Right of first refusal over shares measured at book value: valid

(Decision of the Directorate-General for Registers and Notaries of 15 November 2016)

Gómez-Acebo & Pombo Corporate and Commercial Area

1. Factual circumstances.

The Directorate-General for Registers and Notaries ("**DGRN**"), in its decision of 15 November 2016 (Official Journal of Spain ["**BOE**"] no. 291 of 2 December), focuses on a traditionally controversial issue, as is the limitation of parties' private autonomy - art. 28 of the Companies Act ("**LSC**") - in the drafting of articles that limit the transferability of company shares. It admits the validity of a provision in articles of association pursuant to which: "*The right of first refusal shall be exercised taking the shares subject to transfer at their fair value, which will be the lower of the following: the price notified to the company by the transferor shareholder, or the book value resulting from the last balance sheet approved by the General Meeting. Where the proposed transfer is for consideration other than the sale and purchase or for no consideration, the fair value will be the same as the book value resulting from the last balance sheet approved by the General Meeting*".

The dominant doctrine has traditionally held that a shareholder's right to obtain the real or fair value of his/her shares in the event of a share transfer is a requirement that arises from the very purpose of company formation agreements, which entail shared risks and benefits. From this perspective, setting aside the fair value criterion in order to apply that of book value would be unlawful in the absence of adjustment factors. This is what is inferred from arts.107(d)(2) LSC, concerning a private limited company, and 123(6) of the Register of Companies' Rules ("**RRM**"), concerning a public limited company; and even from art. 175(2)(b) RRM, which allows registration of a unanimous agreement reached between the shareholders on "*the criteria and systems to determine the fair value of the shareholdings in the event of inter vivos transfers and transmissions mortis causa or the application of the obligation to transfer under art. 188(3) RRM*".

The DGRN had already admitted the validity of articles that laid down objective measurement or appraisal systems that respond in a "clear and unequivocal" manner to the legal requirements of "impartiality and objectivity" and that "properly ensure the appropriateness of the outcome to the true value of the measured asset", though always with the idea of safeguarding the shareholder's right to receive fair value (cf. Decisions of the DGRN of 28 January 2012 [BOE no. 43 of 20 February] and 3 June 2013 [BOE no. 160 of 5 July]).

The decision of 2 November 2010 (BOE no. 283 of 23 November) also allowed the calculation of the value of the shareholding according to balance sheets ("the average of earnings after taxes over the last four financial years, according to balance sheets dated 31 December, and the value of real property owned by the company"), but it did so in connection with an *ad nutum* exit by enforced transmission to the company itself. Here it was a case of regulating a right to departure "added" to the transfer of shares to other shareholders or third parties and, therefore, cannot be cited as a precedent.

The importance of the decision of 15 November 2016 lies in the fact that it separates itself from previous doctrine of the DGRN and that set in the decision of 20 August 1993, whereby "*the right of a company and its shareholders to prevent the entry of new unwanted shareholders cannot be recognised to the detriment of the no less legitimate right of a shareholder to obtain the real value of the shares he or she intends to dispose of*".

Firstly, because the legal rules on fair value in the event of a share transfer are not conceived as deriving from the purpose of the company formation agreements, but as a means to prevent excessive conditioning or limitation of transfers. Consequently, validity will be analysed according to whether or not the resulting effect is that the share is virtually untransferable (arts. 107(d)(2) and 123(2) LSC). From this perspective, there are no objections to validity, because: "*an article such as that rejected in the contested examination report cannot be regarded as an indirect prohibition of disposition, since it does not prevent, ex ante and objectively, the obtainment of fair value, or value more or less close to such according to the company's circumstances, profit or loss and retained earnings*".

The systematic basis is underpinned by the possibility of introducing privileges in the financial (equity-holding) rights attached to shares, in the distribution of company profits and in the shareholders' liquidating dividend (arts. 95, 275 and 392(1) LSC), in compliance with the one-sided agreements prohibition under art. 1691 of the Civil Code ("**CC**"): "*an article such as this one merely confines (to the book value) the financial content of the shareholder's right to receiving the value of his shares in the company in the event of a voluntary transfer, without actually preventing the same and thus not rendering said shares virtually untransferable*". And it matters not if, at the time of the transfer, the book value is lower than the fair value: "*nor can it be said that it entails unjust enrichment or enrichment without cause for the other shareholders or the company, inasmuch as it responds to that previously agreed and accepted by all the shareholders*".

2. Scope of the DGRN's doctrine.

The doctrine contained in the reviewed decision, which will be controversial, has certain limitations:

(i) The right of first refusal at par value remains unlawful, not only because it would render the share virtually untransferable, but also because it would be contrary to the company formation agreements and to the one-sided agreements prohibition (art. 1691 CC). A deviation would only be permitted if there is just cause.

(ii) The contained doctrine should not be extrapolated to the wording of shareholder exit and expulsion clauses because (except for the *ad nutum* exit) they arise from a different rationality, although such extrapolation is something to be expected (cf. judgment of the Madrid *Audiencia Provincial* of 24 July 2015).

(iii) Difficulties may arise in the application of the rule to a specific case. The decision itself states that if, because of the circumstances of the case at issue, the determination of the value of the shares may be excessive or unconscionable for the shareholder (arts. 1 and 57 of the Code of Commerce, arts. 7, 1258, 1287 and 1291 CC) or involve prejudice to third parties: "*then judicial control will be assured, taking into account such circumstances*". This control will have regard not only to an excessive deviation between the book value and the fair value that makes it possible to conclude that the article renders the share virtually untransferable, but also the article's illegality (or the one-sided agreements prohibition). The question begged is when should a deviation be considered "excessive"?

(iv) The decision itself states that the article is not valid for the purposes of the company exercising its right of first refusal since, on account of the value being determined by means of a balance sheet approved by the general meeting, it cannot be considered an "impartial" or "objective" measurement system. In our opinion, the same (and unjustified) objection could be made to such exercise by the shareholders, since they determine with their votes the approval of the balance sheet by the general meeting and with it (indirectly) the share value. In fact, what happens is that if the balance sheet does not "properly" reflect (in accordance with the law) the book value, such cannot be taken as reference for the exercise of the right of first refusal, either by the company or by the shareholders.

(v) It is still unclear whether unanimity is required for the introduction of such provisions, as the decision seems to point at, or if an agreement reached by the majority applying the pre-commencement period under art. 123(1) LSC in the case of a public limited company would suffice. In all companies limited by shares, consent of all shareholders is required to introduce amendments to the articles of association that involve new obligations (art. 291 LSC) - giving notice for the right of first refusal - or the consent of those affected if the individual rights of shareholders are affected (arts. 291 and 292 LSC). Although disputed in case law, it seems reasonable to think that a shareholder's right to dispose of company shares is not disposable by a majority, whereby the shareholder's consent would always be necessary.