THE POSITION OF THE MINORITY SHAREHOLDER IN A SUBSIDIARY IN SPAIN.

Some foreign companies with a subsidiary in Spain usually ask about their position as shareholders of less than 50% of the shares of a Limited Liability Company (S.L.), in Spain, when there is a conflict between partners. Some of them even appoint us as legal representatives to act on their behalf as minority partners of a Spanish subsidiary.

1.- Common problems for the minority shareholder.

The minority shareholder normally deals with two types of problems, that can be given or not at the same time:

- The expropriation of the value of his stake by the majority partner.
- The illiquidity of his equity capital.

The first problem is given when the majority shareholder is the one who designates the director of the company, and the minority shareholder is moved out of the company's management. The combination of the majority in the equity and the influence over the management held by the majority partner results in the possibility that the majority shareholder behaves as if the company belonged only to him.

The majority shareholder can deny systematically the distribution of dividends; reduce the real operating income of the year's profits to reduce as well the minimum required by the law; hire staff from his own family/group or near environment; assign himself a salary, attendance fees and other expenses; finance other projects in which the minority shareholder will not be part of, with the company's money; or even buying assets in its own interest. Clearly, all of these situations don't happen in all companies, but our experience shows that these abuses cause conflict between partners, as there is a breakdown of trust, or how the courts call it, a lack of *affectio societatis*.

The second problem arises when the minority shareholder wants to leave the company and asks the majority partner to buy his shares. Then, the minority partner realizes that the majority shareholder is not bound to buy the minority's shares, and even less, buying them according to the price that the outgoing minority partner considers fair. At this moment, the minority shareholder finds out that his shares in the company have no liquid value, unless the majority partner agrees to buy his shares.

If the majority shareholder has verified at any moment that with the stake that holds at the moment can behave as if he had the 100% of the company, then it will be difficult for him to agree and buy the minority partner's stakes, with whom he lost faith.

Even in many cases, we can see it the other way around: if the majority shareholder turns down buying the outgoing minority shareholder's stakes, it is because he is already acting as if he had 100% of the company, and it would not make any sense for him to buy the shares, as buying them will not make any difference, because indeed, he already holds 100% of the company.

Sometimes we can find as well one psychological aspect, and it is that the majority shareholder who takes part in the company's management, and who over the years tends to forget the minority partner's contribution and starts to see him as an obstacle to the business because he no longer contributes to the company's growth.

Thereby we arrive to the situation in which many minority shareholders get involved, who not only realize that his partner is taking over the company as if it was only his, but they also discover that, when leaving the company, without the willingness of his partner, his shares value gets reduced to nothing.

2.- Some solutions for the minority shareholder

Company law provides some legal tools that allow the minority shareholder to fight against the majority partner's expropriation behaviour and, in some cases force the majority shareholder (or the company itself) to buy the shares at a reasonable price. Therefore, on one hand, we can talk about control measures, and on the other hand about withdrawal measures.

- **1.- Control measures**

The control measures that the minority partner has at his disposal are aimed at controlling somehow the management of the company. The control measures belong to the director, as the majority shareholder is not responsible for the company's management. But it will be usual that, if there is a difficult situation, the majority partner is the sole manager.

The main control measures are: 1) right to information about the financial statements and the general accounting; 2) right to convene a General Meeting, proposing the items to be discussed in the agenda, and even request the presence of a Notary; and 3) right to request the appointment of a financial auditor by the Mercantile Register.

- **2.- Withdrawal measures**

The main withdrawal measures would be, on one side, exercise the right to exit the company acknowledged by the Law, and on the other side, the possibility to exclude partners who fail to honour their ancillary commitments, or managing partners who breach the prohibition of competition or are condemned to indemnify the company, or lastly, in the event of forced liquidation of the company with the distribution of the company's earnings among shareholders.

In respect of the right to exit the company, the Law recognizes the minority partner the right to exit the company in specific cases, forcing the company to buy his shares at a real value, this is, according to an independent appraiser's assessment.

These cases are: 1) supersession or amendment of the company purpose; 2) extension of company term; 3) company reactivation; 4) creation, amendment or early cancellation of ancillary commitments; 5) no distribution of at least 25% of dividends.

Of all these cases, the most interesting one, due to its newness, is the right to exit when the company is not distributing at least 25% of the operating incomes, as long as, the company has been registered in the Mercantile Register in the last five years, and has made profits for the last three years.

What may happen, is that the majority shareholder has ensured to reduce as much as possible real operating income of the year's profits to reduce as well the sharing profits. ¿And how does he do it? The majority shareholder will increase the expenditure supported by the company, and reduce the profits; such as salaries and wages, that will normally receive the majority partner; and other operating expenses, which are in his direct or indirect benefit; or by purchasing of assets for the enjoyment of the majority partner, like cars, computers, phones, etc.

By doing so, the minority partner finds out that the majority partner has already distributed the operating income of the year's profits on the course of the financial year. And at the end of the financial year, remains a residual benefit from which the legal minimum distribution of 25% is agreed. Thus, in exchange for a small concession, the majority shareholder avoids the right to exit of the minority partner.

Regarding other legal causes to exercise the right to exit, since they depend upon the decision of the General Meeting, it may seem that in practice they won't happen, but sometimes there are some possible alternatives that even without the agreement of the General Meeting, that could enable the right, just like the amendment of the company purpose.

3.- Other practical solutions

We are going to focus next on some cases that we have been able to implement in real cases with our clients.

3.1.- Thorough revision of the annual accounts so that the real operating income of the year's profits come to the surface

As we said, since the partner can exit the company if there is no minimum dividend distribution, of 25% now, what makes that the majority partner purposes the distribution of that dividend, and therefore, avoids the possibility for the minority shareholder to exercise his right to exit.

What normally happens as well, is that the operating income of the company does not reflect the company's real benefit and in fact the majority shareholder has been appropriating as salary or payment, or with the purchase of assets for himself or his family, hiring a supplier to whom he has generously paid for its services, etc.

The way to control these diversions of the company's operating income is by analysing the annual accounts; requesting information from the director about any suspicious financial statements; and request as well the presence of a Notary in the Ordinary General Meeting for the approval of the financial statements, to notice any possible irregularity.

At the same time, we can also request an audit of the annual accounts. The partner with at least 5% of the equity capital may request from the Mercantile Register the appointment of an auditor within the first quarter of the new financial year, regarding the previous fiscal year's accounts. By doing so, in the Ordinary General Meeting, we will already have the auditor's report.

All of this can help us, once we vote in favour of the distribution of the minimum provided by the art. 348 bis of the Companies Act (LSC), to impugn the annual accounts based on not reflecting a faithful image of the patrimony and hiding the real and higher operating income and therefore allege that the legal minimum dividend has not been distributed, but rather a lower amount and consequently the right to exit can be exercised.

Another action that we will exercise is the action for liability to reimburse and compensate the company, if we can demonstrate that the managing partner has been expropriating the company's assets. We have to consider, this case, is not a direct damage to the minority shareholder, but to the company, consequently, the objective for the liability action is to repair the damage caused to the company. Depending on the percentages that the partners hold, this action may lose interest because a condemnatory judgement will be useless if the minority partner does not receive anything at all. However, it can be useful to justify the exercise the right to exit for having agreed to distribute a dividend lower than the minimum legally required.

3.2.- Possibility to exclude the managing partner who breaches the prohibition on competition

In some cases, the expropriation made by the majority partner consists of creating another company, in his name or through a figurehead and divert part of the company's business. This way, while the company shared with the minority partner bears the operating expenses, his new company appropriates some incomes, or takes profit through a different company holly owned.

Facing this situation, the minority partner can file a lawsuit against the managing partner for disloyalty, by breaching the prohibition on competition. Given a favourable judgment, the minority partner may exclude from the company the majority shareholder. Nonetheless, the company will have to pay the real value of his shares. But sometimes it can be a great solution.

It can be used as well, as another legal tool, the precautionary measure that consists in that the Court responsible for the case of unfair competition designates a trustee for the new company. By doing so, we prevent the majority shareholder to divert the business back to a different company other than the defendant through the trial.

Both, the lawsuit against the manager and especially the precautionary measure requires a huge evidentiary activity, which usually goes through detective's reports to prove that the new company is owned by the majority partner manager and that the majority partner is diverting clients, invoices, etc. to the new company, in which the minority partner is not part of.

3.3.- The labour perspective

In many occasions, the partners of a limited liability company provide work and experience, rather than capital. Many companies start their activity with the minimum capital required to set up a company, 3,000 euros and in many of them, each partner is in charge of a part of the company's management. For example, one of them is responsible for the technical part, another for the business aspect, another one for the financial section, etc. In these companies, the problem arises when one of the partners considers being providing or working more than the others. Or even when one of them no longer dedicates time to the company, but still receives some retribution or requires its dividend.

The problem comes from the moment that the partners set up the company, considering that they should have agreed to establish ancillary commitments in the bylaws' company. By doing so, if one of the partners stops working the other partner can exclude him. But, once we have the problem, what can the minority shareholder, that keeps working, do and sees how the majority partner does nothing or almost nothing?

One good solution can be found in the labour field, in other words, the problem can be seen from a labour perspective. We need to remember that, as a general rule, the partner with less than a third of the capital, and without a managing role, can be an employed worker, and therefore, it is possible that the minority shareholder who has been working as self-employed for the company can file a lawsuit against the company, so that the Court declares that there exists an employment relationship, with payment of overdue contributions. Or, depending on the point that the conflict between the partners has reached it is possible to find the solution in a lawsuit for wrongful dismissal.

There are several cases in which the conflict between partners in a limited liability company end up in a labour dispute before the social jurisdiction.

3.4.- Dissolution as per the law for not adapting to the Professional Companies Act

It is a very particular case, but that we have seen it in practice. The Professional Companies Act regulates the companies that provide services that require qualified professionals, such as engineers, lawyers, architects, doctors, etc. This Law provides that these companies that engage in professional activities and have not adapted the bylaws to this Act will be dissolved ex officio by the Mercantile Register.

Nowadays, the Mercantile Register denies the inscription of some acts on the basis that it is a company not adapted to the Professional Companies Act, declared them dissolved and granting a period to the company to correct the defect by reactivating the company and adapting its bylaws.

Precisely, the reactivation of the company results in the partner's right to exit. Likewise, the adaptation to the Professional Companies Act grants the partners' right to exit without any justification.

In fact, not adapting the professional company to the Professional Companies Act provides the partner with the right to exit.

3.5.- De facto amendment of the company purpose

One of the causes for exit legally establish is the supersession or amendment of the company purpose. As we said before, in a conflict between partners it is unlikely that the majority shareholder agrees to change the company purpose and give the right to exit to the minority partner.

But, on the other hand, it may happen that the majority partner sets up some subsidiaries or beginning a new activity different from the one defined in the company purpose. In fact, there are some cases that the company purpose modification is the origin of the partners' disagreement.

Well then, these are the cases when the minority shareholder can file a lawsuit against the company, seeking a declaration that there has been a de facto modification of the company purpose.

Once again, the evidentiary activity of the plaintiff partner plays an important role, as it is about showing proof that the company engages in a different activity than the one established by the company purpose. Occasionally, the line between substantially modifying the company purpose and adapting to the market's requirements can be very thin.

3.6.- The problematic directors' remuneration

In most companies, the standard bylaws establish that the manager's position is for free. It is done this way because if it is stated that the position is remunerated it is necessary to establish the calculation formula for the retribution and this may cause registration problems in the Mercantile Register. So, the solution to this case, when setting up the company and there are no problems between partners, is establishing the position as for free.

However, after a while, the majority shareholder and director may consider that he has the right to get paid for the time he dedicates to the company's management (keeping the accounting or at least signing the annual accounts, hiring employees, solving the daily problems…) So, what the majority partner will normally do, is assign himself a salary.

The Law establishes that any contract between the manager and the company must be approved by the General Meeting. And normally, neither a General Meeting has been held, nor does a minute book exist, nor have the bylaws been modified. It is useless to say that the director gets paid as a worker and not as a director, as the jurisprudence has established that the director's condition absorbs the condition as a worker since it lacks the characteristic element of an employment relationship: the alienation

All of these can result in a lawsuit filed by the minority shareholder against the director partner for violating the bylaws and the duty of loyalty, requesting that the majority shareholder shall return to the company all the amount received as a salary without the authorization of the General Meeting, or without the bylaws establishing a salary in the director's position.

3.7.- The sale of the minority partner's shares to a third party.

In Limited Liability companies the minority partner will not consider the possibility of selling his shares to a third party. There are two different reasons: the first one, because the majority shareholder has to accept the entry of the third party, and the second one, because there won't probably be anyone interested in acquiring a minority stake in a company in which the partners are involved in a conflicting situation and that the minority partner wishes to get rid of.

However, depending on the type of company and the assets it has, it is possible that a third party may be interested in acquiring the minority partner's stake to exert control over the majority shareholder and therefore require the minimum dividend of 25% of the operating income.

Overall, the transfer of shares in a limited liability company may be freely transacted among partners or in favour of some family members, and a right of preemption in favour of the partners if the sale is made to a third party. So, if a minority shareholder wants to sell his stake, he needs to find a third party interested in buying and report it to the director, who will at the same time report it to the other partners, giving them a period to exercise their right of preemption, in the same conditions as the third party is going to purchase the stakes. On the contrary, the minority shareholder will be able to sell his stakes to the third party who made the offer.

The possible entry of a third party, unknown to the majority shareholder and act who may act as the controlling partner of the manager and the majority partner, is in itself an unlocking tool of conflicting situations.

4.- Conclusions

The disputes between partners are very complex, and require a long term planning, considering that, unless they reach an agreement at the beginning of the conflict, they normally end up in a judicial claim.

The tools that the minority partner has at his disposal are very varied, depending on the case, and they do not come down to ask for information and calling a General Meeting.

And, of course, in addition to what we have explained, there is an underlying related to the personal relationship between partners that will be affected and altered by the conflict. Sometimes this personal relationship between partners can affect the strategy to solve the conflict.

In our law firm, we have a wide experience in the management and resolution of conflicts between partners and directors, and that means that we have faced very different situations according to the types of companies, partners, and the conflicts between them. With a team of lawyers specialized in business law, and other areas involved, such as labour law, tax law, criminal law, or economists to analyse the accounts, enables us to offer a high quality legal advice in this matter.