situation is found in chapter 25, Sections 21–22 of the Companies Act. It refers to clear cases of long-term abuse of power by majority owners. Oppressed minority shareholders who own at least one-tenth of all shares may request a court to order the company to dissolve. The company can then request the court to order the company to buy the petitioner's shares *in lieu* of liquidation. Hence, on the petition of the company, the minority shareholders can be obliged to transfer their shares and receive a value corresponding to the residual, instead of liquidation of the firm. From the minority shareholders' perspective, this exit solution is, however, the right to force a liquidation of the company, a decision that normally requires a majority vote. The fact that the majority shareholder(s), as controller(s) of the business, can instead request to buy out the minority is rather how the exit is executed. It should be noticed that the rules have a very narrow sphere of application, as the abuse must include an infringement of law or the articles of association, must be grave and long-term, in combination with the thresholds of holdings for the minority. Consequently, case law on this minority exit alternative is indeed very limited and no cases has reached the Supreme court.[26]

The third and final exit situation is found in the Takeovers Act (2006:451) and the Takeover Rules for regulated markets, and for certain trading platforms issued by the Swedish Corporate Governance Board. These rules originate in the EU Takeovers Directive (2004/25/EC), implemented through chapter 13, Section 8 of the Swedish Securities Market Act (2007:528). According to the main rule in the Takeovers Act, if a shareholder, or new investor, alone or together with a related party, acquires shares in a company that is listed on a Swedish regulated market and by this trade acquires more than 30 percent of the voting power, the shareholder must immediately announce the size of the holding. The shareholder must also make a public offer regarding the remain-

25 Government bill Prop. 2004/05:85, p. 437.

26 The closest Supreme court case is NJA 2018 s. 545 "Mama Africa", but it relates to chapter 25, Section 23 which entitles the minority shareholder to request the appointment of a "receiver" to manage the company *in lieu* of the board of directors until the court's liquidation order has become final. The actual oppression dispute was settled in Svea Court of appeal RH 2018:39. See also *Andersson*, in: Andersen/Clausen, et al. (eds.), Shareholder Conflicts (fn. 6), p. 168–169.

ing shares in the company within four weeks. Thus, the rules require a shareholder to acquire shares (make a mandatory bid) in some situations. As the regulation on takeover bids concerns public companies and not closely held firms, which is the topic of this study, mandatory bids are not included in this study.

In summary, only a few very limited exit situations are regulated in the Companies Act. The Swedish act lacks, for example, exit mechanisms such as the right to call for redemption of shares or dissolution of the firm in cases of collapsed collaborations or deadlocks as in, for example, the Norwegian Asl Ch. 4, Sec 24–25, the German GmbH-Gesetz § 61, and the Dutch Civil Code, Sec 335–343 in Book 2.[27] Consequently, the Swedish legislation is of little help in enabling exit strategies in order to, for example, avoid harmful lock-in effects or resolve conflicts between shareholders. Instead, the shareholders must anticipate potential conflicts and deadlocks, and make provisions for solutions in contracts. Such anticipation is often subject to legal advice, which makes the shareholders dependent on advisors. The need for adequate conflict-resolution mechanisms and exit strategies is extensive and further research in this area is called for.[28]

4. Empirical findings

4.1 Findings Overview

The empirical data show how different exit strategies are employed to face a wide range of exit situations. The findings can be structured into four categories based on whether it is a full or partial exit, and whether it is combined with the entry of new shareholder(s) or not. Out of these categories, one is dramatically more complex than the others, namely situations with *partial exits* without the entry of new shareholders (see *infra,* sections 4.7–4.8). I believe that this finding shows an important way in which closely held companies differ from other businesses when it comes to ownership changes. The two important characteristics of closely held businesses, namely the common use of transfer restrictions and the limited or even non-existent open market for the shares, limits the exit situations under the other three categories, and instead complicates partial exits without the entry of new shareholders.

27 See e.g. *Joseph A. McCahery/Erik P.M. Vermeulen*, Conflict resolution and the role of courts: An empirical study, in: Mette Neville/Karsten Ensig Sørensen (eds.), Company law and SMEs, 2010, p. 207–245, 225–228.

28 *Andersson*, in: Neville/Sørensen (eds.), Company law and SMEs, (fn. 6); *Andersson*, in: Andersen/Clausen, et al. (eds.), Shareholder Conflicts (fn. 6); *Neville*, in: Neville/Ensig Sørensen (eds.), Company law and SMEs (fn. 6).

The four categories were not identified before the interviews took place but developed during the analysis as a pedagogical tool to understand which exit situations are connected to which exit strategies. However, before presenting the four categories, attention needs to be paid to the differentiated understanding of the exit problem among the respondents.

4.2 Acknowledging the Problem

The respondents in this study showed dissimilar understanding of the term *exit.* Some advisors had never heard of an exit theme of shareholders' agreements, while others saw it as the most important issue to regulate. Some respondents, such as Advisor #8, who is active in the capital city with many institutional investors as clients, had a narrow and specific understanding of the term.

"But this is not what we traditionally mean with an exit. If you speak about an exit, then you speak about taking the firm to the capital market, or a trade sale where you scan the market for an external buyer who is interested in taking the business on its next journey." Advisor #8

Consequently, the respondents seemed to value the need of regulation of exit opportunities differently, leading to a spread of practices. On the one hand, some advisors did not see exits as a particular problem. Indeed, some closely held businesses seldom face ownership transfers. For example, in the family business literature, longevity, both in ownership and management, is identified as a key characteristic of family firms, leading to few changes in ownership structure.[29] From this perspective, exits are rare and follow the lifecycle of a person, and therefore may not be seen as worth planning for. Advisor #5 stressed that if you advise the clients well from the start, e.g., in succession planning and making sure that siblings with no interest in the firm are compensated in other ways than becoming passive owners, exits are not a priority topic for either discussion or regulation. Advisors #10 and #18 saw no reason for particular exit regulation: transfer restrictions are enough to regulate ownership changes. Advisor #18 pointed to the importance of regulating the value of the shares, and that this value is perceived as fair. According to this advisor, parties always end up with an agreement in an exit situation if the value has been fairly set.

On the other hand, some advisors presented the reverse picture. Advisor #16 stressed that exit is the single most important question to regulate in a shareholders' agreement.

29 *Ethel Brundin/Emilia Florin Samuelsson/Leif Melin*, "Family Ownership Logic: Framing the Core Characteristics of Family Business", Journal of Management & Organization 20 (2014), 6, 14–15.

"When I started 30, 25 years ago, I wrote shareholders' agreements, because I had no experience, to lock in the owners so no one could get out. Today, I look at co-owning a company more as a marriage, and today we know that it is easy to get a divorce. So, we must talk about and find a solution for what happens if we cannot agree." Advisor #16

All respondents were asked how important it is to regulate for shareholder exits in the articles of association or in shareholders' agreements. Advisor #12 answered that it is absolutely very important as the default rule of the free transferability of shares would otherwise apply. This advisor mentioned how difficult it is to apply the rules of chapter 22 of the Companies Act: the majority shareholder often holds fewer than 90 percent of the shares. More commonly, a small group of main owners are unhappy with a trouble-making minority shareholder, and the act is of no help in this situation. Advisor #6 was more modest, but expressed that exits are often overlooked.

"I think this is often what is missing, a structural business partner divorce." Advisor #6

Advisor #13 also talked about a *divorce* between business partners.

"It is equally important to choose whom to start a business together with, as whom to marry. You pool your finances and do lots of things together, it's on the same level." Advisor #13

4.3 The Four Categories of Exit Situation

Changes in ownership structures can be either full or partial. Full ownership transfers occur, for example, with a trade sale, a management buy-out, or when an older generation leaves the business to a younger generation. Partial exits come in the form of an exiting shareholder transferring his or her shares to a new shareholder, e.g., when a shareholder retires or when shares are inherited. When an exit is combined with the entry of a new owner, I call it an ownership replacement. In these situations, the holdings of the remaining shareholders will normally stay the same. However, exits can also come in the form of shareholders leaving the company without the entry of new owners, i.e., an ownership exit. This means that the shares are either acquired by the remaining shareholders or withdrawn by the firm. Ownership exits without the entry of a new shareholder can lead to a redistribution of power in the firm.

The four exit categories, based on whether it is a full or partial exit, and whether it is combined with the entry of a new shareholder, are illustrated in Figure 1. In the next sections, I present situations that fall under each of the four categories, and with support from the interviews, I give examples of what causes these situations.

Figure 1: The four categories of exit situation

	Full	*Partial*
Ownership replacement	All current owners transfer their shares to new owner(s)	One or several current owners transfer their shares to new owner(s)
Ownership exits	All current owners transfer their shares, without the entry of new owners	One or several current owners transfer their shares, without the entry of new owner

4.4 Full Ownership Replacement (1st Quadrant)

The first quadrant refers to situations in which all current shareholders together, and at the same time, transfer their shares to new owner(s). This form of exit can relate to both business success and failure, which is exemplified below from a closely held business perspective.

The first example is a joint exit undertaken to cash in on the investment. Entrepreneurial teams can have an exit in mind already when starting the business, i.e., a common understanding that the business activity is to build up value during a few years, and then to be sold. The respondents mentioned that even if this was the joint ambition of the founders, times change, which can cause changes in their perspective, and opportunistic behavior can split the owners. However, as there is a limited market for shares in closely held companies, and as the price per share is largely dependent on whether all the shares or just a stake in the firm is for sale, an exit might be impossible without shareholder consensus. In shareholders' agreements, exits of this kind can be regulated through drag-along and tag-along clauses. A drag-along clause entitles an owner, often a majority shareholder, to force minority shareholder(s) to join a sale of the company. Conversely, a tag-along clause entitles the minority shareholder(s) to join if the majority owner has found a buyer for the business. It is worth mentioning that setting up exit plans, and drag-along or tag-along clauses, when the firm is started seems to be mainly a large city phenomenon. Institutional investors, venture capitalists and business angels are commonly found in the capital region, and they will demand a drag-along clause in shareholders' agreements in return for their investment, even if they hold minority posts.

"... an institutional investor always wants the possibility to realize the value of the shares, so there will always be a way to force an exit. [...] If you have an institutional investor, then you also have a drag-along clause." Advisor #9

In contrast, advisors operating in small cities or rural areas often mentioned that this is never the case with their clients.

"Most often, there is no request for an exit time horizon, you sit there presuming you will own the business forever." Advisor #15

The second example of an exit with full ownership replacement is when the current owner(s), comes of age, and a transfer of ownership is inevitable, and in cases of the sudden death of a sole owner. In a Swedish survey from 2017, owner managers who anticipated an ownership change within the next decade were asked to speculate about who would be most likely to take over the business. In this survey, 37 percent of the respondents foresaw an acquisition by another business as the most likely ownership change, while one out of five answered that the business would be taken over by a family member.[30] Succession planning is a key topic in management literature, and in legal consulting, and is often portrayed as a long process followed by one definitive full-ownership replacement. However, just as the modest intra-family succession rate indicates, the current owner might not fully believe in the ability of potential successors, while the willingness of the younger generation might depend on whether they are included as owners. Hence, letting go of the business can be difficult for owner managers.

"Many times, I as the advisor feel 'Now it is time to quit', so I try to find support from the auditor or tax advisor to justify why the owner should do this or that. [....] Because as an advisor, I feel this is what is best for the client, i.e. the business, not the owner." Advisor #4

Consequently, as the older generation often finds reasons to stay in the business and co-own it with the successors, the succession of the firm becomes partial instead of full. This is shown *infra* in the complexity of the 4th quadrant of partial ownership exits, and explains the limited scope of the 1st quadrant.

4.5 Partial Ownership Replacement (2nd Quadrant)

The second quadrant refers to situations in which one or several current owners, but not all, transfer their shares to new owner(s). Thus, this is a partial exit, in which owners are replaced by new shareholders. From the interviews, it is evident that this category of exit is very limited. The reason is that these situations are what transfer-restriction clauses, found in the articles of association and/or in shareholders' agreements, aim to avoid. The purpose of a transfer restriction is to prevent an unwanted person acquiring shares and entering the constella-

30 Företagarna, "Ägar- och generationsskifte i svenska företag – överlåtelse eller avslut?", 2017, p. 25. This is a report written by an organisation that support local networking for business owners. The report is available to download here: https://www.foretagarna.se/politik-paverkan/rapporter/2017/agarskifte/.

tion of current owners. Hence, the successful application of a transfer-restriction clause will normally result in a situation in the 4th quadrant, and not in the 2nd quadrant, dependent on who is appointed to acquire the shares instead of the unwanted person. As mentioned *supra* in section 3.1, transfer restrictions are very common in Swedish companies, in particular post-sale purchase rights.

However, it should be noted that transfer restrictions only regulate what happens *if* an owner transfers his or her shares. A transfer restriction does not function to enable share transfers. Thus, it does not give a shareholder the right to transfer, in combination with the obligation of another person to acquire the shares. Consequently, transfer-restriction clauses are of no legal help in regulating exit situations. Nevertheless, some respondents in the interview study explicitly referred to transfer-restriction clauses also in cases of shareholder exit. The main reason was that a transfer-restriction clause in a shareholders' agreement normally includes a value-of-shares clause. With a set price of the shares, the shareholders might agree more readily on an exit solution when the question arises.

A second reason for the limited number of exit situations under the 2nd quadrant is the limited market for shares in closely held businesses. Even if a shareholder wants to leave the business, it might not be possible to find an external buyer. Potential buyers are instead found internally, among the current owners. Consequently, the lack of a market also leads to more exit situations falling into the 4th quadrant instead of the 2nd quadrant.

4.6. Full Ownership Exit (3rd Quadrant)

Shareholder exit can mean "firm exit". In the 3rd quadrant we find exit situations in which all current owners leave the business, without the entry of new shareholders. Hence, the exit is equivalent to a liquidation of the company, either by voluntary winding up or by insolvent liquidation. In the Swedish survey from 2017, 1100 respondents were asked what they considered to be the most likely ownership alternative. Twenty-five percent answered that there were no ownership alternatives: the company would be wound up. However, this result was very closely correlated with the number of employees. Among those respondents who anticipated liquidation, 80 percent were single entrepreneurs, and the rest had 1–10 employees. Hence, in companies with more than 10 employees, winding up the company is not a likely exit.[31]

Exits in the form of liquidation are normally not part of the planning and regulation of ownership change, but there are some exceptions. A liquidation can be

31 Ibid., p. 22–23.

the result of a conflict among owners. As noted *supra* in section 3.2, the Swedish Companies Act includes one provision that entitles minority shareholders, who are subject to long-term abuse of power by majority owners, to petition the court to order liquidation of the company. The rules, found in chapter 25 of the act, set up strict requirements, making them almost impossible to apply. Yet, liquidation may be the only realistic solution to a conflict among shareholders.[32]

"Sometimes we simply add a clause stating that if the [shareholders of the] company cannot agree, the parties shall pass an ordinary resolution to wind up the company. Because this is the worst of the worst. And so, you force them to agree on another solution." Advisor #6

This advisor used the threat of liquidation to give the owners an incentive to come to an agreement. In particular, companies with 50/50 ownership structures, i.e., two shareholders with equal shares, are in severe need of a conflict-resolution rule. With no majority vote, the business is subject to a deadlock and not even a decision to wind up the company can be taken. The right to force a liquidation can be used for this purpose, e.g., in connection with a consensus clause in the shareholders' agreement. If the owners have not reached consensus in a matter listed in the shareholders' agreement within a certain period of time, the contract imposes a duty to pass a resolution at the general meeting to dissolve the firm.

"I tell everyone, 'Do not own the business 50/50. And if you do, make sure you have a shareholders' agreement. It won't work otherwise.'" Advisor #15

4.7 Partial Ownership Exit (4th Quadrant)

The fourth and final quadrant contains the most complex category of exits. It refers to situations in which one or several, but not all, owners exit without the entry of any new shareholders. Interestingly, for this category the respondents did not give examples of the oppression of minority shareholders, which are the target situations of chapter 25, Section 21–22 of the Companies Act. Instead, the legal advisors mainly addressed situations in which shareholders disagree and have different aims and ambitions. This finding is in line with previous research by Neville.[33] When analyzing the exit situations in this quadrant, I found that the complexity makes it necessary to distinguish between several subcategories, which are presented *infra*, section 4.8. However, an ad-

32 *Cf. Frank H. Easterbrook/Daniel R. Fischel*, "Close Corporations and Agency Costs", Stanford Law Review, Vol. 38(2), (1986), 271, p. 286–287.

33 *Neville*, in: Hirte/Teichmann (eds.), The European Private Company (fn. 6), p. 198–204; *Neville*, in: Neville/Ensig Sørensen (eds.), Company law and SMEs (fn. 6), p. 247, 274–275.

ditional distinction between the exit situations is presented here, based on how the exit is executed.

The first alternative is that the other current owner(s) acquire the shares from the exiting shareholder, with the redistribution of power that follows. For example, if one out of four shareholders with equal shares exits the business, the other three may proportionally take over the shares, leading to one third of voting power for each shareholder. The shares may also be acquired by only one of the shareholders, leading to one main owner without majority vote, and two minority owners. Those advisors who saw no need to regulate for exit strategies in the shareholders' agreement seem to foresee this kind of situation. With a consensus among the owners on who must leave, the transfer restriction seems to be used "backwards", e.g., an exiting shareholder may announce a wish to be bought out under the provisions of a right-of-first-refusal clause, even if such a clause is not designed to ensure a right to exit. According to some advisors, the potential need of regulation *ex ante* is on the price of the share. Hence, these advisors refer to the importance of a clear and fair value clause.

A second procedure by which the exit may be carried out is for the company to redeem the shares. Capital that otherwise can be used for dividend can be used for redemption of shares from the exiting shareholder, in combination with a reduction in share capital. (This may lead to a need to restore the share capital, to prevent it falling below what is stipulated in the articles of association or the legal minimum). A redemption clause can be included in the shareholders' agreement, giving each shareholder an individual right to require the company to withdraw the shares in exchange for money. However, this mechanism will only work if all shareholders give their consent at the time when the redemption decision is taken at the general meeting, as the decision will infringe the legal principle of equal rights.[34] Several advisors, but far from all, mention this alternative and consider it to be the first alternative when enabling a shareholder's exit, provided that the company has enough capital. Therefore, the solution with the redemption of shares seems to be a practice that advisors often advise. However, an alternative practice has also been detected. Advisor #2 gave a concrete example of this mechanism having been incorporated into the articles of association instead of a shareholders' agreement. In this company, the right to call for redemption was given to all (minority) shareholders and to the company itself, after a decision by the company board or general meeting. The regulation in the articles of association was complemented by a shareholders' agreement stating that redemption of shares was to be the first-hand alternative in a situation in which an individual shareholder desired to

34 chapter 4, Section 1 of the Swedish Companies Act (2005:551).

exit, but if this mechanism could not be utilized, due to a lack of capital, the right to exit was combined with the obligation of the remaining shareholders to acquire the shares. Interestingly, only Advisor #2 promoted this exit strategy. In contrast, some advisors (Advisors #6, #7 and #16) wrongfully stated that the legislation prohibits parties from including any type of exit clause in the articles of association.

4.8 Subcategories of Partial Ownership Exit

4.8.1 The Misbehaving Owner – Breach of Contract

Forcing a shareholder to exit can be a sanction for breach of contract. The respondents presented different examples of this and advisors seem to distinguish between *good leavers* and *bad leavers*. One example is a lack of dedication. In a shareholders' agreement, the owners can commit to the common entrepreneurial idea for a specific time period, e.g., five years, sometimes combined with a ban-of-transfers clause. If one shareholder drops out, the contract gives the other owners the right to acquire the shares with a discount, e.g., 20 percent per year. Thus, if a shareholder leaves after three years instead of the contracted minimum period of five years, the other shareholders can buy the shares for 60 percent of the value stipulated in the shareholders' agreement. Other examples of misconduct that can cause a bad-leaver situation are breaches of a competition clause, or breaches of a drug and alcohol policy in the contract.

"Then, you often have a right to acquire the shares, if you end up in a breach of contract that leads to damage for either the other shareholders or the company." Advisor #1

4.8.2 The Unwanted Passive Owner

Closely held firms are often managed by the owners. In some of these firms, only those who work in the company may own shares. Consequently, passive ownership can be perceived as a problem. Advisor #1 reflects on the problem with both active and passive owners, and the feelings it can cause among the owners:

"We don't want to pay a dividend to someone who contributes nothing. If you own shares, you must do the work, or we buy you out." Advisor #1

Another respondent described problems with unwanted passive owners.

"The majority owner has contacted me. I'm a member of the board and we have one owner who came in after the company acquired his firm. He got 7 percent of the shares, or so. All was good, but then they thought, 'But he is not really contributing, he is just dead weight'. And now when we are

entering a succession process to the next generation, he sits there with his 7 percent blocking the path. And on top of everything, he has stopped working in the business, and there is nothing in the contract that forces him to sell his shares when he retires." Advisor #4

In this story, the advisor expressed a regret that passive ownership was not regulated in the shareholders' agreement. Neither the owners nor the advisor had foreseen the potential conflict. Other advisors pointed out the need to regulate this in advance through a clause that forces a shareholder to sell his or her stock if (s)he retires or stops working in the firm for other reasons.

"And if you quit, stop working in the firm, then you commit a breach of contract according to the shareholders' agreement, and the other contracting parties have the right to acquire your shares." Advisor #12

4.8.3 Disagreements, Conflicts, and Deadlocks

Different ambitions and business goals can split the owners. Some exit situations that encounter this have already been mentioned *supra*, e.g., unwanted passive owners who are required to sell their shares, or a drag-along clause that forces a minority shareholder to transfer his or her shares if the majority owner accepts a bid, see *supra,* section 4.4. Different ambitions can be present when the business is started, or they may arise along the way, e.g., when the second generation takes over and some siblings want to cash out while others want to pursue the vision of the founder(s). Some respondents described their aim to avoid potential conflicts due to split ambitions and goals.

"I try to make them discuss their ambition with the firm, do they have the same target? Maybe it is okay if one owner wants to build something for generations to come and the other wants to leave in five years and cash out. It could be okay to start the business together nevertheless, but then you should be aware of it." Advisor #13

However, the risk of harmful disagreements, conflicts, and deadlocks, makes some advisors advise against splitting the ownership.

"In these situations when you add an owner, the CEO gets shares, a business partner gets a few percentages, etc. It often leads to problems". Advisor #4

A severe or long-term conflict creates a need to end the co-ownership. One solution is to sell the firm to new owners, as discussed under the 1st quadrant (see *supra,* section 4.4). However, situations in the 4th quadrant mean that at least one of the current shareholders remains in the business, while others leave. Hence, the remaining owner(s) will buy out the shares of exiting shareholders. Practice on how to regulate for this *ex ante* in a shareholders' agreement differs, depending on the bargaining power of individual shareholders. Hence, different tactics are necessary, depending on whether the shareholders have equal or unequal bargaining power.

Equal voting power. Several respondents, among them Advisors #11, #15, #16 and #17, discussed problems related to 50/50 ownership structures, i.e., two shareholders with equal shares. Such ownership structure can be catastrophic if a conflict arises. This makes some advisors dissuade clients from an ownership structure with equal shares. Business owners might, however, claim that a 50/50 ownership structure is necessary, as it demonstrates mutuality and trust. An ownership structure in which one shareholder in a mutual collaboration has a majority vote may itself cause conflict. This might be the reason that business owners, contrary to their advisors' recommendation, choose an ownership structure in which no individual has a majority vote.

Nevertheless, 50/50 companies exist, and this makes it necessary to include clauses in a shareholders' agreement to resolve deadlocks. These clauses are often given dramatic names such as a "shotgun clause" and a "Texas shootout clause".

A shotgun clause allows one shareholder to offer a specific price per share to the other shareholder. The offeree must then either accept the offer or buy the shares of the offeror for the same price. Thus, a classic shotgun clause is very definite. However, even if the parties are equal in their holding, they may be unequal in their financial capacity. In such a case, the shareholder with deepest pockets may misuse a shotgun clause to take over the firm.[35] It might also be difficult to predict the parties' financial situations in the future, as the shareholders' agreement can be written years or decades before the clause is taken into use.

"I only use this clause when the parties are rather equal, financially that is. It is very unfair if you have the big investor against the small founder." Advisor #6*"It is hard to find a good solution. It depends on who is weak and who is strong, what you want to achieve. So, I don't know. It is hard to find something that works every time. And then, it is better not to."* Advisor #17

Another shotgun alternative was advocated by Advisor #17. Both parties place their bids in sealed envelopes: the party with the higher bid has the right to buy the other shareholder's shares for the price of the lower bid. The argumentation was that the person with the higher bid will get what she wants, i.e., the shares, but pays no more than what the losing bidder was willing to pay for the shares. Other alternatives were mentioned in the interviews, e.g., the shareholder who places the higher bid has the right to buy the shares for a price that lies between the higher and the lower bid.

An alternative to a shotgun clause is an auction clause. Advisor #16 had experience of using such clause. The auction is conducted by an independent

35 See also *Svante Johansson*, Voluntary Remedies – the Agreed Solutions to Deadlock, in: Mette Neville/Karsten Ensig Sørensen (eds.), Company law and SMEs (fn. 6), 2010, p. 295–303, 301.

third party, and the parties can place no more than three bids. The party with the highest bid will purchase the other party's shares, giving a clear advantage to the shareholder with greater financial resources. In cases of unequal financial power between the shareholders, shotgun clauses or auction clauses can be considered unfair, and should therefore never be agreed upon. Instead, such a situation calls for completely different exit strategies when planning for future changes in ownership structure. The main shareholder, not necessarily the financially stronger party, needs a strategy to remain owner of the business.

Unequal voting power. In companies with an ownership structure with one main owner or group of owners, e.g. the founder(s), and one or several minority shareholders, the solution to a conflict or a long-term disagreement might be obvious: the minority must be bought out. If the shareholders agree on this, the exit is mainly a question of determining a price per share. In other situations, i.e., in which the minority does not accept being bought out, the parties need some kind of conflict-resolution mechanism. As indicated *supra* in section 3.2, the Swedish Companies Act is of little help in such a situation. One of the respondents explained:

"If you fall outside the scope of chapter 22 of the Companies Act, there is no obvious way... You have to wind up the company and that is messy [laughing]." Advisor #6

Chapter 22 of the Companies Act refers only to situations in which a majority owner directly or indirectly holds more than 90 percent of the shares. Often, the rules are of no help, simply because the minority holds ten percent or more of the shares, or the majority is composed by a group of shareholders, e.g., an entrepreneurial team or group of family members. This gives rise to a specific kind of regulation.

"He [the client] wants to test a key employee for 2–3 years. Some kind of co-owner trial period. And then you contract a right for him to repurchase the shares if he is not happy with the person." Advisor #16

Advisor #16 illustrated one way in which the majority shareholders(s) can retain control. The advisor explained that this is regulated as a mutual right, both a *call* option for the majority owners(s) and a *put* option for the employee. Thus, the minority owner is granted the right to request to be bought out. This advisor has also used such call and put option clauses in family firms, in order to test the commitment and ability of the younger generation.

A common regulation in shareholders' agreements is a consensus clause that stipulates that certain decisions in the company must be taken by all unanimously by all shareholders. Such a clause grants the minority greater power than follows from their holdings. Advisor #15 gave one example when this is connected to an exit situation:

"Sometimes, a majority owner says 'Well, if you use your veto right, I want to have the possibility to end this collaboration.' But this is rather rare." Advisor #15

5. The Need for Exit Regulation and the Swedish Companies Act

5.1 The Law as a Standard Contract

Based on the empirical findings presented in section 4 it is now possible to analyze and assess how the Swedish Companies Act correspond to the needs of closely held firms to regulate shareholder exits. Jensen and Meckling depict the firm as a nexus of contracts.[36] The corporation is seen as a hub in a web of contractual relationships with shareholders, directors, and creditors. It is also the common counterparty in numerous contracts with, e.g., suppliers, employees, and customers.[37] Against this background, company law is understood as a standard contract regulating the contractual relationships in the nexus. By doing so, it reduces the parties' transactions costs. Hence, one purpose of company law is to lower transaction costs by providing a ready-made standard contract.[38]

The standard contract should correspond to what rational parties would have contracted for if they had had perfect information, did not encounter significant transaction costs, and could be fully confident that the agreement will be honoured.[39] The so-called "Hypothetical Bargaining Model" can be used to select which rules to include in the legislation.[40] However, the law cannot at the same time fit all firms of all types and sizes at all stages of their lifecycle. Therefore, the law should as a starting point be of default character. Parties must be allowed to derogate from the legal norms when they find it necessary. By se-

36 *Michael C. Jensen/William H. Meckling*, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", Journal of Financial Economics 3 (1976), 305.

37 *Armour/Hansmann, et al.*, in: Kraakman/Armour, et al. (eds.), Anatomy (fn. 1), p. 5.

38 See e.g. *Frank H. Easterbrook/Daniel R. Fischel*, (fn. 32), p. 283; *Lucian A. Bebchuk*, "The Debate on Contractual Freedom in Corporate Law", Columbia Law Review 89 (1989), 1395, 1397.

39 See e.g. *Brian R. Cheffins*, Company Law: Theory, Structure, and Operation, 1997, p. 264–265; *Frank H. Easterbrook/Daniel R. Fischel*, "The Corporate Contract", Columbia Law Review 89 (1989), 1416, 1445; *Jeffrey N. Gordon*, "The mandatory structure of corporate law", Columbia Law Review 89 (1989), 1549, 1549–1551.

40 See e.g. *Ian Ayres/Robert Gertner*, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules", The Yale Law Journal 99 (1989), 87, 90–91; *David Charny*, "Hypothetical Bargains: The Normative Structure of Contract Interpretation", Michigan Law Review 89 (1991), 1815; *Easterbrook/Fischel*, (fn. 39) p. 1433; *Richard A. Posner*, Economic analysis of law, 1998, p. 396.

lecting legal rules that fit *typical* parties to the specific contractual relationship in mind, the legislation forces fewer parties to bear the cost of contracting to derogate from the default rule. For this reason, the term "majoritarian defaults" is sometimes used.[41] Ideally, company law should provide a full-cover standard contract. From the hypothetical bargaining model perspective, the legislature is in a better position than the average parties to formulate all covering contracts, i.e., contract with a high degree of idealization.[42] The lawmaker has the advantages of a higher degree of rationality and more information that follow from specialization. Thus, the literature supports an all-covering corporate law that regulates both frequent and rare situations.

This study shows a wide range of exit situations that can occur for closely held companies and their shareholders. The exit situations are organized into four categories. The overarching conclusion, as shown below, is that neither the variety of exit situations under each category nor all four categories are currently covered by the Swedish Companies Act. Thus, for this reason, the act does not correspond to majoritarian defaults and does not a uphold a high degree of idealization, which hampers its ability to function as a standard contract.

Section 3.2 *supra* discusses which exit situations are currently regulated in the Swedish Companies Act. The general rules in chapter 22 deal with partial ownership exits (4th quadrant). This is a powerful exit strategy, as it does not set up any specific requirements for its application. The minority shareholder may, at any time and for any reason, transfer his or her shares to the majority owner, with a corresponding duty of the majority owner to acquire the shares, and *vice versa*. There are, however, at least two problems with the rule as an exit strategy. The first problem is that the rule applies only to situations in which the minority shareholder(s) holds less than ten percent of the shares. Further, and this may be even more cumbersome, it does not apply when the majority owner consists of a group of shareholders, e.g., the founders or a family, even if they together hold more than 90 percent of the shares. Hence, as pointed out by some respondents, chapter 22 is of little help when solving exit situations in closely held firms.

The second problem with chapter 22 of the Companies Act is that it is a mandatory regulation. Hence, the parties are not allowed to adjust the rule to fit their situation, e.g., to apply the rule even if the majority "owner" are the two founding members, or if the minority holds 15 percent of the shares. The level of ten percent holdings constitutes the threshold for many minority share-

41 *Ian Ayres/Robert Gertner*, "Majoritarian vs. minoritarian defaults", Stanford Law Review 51 (1999), 1591.

42 *Charny*, (fn. 40), p. 1821.

holder protection rules in the Swedish Companies Act, and an investor or key employee who is offered shares in the business thus has reasons to aspire to a holding of ten percent or more. The mandatory regime also means that the parties cannot set up requirements for the rule to apply. As exemplified *supra* in section 4.8.1, shareholders' agreements can contain exit rules for misbehaving shareholders, bad leavers. However, it is not possible to link the application of chapter 22 exits to misconduct of any kind, neither in the articles of association nor in the shareholders' agreement. In my understanding, the two problems with chapter 22 manifest the unfortunate narrow purpose of the rules, i.e., to ease mergers between a parent and daughter company. These rules are not intended to regulate shareholder exits in general.

The second currently regulated exit situation is found in chapter 25, Sections 21–22 of the Companies Act. It refers to clear cases of long-term abuse of power by majority owners. The structure of the exit is rather intriguing. Initially, the rules give the oppressed minority the right to request the court to wind up the company. This exit strategy falls under the 3rd quadrant, and leads to a full shareholders' exit. However, the company can request the court to order the company to redeem the minority shareholders' shares *in lieu* of liquidation, and the exit thus moves into the 4th quadrant, with a partial shareholder exit rather than a full exit. Similar exit strategies are not found in practice among the respondents, but one advisor emphasized that one purpose of including a right to require liquidation of the firm in deadlock situations is to force the parties to negotiate (see *supra,* section 4.6).

The problem with the exit situation specified in chapter 25 is that the requirements it sets are too high for the legislation to function well. Multifaceted cumulative requirements narrow its application significantly. Additionally, the lack of court cases seams to result in some legal uncertainty.[43]

In summary, the Swedish regulation is of very little help, if any, to provide exit solutions in closely held firms. Among the different exit situations identified in this study, those in the 2nd quadrant correspond most closely to the provisions of the Companies Act. However, this regulation does not *enable* exits, but uses transfer restrictions to *avoid* some situations. Further, the exit situations in the 1st quadrant are not at all covered by the legislation, and only a limited number of atypical situations in 3rd and 4th quadrants have any support in law. Together, this makes the owners dependent on contractual solutions.

43 See e.g. *Erik Nerep/Johan Adestam/Per Samuelsson*, Aktiebolagslag (2005:551), 2019, section 2.1.

5.2 The Cost of Contracting

When the legislation fails to provide provisions that fit the needs of specific parties it gives them reason to draft tailored rules in their contract. This is in itself inevitable, as the law never can fit the needs of all companies at all types and sized. However, when the law evokes the majority of parties to tailor their own rules, the legislature fails to provide a standard contract. This study has made the limited use of the Swedish Companies Act to solve exit situations in closely held companies visible. Consequently, the need for contractual regulation is evident, with the subsequent costs for the parties.

In earlier research, we have demonstrated how the design of corporate law imposes transaction costs on the parties.[44] We show that the opt-out regulatory technique is often associated with high transactions cost causing "stickiness" and a low level of default. Therefore, we conclude that it is not sufficient to rely on only default opt-out rules, other regulatory techniques should be considered, such as opt-in alternatives and menus.[45]

Opt-out defaults allows parties to tailor their contract. From a company law perspective, this contract could be the articles of association or a shareholders' agreement. It is commonly argued that such contractual regulation should come in the form of articles of association, as it will have legal effect not only for the contracting parties, but also for both the firm and potential third parties. In contrast, if a party to a shareholders' agreement in breach of the contract does not honour the contracted exit solution, there is no legal way to force this person to transfer or acquire the shares. Only contractual sanctions, such as liquidated damages will apply to the breach of contract.

"*I have come across situations where the owners have received a bid for the business, and you use the drag-along for the other shareholders, but one shareholder absolutely refuses. And then you start to threaten 'You will be liable for liquidated damages: it will cost you', but the person continues to refuse. And so, the deal will not happen. It's really tricky.*" Advisor #9

Hence, exit strategies are more powerful if they can be included in the articles of association. However, this is often not possible as it would be an illegal departure from the principle of free transferability of shares (see *supra,* section 3.1). This is also what several respondents expressed in the interviews. There was, however, one exception among the respondents. As described in section 4.7, Advisor #2 has used a redemption-of-shares clause in the articles of association instead of in the shareholders' agreement, which otherwise

44 *Hanna Almlöf/Per-Olof Bjuggren*, "A regulation and transaction cost perspective on the design of corporate law", European Journal of Law and Economics 47 (2019), 407.

45 Ibid., p. 423–425.

seems to be the common practice. The clause in the articles of association was supplemented by a shareholders' agreement stating that redemption of shares shall be the first-hand alternative in exit situations of individual shareholders, but if this mechanism cannot be utilized due to a lack of capital, the right to exit the firm was combined with the obligation for other shareholders to acquire the shares. Advisor #2 has also provided an example of this clause as it has been approved and registered by the Companies Registration Office. The reason that this exit clause was approved in the articles of association, and no other discussed exit strategies, must be that the obligation to *acquire* the shares is placed on the company, not individual shareholders. Hence, as this exit strategy targets the firm instead of the shareholders, it does not violate the free transferability of shares. Nevertheless, this study shows that this is not common knowledge among legal advisors. Via an opt-in regulation in the Swedish Companies Act, this exit strategy would be visible to all, which would likely increase the knowledge and usage of such redemption-of-shares clause.

Finally, and in contrast to the arguments above, one may argue that advisors are in better position than the legislature to assist parties in tailoring contracts. Consequently, the described structure of the legislation with opt-out defaults might be without major problems. My interview study can also provide some evidence that parties in fact seek assistance from advisors, helping them to tailor their contract. However, some advisors in my study show little understanding for the exit problem in closely held companies, see section 4.2, and as shown throughout section 4 the level of knowledge and practise varies tremulously. In addition, contracting itself is costly including the cost for seeking advice. The costs of contracting can be structured into three categories: contact, contract and control costs.[46] High contracting costs carry a risk that rational parties will choose to not consider contingencies and stay with suboptimal default rules, or accept the uncertainty of no regulation, instead of contracting for a tailored solution. One reason for rational inactivity is that the parties believe that a situation is unlikely to occur and therefore not worth negotiating about.[47] For this reason, an interview study with advisors will not ever catch parties that never seek advice, no matter if they make their own homemade shareholders' agreements, or simply do not do anything. Additionally, as developed by Williamson[48] in transaction cost economics, bounded ra-

46 *Bart Nooteboom*, "Firm Size Effects on Transaction Costs", Small Business Economics 5 (1993), 283, 285.

47 See e.g. *Melvin Aron Eisenberg*, "The Structure of Corporate Law", Columbia Law Review 89 (1989), 1461, 1464–1466; *Russell Korobkin*, "The Status Quo Bias and Contract Default Rules", Cornell Law Review 83 (1997), 608.

48 *Oliver E. Williamson*, "The Economics of Organization: The Transaction Cost Approach", American Journal of Sociology 87 (1981), 548, 553–554.

tionality makes explicit contracts between parties more or less incomplete, because humans are incapable of foreseeing the future and covering all contingencies in a contract. When addressing the contractual relationship between parties, we must not only see the cost of what is regulated in contracts or by law, but also acknowledge the cost of no regulation. For example, no regulation result in low predictability, which is associated with potentially high *ex post* costs, e.g., in the form of litigation.

5.3 Conclusion and Call for Legislative Change

The conclusion of this study is that the Swedish Companies Act does not function as a standard contract for closely held firms. Instead, the legislature places on the owners the costs of contracting to regulate for exit strategies in shareholders' agreements. If the costs are too high, it will lead to no contract, and consequently no exit solutions will be available to ease shareholder disagreements, conflicts, or deadlocks. This calls for legislative change.

Generally speaking, the purpose of such a legislative initiative should be to cover all four categories in Figure 1, see *supra,* section 4.3. Even if the interviews with the advisors provide us with a wide range of exit situations, they nevertheless can be organised into these four categories. Hence, there are some common features allowing us to strive towards a standard contract with a high degree of idealization.[49] I present below suggestions to improve the situation.

First, the legislature should recognize that the principle of the free transferability of shares is generally unwanted by closely held firms. These firms constitute the vast majority of all companies in Sweden, and thus free transferability should not be the default rule for private companies. I argue that the post-sale purchase rights clause should be the default rule, followed by opt-in alternatives: free transferability, consent clause, and right-of-first-refusal clause. At the same time, the legislature should consider introducing a temporary ban on transfer clauses, which are sometimes used in, e.g., start-ups, as a fourth possible opt-in alternative.

Second, if the principle of free transferability of shares is no longer the starting point, what prevents shareholders from including exit strategies in the articles of association? In particular, when any obligations created by the articles are mutual, e.g., when the majority owner can request to buy, and the minority shareholder has the right to request to be bought out, I see no convincing argu-

49 *Cf. Hanna Almlöf/Per-Olof Bjuggren*, "A regulation and transaction cost perspective on the design of corporate law", European Journal of Law and Economics 47 (2019), 407, 418–419.

ments against allowing such a regulation in the articles of association. For example, this would open the opportunity to regulate for situations in the 1st quadrant of Figure 1, something that is not possible with today's Companies Act.

Third, the mandatory exit rule found in chapter 22, Section 1 of the Swedish Companies Act should be default regulation, allowing shareholders to tailor the rule to fit their ownership structure to cover additional exit situations in the 4th quadrant of Figure 1. The exit solution in chapter 25, Section 21–22 should be relaxed and broadened. When redesigning these rules, experience from other countries should be taken into consideration, see examples *supra*, section 3.2. For example, Norway has chosen a broader scope for exit regulation, allowing the minority (and the company) to call for redemption of shares not only in case of infringement of law and abuse of power, but also in cases of severe and long-term disagreement between the shareholders.[50]

Additionally, increased knowledge among legal advisors that redemption-of-shares clauses can be included in the articles of association would ease the situation. Such clauses place the duty to "acquire" the shares on the company, and not on individual shareholders, and hence, do not infringe the principle of free transferability. In this study, only one out of eighteen advisors used this opportunity, and several advisors erroneously stated that it is not compatible with the Companies Act. The legislature can help here. By adding an opt-in redemption-of-shares clauses to the Companies Act, it could both have a signalling effect on parties to choose this alternative[51], and enable network externalities for the clause.[52] This is a fourth suggestion for legislative change.

6. *Concluding Remark and Avenues for Further Studies*

This study has explored the need for exit regulation in closely held companies and revealed a clear mismatch between the need and the solutions offered by Swedish legislation. For this purpose, there is a call for legislative change. Four suggestions have been put forward in the conclusion.

50 The rules are found in the chapter 4, Section 24–25 of the Norwegian Companies Act, Lov om aksjeselskaper (aksjeloven).

51 *Henry Hansmann*, "Corporation and Contract", American Law and Economics Review 8 (2006), 1, 12; *Ian Ayres*, "Menus Matter", The University of Chicago Law Review 73 (2006), 3, 4.

52 *Michael Klausner*, "Corporations, corporate law, and networks of contracts", Virginia Law Review 81 (1995), 757, 826–829.

Avenues for further research include comparative studies of exit regulations in national company laws in search of best practice.[53] The model in Figure 1 can be used as a tool in such comparative study to assess the scope of different regulatory alternatives. The model in Figure 1 can also be used to structure an analysis of best practise among advisors to learn more of exit solutions tailored to different exit situations. Also, as this study does not explore the use of pricing clauses in shareholders' agreements or in articles of association, and the respondents expressed widely differing views on the exit regulation and its priority, there is a research opportunity here on pricing mechanisms that would benefit from an interdisciplinary approach. Finally, studies on shareholders' entries into closely held companies could be fruitful to explore potential instruments to prevent shareholder disagreements, conflicts, and deadlocks.

53 A good start is presented by *Neville*, in: Neville/Ensig Sørensen (eds.), Company law and SMEs, (fn. 6), p. 262–274.