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*A National Newsletter committed to Lawyers, CPAs, and Business Planners
who need to stay current in a fast-changing field.*

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News Briefs

Check-the-Box. Simplification of Entity Classification Rules, 26 CFR Parts 1, 301, and 602 became effective January 1, 1997. The final regulations were published in the Federal Register on December 8, 1996 at pages 66584-66593. They are available on our website. **There is no longer a need to avoid corporate characteristics.** The regulations have been published and with no significant changes from the proposal that was issued last spring.

Ball Passed to the States. The need to revise the statutes of fifty states exists. All state statutes are workable, yet all contain dead wood resulting from the past need to avoid corporate characteristics. **This is a unique opportunity for the National Conference of Commissioners on Uniform State Laws to step forward with a simplified act to take advantage of the simplified rules.**

Tax Matters Member. The IRS on December 23, 1996 published its final regulations on the Designation of a Tax Matters Member for LLCs. The new regulations are at 61 FR 67458-67463. The new regulations have only minor changes from the proposed regulations and make Rev. Proc. 88-16 obsolete. For a copy of the Tax matter member regulations see our website.

Vermont. Under the new check the box regulations Vermont taxes entities that are partnerships for federal tax purposes a minimum of \$150.00. All other entities are taxed

7. **Method of accounting.** In certain circumstances, C corporations have much greater flexibility than S corporations and Subchapter K entities in choosing their accounting methods.

8. **Net losses.** Losses of pass-through entities are personal to their owners. Losses of C corporations belong to the entity. They may be used to offset entity income from other years, and they may also serve as a major attraction to potential acquirers.

Non-tax advantages

1. **Attractiveness to pension funds and other tax-exempt investors.** Because of concerns about unrelated business income and other issues, pension funds and other types of tax-exempt non-profit organizations have traditionally felt more comfortable about investing in C corporations than in pass-through entities.

2. **Foreign investors.** Foreign individuals and entities that are interested in investing in the U.S. often prefer to invest in C corporations, since if they invest in pass-through entities, they may be required to file U.S. tax returns and to pay U.S. taxes on their share of entity profits.

3. **General legal concerns.** Most legal and drafting issues in forming and restructuring C corporations - including issues relating to the accurate documentation of a business's capital structure and rules for internal governance, have long been resolved, especially in the case of high-growth companies that need to tailor their structure to attract outside investment. These issues can be more difficult to handle in the case of S corporations and far more difficult with LLCs and other unincorporated business entities. **LLCR**

EXPULSION & WITHDRAWAL IN CLOSE COMPANIES - SOME EUROPEAN COMPARATIVE LAW ASPECTS

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A statute governing expulsion and withdrawal in « close companies » (the *société privée à responsabilité limitée* and the private *société anonyme*) recently came into force in Belgium. This statute was partially inspired by a prior Dutch statute designed for close compa-

Editor's Note: As LLCs become more common and with adoption of the check the box classification system practitioners are not as concerned with the structure of the LLC. *In this article we are provided with a comparison of several European codes involving the withdrawal and expulsions of members from LLCs. This European experience should be invaluable to both the American practitioner and to state legislatures who are struggling with these issues.*

nies (the *besloten vennootschap met beperkte aansprakelijkheid* and the private *naamloze vennootschap*). The following article summarizes how the issues of expulsion and withdrawal are being explored in close companies (i.e. the equivalent of the U.S. L.L.C.s and closely held corporations) in Belgium, the Netherlands, Germany and France. As to terminology, the terms expulsion (currently used in the U.S.A.) and exclusion (more likely to be used in Europe) will be used indifferently. Jurisdictions lacking of a general statutory framework will be first analyzed (Germany and France). Jurisdictions provided with statutes organizing expulsion and withdrawal in close companies will be considered afterward (the Netherlands and Germany).

I. Two jurisdictions deprived of a general statutory framework organizing expulsion and withdrawal : *Germany and France*

Germany

A. Expulsion

1. Expulsion of a shareholder from a GmbH (L.L.C.). The statute regulating the GmbH does not contain any general specific provision as to expulsion of a shareholder. The possibility of expulsion outside the statutory framework of the GmbH raised controversy in the 1920's (most authors denied this possibility as contrary to the GmbH as an « institution » and ill fitting into the statutory regulation of the company). Nonetheless, the Reichsgericht (highest jurisdiction in the country before the second world war) in the 1940s and the Bundgerichtshof (highest jurisdiction after the second world war) in the 1950s did recognize an extrastatutory power of expulsion. A distinction is drawn between expulsion according to a provision to be found in the company's by-laws and expulsion in the absence of such provision.

1.1. Expulsion according to a provision in the by-laws of the GmbH.

Contractual freedom is an important element in the regulation of GmbHs. A contractual expulsion provision is therefore valid, providing that the following conditions are complied with :

- insertion in the by-laws through a 3/4 majority decision. The decision of expulsion itself may be effectuated though a simple majority vote, the shareholder concerned by this decision may not himself participate in the vote;

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- discretionary expulsion clauses will be admitted only upon showing of exceptional circumstances. It is therefore advisable to formulate a criterion of expulsion that can be judicially controlled.

1.2. Expulsion in the absence of any contractual provision.

In this case, a suit of expulsion may be brought before the courts. Expulsion will be admitted if a « serious motive » can be articulated against the shareholder to be excluded. The GmbH's decision to institute proceedings must be taken by a 3/4 majority (this is the type of majority required for dissolution of the company for which expulsion is seen as an alternative solution), the shareholder concerned being prohibited from participating to the vote. The reasons for this judicial admission of expulsion in the GmbH are :

- the general principal of law that there must be a possibility to terminate a relation of indeterminate duration upon demonstration of a serious motive;
- the existence of a duty of loyalty (*Treupflicht*), in the person of each shareholder, the violation of which would make unbearable the continuation of his presence in the company.

1.3. The financial compensation of the excluded shareholder must correspond to the real value of the participation to be transferred.

The judge chooses freely between any of the the three valuation methods:

- based on the intrinsic value of the elements composing the company property (*Substanzwert*);
- based on the global value of the enterprise perceived as a going concern (*Etragswert*);
- based on the average of the results obtained in applying the two preceding methods (*Mittelwertmethode*).

2. Expulsion of a shareholder from an AG (corporation).

Contrary to the GmbH's statutory regime, contractual freedom is severely limited in the context of an AG. This observation, coupled with the assertion that there would be no personal relations between the shareholders of an AG (only the financial aspect of the participation matters) and therefore there is no necessity of providing for the expulsion of the latter, traditionally led the authors to approve the BGH in denying the possibility to exclude shareholders from the AG.

This solution may be reviewed in the future for the following reasons :

- doctrinal pressure arguing that the possibility of expulsion should be counted among the general principles prevailing in any type of business association;
- evolution in the case law of the BGH that recently recognized the existence of a duty of loyalty in the relations between shareholders of an AG after having long refused such recognition on the basis of the asserted lack of personal relationships between the shareholders of the AG;

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- statutory recognition of the specificity of the so-called « small » AG in which the personal character of the relations between the shareholders would be even more obvious.

B. Withdrawal

1. *Withdrawal of a shareholder from a GmbH (L.L.C.).*

We have seen that the GmbH statute does not expressly regulate expulsion. It also does not regulate withdrawal. The right of withdrawal of a GmbH shareholder was judicially recognized a long time ago. The withdrawal is effectuated through an unilateral expression of the withdrawing party's will, the validity of which will be susceptible of a subsequent judicial review on the basis of the (in)existence of a serious motive (circumstances that render the continuation of the withdrawing party's shareholding unbearable). The GmbH by-laws may contain a withdrawal provision. The principles governing the financial compensation of the withdrawing shareholder are comparable to those applied in the case of expulsion.

2. *Withdrawal of a shareholder from an AG (corporation).*

German law does not address specifically the problem outside the traditional possibility of a shareholder in such business association to sell his shares.

France

A. Expulsion

It would be inappropriate, for the purpose of a brief description of the relevant principles applicable in French law, to make a distinction between the S.A.R.L. and the S.A.. For both, no general statutory provision exists and for both the same basic attitude applies. Apart from marginal cases, French company law is traditionally hostile to the recognition of a general principle permitting the expulsion of a shareholder, at least when the motive of exclusion is persistent dispute between shareholders for this solution might lead to unjust results when one cannot determine who originally caused the dispute. There are, however, scattered judicial attempts, based upon varying and uncertain grounds, to validate some decisions of expulsion or to pronounce an expulsion. However, recently, the Court de cassation (highest jurisdiction in the country) rendered a decision seemingly disapproving such attempts in the absence of express statutory regulation of the matter. It can also be generally observed that the trend today is to recognize the validity of expulsion clauses inserted into the company's by-laws. This trend is confirmed by the recent statute organizing, especially for the purpose of facilitating the formation of *joint ventures* using the vehicle of the French S.A., the *société par actions simplifiée*. Indeed this statute expressly asserts the validity of expulsion clauses inserted into the company's by-laws. It has also been implicitly approved by a decision of the Cour de cassation.

The financial compensation of the excluded shareholder generally must correspond to the just price for the shares to be transferred. An expert valuation will often have to be sought (article 1843-4 of the Civil code).

B. Withdrawal

1. *Withdrawal of a shareholder from a S.A.R.L. (L.L.C.).*

The French company law statute does not generally assert any right of withdrawal for a shareholder in such company. However, it does indirectly provide the shareholder with such right in one particular case : when the shareholder purports to transfer his shares to a stranger (that is a person who was not already a shareholder), the transfer has to be approved by the other shareholders according to a 3/4 majority decision; would the approval be denied, then the candidate transferor has a *right* to have his shares be taken over by the other shareholders or third parties designated by the latter within a six months delay (art. 45, third part, of the French company law statute). The financial compensation of the transferring shareholder will compulsorily be made according to article 1843-4 (*supra*) of the Civil Code (contractual determination *ex ante* is not permissible).

2. *Withdrawal of a shareholder from a S.A. (corporation).*

French law does not address specifically the problem outside the traditional possibility of a shareholder in such business association to sell his shares.

II. Two jurisdictions provided with a general statutory framework organizing expulsion and withdrawal : *the Netherlands and Belgium*

The Netherlands

In 1990, a statute modifying the second book (on legal persons) of the Civil code (NBW) for the purpose of introducing provisions for the settlement of disputes (*geschillenregeling*) came into force (articles 2:335 and foll. of the Civil Code). It did introduce a unified regulation for judicial expulsion and withdrawal in close companies whatever their form (B.V. or N.V.). This statutory regulation is subsidiary (see art. 2:337 NBW), which means that contractual procedures for the settlement of shareholders' disputes prevail over the judicial procedure instituted by art. 2:335 and foll. NBW.

Experience with judicial valuation of shares has revealed that the judge's determination tends to be objective (taking into account the profitability of the company in ordinary circumstances) rather than subjective (which would involve the acceptance of a minority discount, for instance).

A brief description of the headlines of the statutory regulation follows.

A. *Expulsion (art. 2:336 - 2:342 NBW)*

- the plaintiff : one or more shareholders possessing at least one third of the capital;
- the defendant : a shareholder whose behavior damages the interest of the company to such an extent that continuation of his shareholdership cannot be tolerated;
- the suit may not be filed by the corporation itself or a subsidiary thereof;
- the judge having jurisdiction is the court of first instance of the judicial district in which the company has its real seat. Review is reserved to a specialized enterprise chamber of the Amsterdam Court of appeal;

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- the defendant may not, after service of the summons, transfer or encumber his shares except with the consent of the parties to the case or with the judge's authorization upon showing by the defendant of a reasonable interest. The judge's decision thereabout is not susceptible of review;
- for the valuation of the shares to be transferred, the judge must firstly seek an expert valuation but he determines finally the price to be paid to the defendant;
- some provisions purport to ascertain the compliance with clauses restricting the transferability (pre-emption clauses) that would eventually be included in the by-laws of the company.

B. Withdrawal (art. 2:343 NBW)

The procedure is roughly the same as the one applying to expulsion (*supra*). The peculiarities of the procedure are mainly :

- the plaintiff : a shareholder whose rights or interests were damaged by the behavior of one or more other shareholders to such an extent that continuation of his shareholdership cannot reasonably be required from him anymore;
- the defendant : the shareholder(s) whose behavior damaged the rights or interests of the plaintiff.

Belgium

It has already been pointed out that the recent Belgian statutory regulation (reproduced in APPENDIX) took its inspiration in the Dutch one.

The statutory provisions on expulsion or withdrawal upon judicial determination are, similarly to the Dutch provisions, subsidiary. Therefore contractual procedures remain applicable.

We will just say a few words on the peculiarities of this statute :

- the concept of « just motive » has been preferred over the formulations contained in the Dutch statute for expulsion and withdrawal. The reason therefore is that the concept of « just motive » is already meaningful for Belgian lawyers for it is used in the context of judicial dissolution for which expulsion or withdrawal are seen as alternatives. It thus operates the link with dissolution and helps establishing a hierarchy in subsidiarity (the most subsidiary procedure is dissolution, then come expulsion and withdrawal). This means that the same concept of « just motive » will not have exactly the same content in the context of each of these proceedings : the more subsidiary the procedure, the more flexible the concept (for instance : an abuse of majority power is not a just motive for dissolution but may be such for expulsion; the personal interest of the withdrawing party is essential whereas the interest of the company prevails in the expulsion procedure etc.);
- no specialized judges intervene (there is no such thing as an enterprise chamber in the Belgian judicial apparatus);
- the judge determines the price, there is no obligation for him to request an expert valuation (although it will often be the case in practice);

- more emphasis is set on compliance with contractual provisions restricting transferability of the shares;

Conclusions from a comparative perspective

We have briefly surveyed the legal treatment applied to expulsion and withdrawal in close companies in two types of jurisdictions : some provided with a statutory regulation (the Netherlands and Belgium) and some without such statutory framework (Germany and France). It is interesting to point out that :

- the jurisdictions provided with statutes do not preclude the use of contractual procedures (in fact they encourage them⁵⁵). This is quite remarkable when one keeps in mind that most provisions of European company law statutes are non-waivable provisions;
- the jurisdictions deprived of statutes stress the possibility of inserting expulsion or withdrawal clauses in the company's by-laws or even in shareholders' agreements. The debate thus appears not to be one, as often in Europe, opposing contractual freedom and statutory intervention. The adoption of a statute appears therefore to be advisable:
 - to stress the *existence* of a possibility of expulsion or withdrawal (consider the uncertainties in France and Germany);
 - to formulate how the law stands as to an important policy orientation that is who is entitled to require the expulsion of a shareholder : the company and/or one or more shareholder. All depends on how expulsion is perceived : is it an additional tool for the majority shareholder to consolidate its power or is it a means for settling disputes between shareholder in the best interest of the company. The jurisdictions under review, with the possible exception of France where no definite position is expressed, clearly see expulsion as a (radical and therefore subsidiary) dispute resolution mechanism (the statutes in the Netherlands and in Belgium prevent the company from filing the suit for expulsion and the shareholder concerned may not participate in the company's decision to file the suit in the German GmbH);
 - to clarify the role to be played by the courts (*ex ante* or only *ex post* ?);
 - to formulate some principles as to determination of the price of the shares to be transferred;
 - to give an incentive to the parties to think the matter over and exchange information in the course of adopting a contractual procedure that will allow them to avoid judicial intervention.

From a general perspective, it is also interesting to point out that the two statutes that have been briefly analyzed make no distinction between companies according to their form (L.L.C. or corporation) but set the emphasis on the public or private character of the company. This is an illustration of a growing trend perceived in comparative law of legal persons.

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The Small Business Job Protection Act substantially liberalized the tax rules effecting S corporations. The new ability of S corporations to have subsidiaries, to have more shareholders, and to have more diversity among shareholders will be extremely helpful to incorporated businesses. We expect, however, that the principal beneficiaries of the changes will be existing businesses already operating in corporate form, whether taxable "C" corporations or S corporations. **LLCs continue to have material operating, planning, and tax advantages for newly created businesses.**

The business convenience of LLCs has also been dramatically improved by the final "check-

and Public Accountant with the Cederberg & Beckwith. His practical organizational and tax issues in transactions and dispositions. He was a member of the committee for the commercial code which was attached at Cederberg & Beckwith, Omaha, Nebraska 68506 Tel. (402) 475-

APPENDIX : articles 190ter and 190quater BCLS

Art. 190ter. - § 1. The present article applies to limited liability companies and to private corporations.

§ 2. One or more shareholders possessing together either securities representing 30 % of the votes attached to the whole of existing securities or 20 % when the company issued securities not representing the capital, or shares the nominal value or the par value of which amounts to 30 % of the company's capital, may request in court, upon demonstration of just motives, that a shareholder transfers to the plaintiff his shares and all securities he holds that can be converted or entitled to subscription or exchange in shares of the company.

The suit may not be filed by the company or a subsidiary thereof.

§ 3. The suit is filed before the president of the commercial court of the judicial district in which the company located its seat, trying the case in chambers.

The company must be summoned to appear. In default thereof, the judge defers the case until an approaching date. The company informs the holders of registered securities.

§ 4. The defendant may not, after service of the summons, transfer or encumber his shares except with the judge's authorization or the consent of the parties to the case. The judge's decision thereabout is not susceptible of review.

§ 5. Upon the filing of his first submissions, the defendant also files a copy of the company's coordinated articles of incorporation and by-laws and a copy or abstract of all agreements restricting the transferability of his shares. The judge enforces the rights resulting from the latter when he orders the forced transfer. The judge may however substitute himself to any party designated by these articles, by-laws or agreements for the determination of the price for the exercise of a pre-emption right, reduce the delays for the exercise of pre-emption rights with a discount, and set aside the approval clauses applicable to shareholders.

Providing that all beneficiaries have been summoned, the judge may decide upon the lawfulness of any agreement restricting the transferability of the defendant's shares or, according to the circumstances, order the transfer of these agreements to the purchasers of the shares.

§ 6. The judge sentences the defendant to transfer, within the delay he determines from the date of service of the judgement, his shares to the plaintiffs, and the plaintiffs to accept the shares against payment of the price he determines.

The decision amounts for the surplus to title for carrying out the formalities relating to the transfer of registered securities.

The forced transfer is to be operated, according to the circumstances, after exercise of eventual pre-emption rights stated in the judgment, in proportion to the number of shares held by everyone, subject to contrary agreement.

The plaintiffs are jointly and severally bound to the payment of the price. The judge's decision is enforceable notwithstanding opposition or appeal. When the decision has been enforced and an appeal has been filed, § 4 applies to the purchasers of the shares.

§ 7. One or more shareholders possessing together either securities representing 30 % of the votes attached to the whole of existing securities or 20 % when the company issued securities not representing the capital, or shares the nominal value or the par value of which amounts to 30 % of the company's capital, may request in court, upon demonstration of just motives, that the person exercising a voting right pursuant to a title other than of proprietorship transfers his voting right to the holder or other holders of the shares.

The holder or other holders must be summoned to appear. Would that not be the case, the claim will be declared inadmissible. § 2, second part, §§ 3, 4 and 5 apply.

The judge's decision amounts to title for carrying out all formalities relating to the transfer of the voting right.

Art. 190quater. - § 1. Every shareholder may, upon demonstration of just motives, request in court that the shareholders in whom these just motives originate take over all his shares as well as convertible securities or subscription rights attached thereto.

Upcoming LLCR Features

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- IRS Study Group Updates
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- Estate Planning
- Court & Administrative Rulings
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- Agency & the LLC
- Fiduciary Duty in the LLC
- Estate Planning & the LLC

§ 2. Article 190ter, §§ 1, 3, 4, second part, and 5, second part, and followings, is applicable. § 5, first part, of the same article is applicable by analogy to the plaintiff.

§ 3. The judge sentences the defendant to accept, within the delay he determines from the date of service of the judgment, the shares against payment of the price determined, and the plaintiff to transfer his shares to the defendants.

The decision amounts for the surplus to title for carrying out the formalities relating to the transfer of registered securities.

The forced transfer is to be operated, according to the circumstances, after exercise of eventual pre-emption rights stated in the judgment. The defendants are jointly and severally bound to the payment of the price.

The judge's decision is enforceable notwithstanding opposition or appeal. When the decision has been enforced and an appeal has been filed, article 190ter, § 4, applies to the purchasers of the shares. 