

Share transfer restrictions in closely held corporations: shareholders' protection and exit strategies

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Share transfer restrictions in closely held corporations: shareholders' protection and exit strategies. Share transfer restrictions represent a typical characteristic of closely held corporations and family businesses. Default provisions of Slovak law on share transfer in limited liability companies creates a broad scope for drafting individual types of restrictions in a most creative variety of manners. When opting for a specific share transfer restriction, shareholders should not only focus on the primary interest of maintaining a stable personal structure of the company with a view of protecting the business from the entry of unwanted third parties, but also take into account potential exit scenarios which – in closely held corporations – often are the only possibility to resolve an ongoing conflict of interests between the shareholders. Therefore, when forming a company, the author assumes it is important to carefully and precisely draft the selected type of share transfer restriction in the corporate contract or shareholders' agreement to properly resolve potential conflicts among shareholders and allow smoothly exit of affected party. Also, shareholders should not neglect to consider the occurrence of situations when statutory restrictions affect the share transfer, and vice versa, when a stipulated share transfer restriction may be unlawful or unenforceable.

Keywords: share transfer restrictions, close corporations, limited liability company, articles of association, contractual freedom, pre-emptive rights, shareholders' agreements

Introduction

“*Had we only considered it in the beginning...*” is a phrase we often hear in practice when it comes to a deadlock, or incurable differences among the shareholders. When forming a company, prospective shareholders mostly concentrate on the economic side of business and, when determining the management and governance, focus on the allocation of property and voting rights, often neglecting to consider efficient mechanisms to resolve potential intracompany conflicts. Overconfidence, overoptimism and initial excitement for doing business prevents the parties from eliciting thoughts about the methods of resolving future conflicts of interests and exit strategies.¹ In addition, increased transaction costs associated with the setting-up of an additional corporate right might lead to a contracting passivity of the prospective shareholders, even in situations where the negotiation of the business parties would be more efficient and improve their position in the legal relationship. Therefore, shareholders often rely on the statutory

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¹ McCAHERY, J. A., VERMEULEN, E. *Corporate governance of non-listed companies*. Oxford: Oxford University Press, 2008, p. 152.

ready-made standards that – although being intended to fill contracting gaps – are often insufficient and inadequate to resolve the case at hand.² Yet a careful consideration of rules agreed beforehand (*ex ante*) has a significant influence not only on maintaining the company's primary ownership structure, but also on a smooth and efficient procedure of a shareholder's exit as one of the potential solutions to a conflict between the shareholders.³

While by definition, free transferability of shares is the one of the defining feature of corporations,⁴ various share transfer restrictions are typical for closely held corporations and family businesses, as stipulated in the articles of association or shareholders' agreement.⁵ Closely held corporations are characterised by a small number of shareholders who live in the same geographic region, are bound by a family bondage, or know each other well, and all or at least as much as the majority of them are represented in the company's bodies, or are key employees.⁶ Personal and family relationships, that underlie the cooperation between the shareholders in closely held corporations, are beneficial for a stable functioning of the company. It is also applied that how closely the corporation is held, may be modified within statutory limits. An appropriately chosen type of share transfer restriction may not only suitably protect the corporate ownership structure from the entry of unwanted third parties, but also provides for a shareholder not being locked in the company for good without a possibility of exit.⁷ In the process of company formation, it is therefore advisable to pay reasonable attention to a careful drafting of share transfer restrictions, their anchoring in the respective document, depending on whether it is intended to be of contractual or corporate nature, and, last but not least, the possibilities of their efficient application in specific situations, *i. e.* in the event of share transfer to other persons or handover to the next generation or legal successors. Share transfer restrictions shall always be considered and appropriately arranged so as the interests of both the exiting and the continuing shareholders in a closely held corporation, and the interest of the business organisation itself, are protected.

The most common ground for a share transfer restriction in closely held corporations is kinship, loyalty and mutual trust between the shareholders.⁸ In practice, share transfer restrictions are utilized as a tool for protecting the interests of the shareholders, the

² In practice we might see that for restricted or excluded share transfers, there are often no exit strategies stipulated between family business members. See PwC Family Business Survey 2021, p. 23.

³ BACHMANN, G. et al. Regulating the closed corporation. In *European Company and Financial Law Review – Special Volume*, No. 4, 2014, pp. 9 – 11.

⁴ KRAAKMAN, R. et al. *The Anatomy of Corporate Law: A Comparative and Functional Approach*. 2. Edition. London: Oxford University Press, 2009, p. 5.

⁵ For open and closed corporations in context of transferability of shares in general, see MRÁZOVÁ, Ž. *Prevod a prevoditeľnosť účasti v korporácii*. In PATAKYOVÁ, M., ĎURICA, M., HUSÁR, J. *Aplikované právo obchodných spoločností a družstva – ťažiskové inštitúty*. 1st edition. Bratislava: Wolters Kluwer SR, 2021, p. 382 et seq.

⁶ LEACOCK, S. Share Transfer Restrictions in Close Corporations as Mechanisms for Intelligible Corporate Outcomes. In *Faulkner Law Review*, Vol. 3, No. 1, 2011, p. 126.

⁷ But we must not neglect to see that disposing of the share is – from the demand point of view – always more or less restricted in closely held corporations, even in the absence of an explicit share transfer restriction.

⁸ EASTERBROOK, F. H., FISCHER, D. R. *The Economic Structure of Corporate Law*. Cambridge: Oxford University Press, 1991, p. 233.

company, and the creditors. Their importance lies in safeguarding the stability of ownership and they serve as control over the composition of the circle of shareholders. Thus, restrictions fulfil the protective function where the ownership structure is meant to be bound to specific individuals. On the one hand, their purpose might be to prevent a discretionary share transfer to persons outside the initial ownership structure; on the other hand, to frustrate the exit of a key shareholder, at least for a certain limited period. Another purpose of restriction arrangements might also be the protection against the strengthening of the position of one of the shareholders to the detriment of the other (minority) shareholders or against the forming of a blocking majority. Any of the named reasons follows a different interest that primarily should be considered when drafting a specific rule restricting share transfers.

Individual methods of restricting transferability of shares may be laid down in corporate contracts (memorandum of association, articles of association), shareholders' agreements or other sideletters. As we will discuss later, share transfer restrictions may be even directly imposed by law. Our further attention will be primarily centred on the interpretation of share transfer restrictions in a limited liability company (*spoločnosť s ručením obmedzeným*) as the most commonly used form of business organisation for small and medium-sized enterprises in Slovak jurisdiction.

1. Transferability of shares and its restrictions

The Slovak law on limited liability companies provides for different requirements for share transfers among the shareholders and the transfer to a person outside the company. While the transfer of a share to another shareholder is allowed with the consent of the general meeting,⁹ the transfer of a share to *extranea* is prohibited by default provisions,¹⁰ unless explicitly allowed by the articles of association, while it may still be subject to the consent of the general meeting.¹¹ Although the Slovak Commercial Code explicitly establishes (intracompany transfer) or admits (external transfer) a share transfer restriction by consent of the general meeting and articulates the consequences of a dissent (transfer not effective towards the company),¹² it does not explicitly provide as to whether it is also possible to restrict the transfers by other means, or whether a transfer to another shareholder may be completely excluded. However, relying on the fundamental principle of the autonomy of shareholders' will, we assume that in a limited liability company, shareholders can stipulate a wide variety of terms and rules that either restrict any transfers, or even exclude them completely.

⁹ Section 115 (1) of the Slovak Commercial Code “*Unless the articles of association provides otherwise, a shareholder may transfer his business share to another shareholder based on an agreement if so approved by the general meeting.*”

¹⁰ Section 115 (2) first sentence of the Slovak Commercial Code “*If the articles of association so permits, a shareholder may transfer his business share to another person.*”

¹¹ Section 115 (2) second sentence of the Slovak Commercial Code “*The articles of association may provide that the transfer of a business share to another person shall require the approval of the general meeting.*”

¹² Section 115 (5) of the Slovak Commercial Code.

a) Types of share transfer restrictions and their legal limitations

Although the only restriction the law provides with respect to a limited liability company is the consent of the general meeting (which will be discussed in more details further below), the default nature of Section 115 of the Slovak Commercial Code allows to draft various forms of share transfer restrictions.¹³ Individual methods of restricting share transfers include the *prohibition clauses*, that both prohibit share transfers in general (transfer exclusion), or subject the transfer to certain *time requirements* (such as the articles of association providing that within five years from the company formation, the shareholder must not transfer its share to another shareholder or a third party), or *personal requirements* on potential acquirers (such as transfer prohibition applying to all persons, except for relatives, the transfer is permitted to existing shareholders only, or the prospective acquiring shareholder is subject to other restrictions relating to education, expertise or kinship). Moreover, the transfer of a share might be subject to the provision of specific terms and rules (such as prohibition to donate the share, admissibility of transfer only upon the settlement of the entire shareholder's contribution, etc.). Shareholders may also be bound by certain conditions only on selected transfers (such as transfer for value to a person other than relatives). The articles of association may further stipulate the terms of transfers in the form of information obligations of the transferring shareholder with respect to other shareholders/company or as an obligation set for (each) acquirer to accede to the shareholders' agreement. Individual restrictions may be drafted as positive or negative requirements. Since a proof of having fulfilled the above-mentioned terms of transfer may prove to be difficult in practice, it is recommended to leave the review of their fulfilment to a company body.¹⁴

We further distinguish *consent clauses*, namely clauses requiring the consent of the general meeting or other corporate boards, specific shareholders with the right to overrule the decision (shareholders with veto right), or of third parties. In our opinion, the transfer of a share in the company may also be restricted by requirement of the consent of a person outside the company (bank, father of a family whose sons are shareholders). The transferability of share may also be restricted by utilizing various forms of pre-emptive right, such as the right of first refusal, the right of first offer, or options (call option, put option). Other share transfer restrictions include the tag-along right, the drag-along right, and the shoot-out clause, that is provisions intended to safeguard an efficient exit tool for resolving potential deadlocks between shareholders and to protect a shareholder from

¹³ We have already identified some methods of share transfer restrictions and elaborated on them further. See ŠULEKOVÁ, Ž. *Obmedzenia pri dispozícii s obchodným podielom*. In *Inštitúty práva obchodných spoločností: verejnoprávne a súkromnoprávne aspekty*. Košice: UPJŠ v Košiciach, 2015, pp. 84 – 98. MRÁZOVÁ, Ž. *Korporačné obmedzenia prevoditeľnosti účasti na spoločnosti a súhlasy orgánov spoločnosti s prevodom účasti*. In HAVEL, B. NEVOLNÁ, Z. et al. *Převody obchodních podílů a akcií* Praha: Wolters Kluwer ČR, 2022, pp. 55 – 73.

¹⁴ PALA, R., FRINDRICH, J., KOMARNÍK, I., MIHÁLIKOVÁ, K. et al. In OVEČKOVÁ, O. et al. *Obchodný zákonník: Veľký komentár. Zväzok I (§ 1 – 260)*, 2nd edition, Bratislava: Wolters Kluwer SR s. r. o., 2022, p. 1852.

opportunistic behaviour of the other shareholder, or an abuse of his majority or minority status. A combination of various restrictions is primarily used to increase their enforceability (such as triggering the put option where the tag-along right is violated).¹⁵

We would like to emphasize that when drafting mechanisms of restricting share transfers, in addition to mandatory provisions, a whole range of private law principles and the rule prohibiting abuse of rights as stated in Section 56a (2) of the Slovak Commercial Code must be observed. Also prohibited are terms restricting share transfers that are in conflict with good morals, fair trade and public order.

Apart from explicitly agreed restrictions, the duty of loyalty may also constitute a restriction in transferring a share in a specific situation. Such duty not only burdens the shareholder transferring the share, but also other shareholders deciding on whether to consent to such transfer.¹⁶ While Czech case law stated that disposing of a share may be restricted in cases where the shareholder would – by way of a dishonest transfer of their share (such as with a view of avoiding statutory duties provided by insolvency law or legal regulation governing company liquidation) – put at risk the operation or existence of the company,¹⁷ in Slovak jurisdiction, the courts have not yet handled the topic of the effects of the duty of loyalty with respect to share transfer restrictions.

b) Consent to the share transfer by the general meeting or other corporate body

As we have stated above, the consent of a company body – the general meeting - to the share transfer is one of the restrictions explicitly introduced by the Slovak law. If a business share transfer is subject to a consent granted by the general meeting, the simple majority of the votes of all present shareholders is sufficient to adopt such a decision in the general meeting under Section 125 (1) (k) of the Slovak Commercial Code, unless the articles of association provide for a higher number of votes required to pass the decision. The consent to the transfer may be requested before or after a share transfer agreement is signed. The transferor is not obliged to provide the general meeting with information on the terms of the transfer, or to specify the person of the acquiror, although for closely held corporations, the transferor will *de facto* have to reveal the acquiror's identity, were he to obtain the consent of other shareholders or the general meeting. The company's decision-making body grants permission to the share transfer as such, meaning it does not approve the share transfer agreement, as there is no statutory duty to submit the wording of such agreement to the general meeting for approval. The

¹⁵ LACAVE, M. I. S., GUTIÉRREZ, N. B. Specific Investments, Opportunism and Corporate Contracts: A Theory of Tag-along and Drag-along Clauses. In *European Business Organization Law Review*, Vol. 11, 2010, p. 434.

¹⁶ DURAČINSKÁ, J. *Povinnosti lojalitý pri prevode obchodného podielu a akcie z pohľadu slovenskej právnej úpravy*. In HAVEL, B. NEVOLNÁ, Z. et al. *Prevody obchodných podielů a akciů Praha*: Wolters Kluwer ČR, 2022, p. 115.

¹⁷ Judgment of the Supreme Court of the Czech Republic, file No. 29 Odo 387/2006 of 26 June 2007. For more see ZVÁRA, M. *Prevod podílu ve společnosti s ručením omezeným a povinnost lojalitý*. In *Obchodněprávní revue*, No. 7-8, 2016, p. 199 et seq.

price or other terms of the share transfer agreement may even be unknown at the time of obtaining the permission, where the permission is granted before concluding the agreement.¹⁸

While the share transfer might be conditional upon a consent granted by other body, such as the supervisory board or other advisory boards, or might not be required at all, the transfer of a *part of share* always requires that a consent of the general meeting be obtained for the share split (Section 117 (1) of the Slovak Commercial Code), irrespective of whether the acquiror of the part of split business share is another shareholder or third party from outside the company.¹⁹ The provision governing the requirement to obtain the consent of the general meeting to the split of the business share is mandatory; the grant of consent might not be vested in another company body, or fully excluded in the articles of association. The consent of the general meeting is obligatory when it comes to the transfer of a part of business share, even if the transfer alone does not require the consent of the general meeting by virtue of law or by virtue of the article of association. The article of association may also exclude the splitting of a business share, whereby the shareholders wish to ensure a limited number of shareholders (shares) in the company.

c) Statutory restrictions with effect on share transferability

In addition to agreed share transfer restrictions, the Slovak Commercial Code also provides for other statutory restrictions with implications for the transferability of shares. One of the statutory restrictions having such an effect is the prohibition to acquire own shares by the company (Section 120 (1) and (2) of the Slovak Commercial Code). The reason behind this prohibition is considered to be primarily the principle of setting up minimum level of equity capital and its maintenance.²⁰ The acquisition of own share by the company is only admissible in strictly defined cases, and only temporarily.²¹ The corporation may transfer the exiting (expelled) shareholder's business share to another shareholder or a third party. In this context, however, the question arises under what terms the company may transfer such share where the articles of association explicitly restricts share transfers. We reckon that transfer restrictions agreed in articles of association should also apply to the transfer of loose share, as the company is bound by the provisions of the corporate contract, whereby such transfer is also subject to the approval of the general meeting. The loose share need not be transferred to another shareholder/third party in its entirety, but may be split and its parts transferred to the continuing shareholders provided they demonstrate interest in acquiring the share.

The transfer of a share is also affected by the prohibition of "cascade shareholdings" (Section 105a of the Slovak Commercial Code), the prohibition to acquire the controlling

¹⁸ See ČECH, P. K některým úskalím převodu obchodního podílu I. In *Právní rádce*, No. 5, 2007, p. 19.

¹⁹ The consent or dissent to the splitting of business share is vested in the general meeting that decide by a simple majority of the votes cast by present shareholders, unless the articles of association provide otherwise.

²⁰ For more, see BAŇACKÁ, L. Prevoditeľnosť obchodného podielu 2. časť. In *Bulletin Slovenskej advokácie*, Vol. 15, No. 3, 2009, pp. 10 – 12.

²¹ Section 113 (5) of the Slovak Commercial Code.

entity's shareholding by the controlled entity (Section 120 (3) and (4) of the Slovak Commercial Code), the existence of the joint shareholding (Section 114 of the Slovak Commercial Code) or a shareholding belonging to the community property of spouses.²² Effective from 1 January 2018, transfers of shares to other shareholders or a third party are also excluded where the entity enjoys a special status (Section 115 (3) of the Slovak Commercial Code), *i. e.* when (i) proceedings to dissolve the company are pending, (ii) the company has been dissolved by way of ruling of a business register court or an insolvency court, or (iii) the company is subject to the effects of a passed insolvency order or granted restructuring. These rules intend to eliminate abusive practices in transferring shares during critical phases of a company's operations. As the said prohibitions exclusively apply to limited liability companies and no other form of business organisations, and also only apply to explicitly specified critical phases of company operations, their mandatory anchoring in the legal provisions has become subject of criticism by the doctrine.²³ Moreover, a share in a limited liability company may not be transferred or acquired by a person held as obligor on the register of authorised applications for enforcement (Section 115 (6) of the Slovak Commercial Code).

The closeness or openness of a corporation also has impact on the conduct of enforcements by attaching the shareholding. Where the articles of association do not allow a transfer or where consent of the general meeting is required, the service of a charging order has the same effects as dissolution of a shareholder's participation in the company by a court. The share of a shareholder having the status of an obligor in enforcement proceedings passes to the company. Although the Commercial Code explicitly provides for only one restriction of a transfer – consent of the general meeting – as a barrier in the conduct of the enforcement leading to the dissolution of the obligor's shareholding in the company, the doctrine do not analyses other types of restrictions and analogically assumes that any share transfer restriction results in the cessation of the shareholder's participation in the company.²⁴ The efficiency of share transfer restrictions is hence also safeguarded by exempting the share with excluded transferability and the company's consent or otherwise conditional transfer from treatment under the enforcement concept, but also from monetization in insolvency proceedings.²⁵ However, we must point out that share transfer restrictions will not apply where the share is a part of a business being transferred;²⁶ in which case the share is deemed freely transferable without any restrictions.

²² Judgment of the Supreme Court of the Slovak Republic, file No. 8 Cdo 196/2018 of 28 January 2020.

²³ For more on critics of these mandatory restrictions see KUBINEC, M. *Prevod obchodného podiel v osobitných fázach fungovania obchodnej spoločnosti*. In HAVEL, B. NEVOLNÁ, Z. et al. *Prevody obchodných podielů a akcií Praha: Wolters Kluwer ČR, 2022, p. 259 et seq.*

²⁴ PALA, R., FRINDRICH, J. PALOVÁ, I. In OVEČKOVÁ, O. et al. *Obchodný zákonník. Veľký komentár. Zväzok I (§ 1 až 260)*. 2nd edition. Bratislava: Wolters Kluwer SR s. r. o., 2022, p. 1323.

²⁵ Section 148 (2) and (3) of the Slovak Commercial Code.

²⁶ BAŇACKÁ, L. *Prevoditeľnosť obchodného podielu 1. časť*. In *Bulletin slovenskej advokácie*, No. 1-2, 2009, p. 19.

2. The nature of share transfer restrictions

As we have stated in the introduction, individual share transfer restrictions may have corporate or contractual character. The form in which the restriction is agreed between the shareholders is generally (but not always) determinant of the nature and the different legal consequences when the restrictions are breached. Generally drafted restrictions included in corporate documents not only bind all shareholders and the entity itself, but also the future acquirors of shares, regardless of the acquisition mode. However, it is also possible that arrangements on transfer restrictions included in the articles of association could be of contractual nature only (that is being arranged only with respect to one or more shareholders).²⁷ This includes situations where certain restriction is drafted individually, is bound to the person of the shareholder, and does not obligate the share acquirors. Arrangements made in the corporate contracts thus may – under certain circumstances – induce the same contractual effects as the provisions included in a separate shareholders' agreement that is exclusively binding on its parties (*inter partes*) and do not bind third parties, unless otherwise demonstrated.²⁸ Transfer restrictions, or other obligations of shareholders associated with the transfer that are included in the shareholders' agreement are of contractual nature (*inter partes*) only.

In this context, the nature of the pre-emptive right²⁹ agreed in the articles of association³⁰ has become highly discussed topic in the Slovak doctrine. The opinions of case law and the doctrine differ in terms of addressing the issue. The Supreme Court of the Slovak Republic proclaimed that the pre-emptive right provided in the articles of association of a limited liability company has only contractual character.³¹ The doctrine, however, refers to the fact that although the ruling of the Supreme Court of the Slovak Republic allows for arrangements on the pre-emptive right with an effect *inter partes*, it also does so in corporate terms with respect to the share acquiror.³² Therefore, if the

²⁷ It must be examined carefully on a case by case basis what the actual will was when negotiating a specific restriction included in the articles of association, and hence whether the provision is of corporate or exclusively contractual character.

²⁸ The wording of individual provisions on share transfer restrictions that are included in shareholders' agreements is similar across jurisdictions, given the influence of the Anglo-American legal provenience. MOCK, S. *Shareholders' Agreements in Family Firms and Closed Corporations* In FLEISCHER, H., RECALDE, A., SPINDLER, G. (eds.). *Family Firms and Closed Companies in Germany and Spain*. Tübingen: Mohr Siebeck, 2021.

²⁹ Shareholders do not obtain the pre-emptive right to a share in the limited liability company *ex lege*, as potential transfer restriction must be established between the shareholders in the articles of association or shareholders' agreement. The stipulation of the pre-emptive right does not restrict the transfer to third parties from outside the company *per se*, but the priority right to buy the shareholding is vested in the current shareholders.

³⁰ The said discourse is wider and also covers the consequences of violating the pre-emptive right, which will not be discussed in detail in this paper.

³¹ Judgment of the Supreme Court of the Slovak Republic, file No. 3 Obo 19/2016 of 26 October 2016 „*If the shareholders wish to have priority in acquiring other shareholders' shares, they need to arrange the option of the pre-emptive right along with the terms of its exercising in the articles of association. Such pre-emptive right has the nature of contractual pre-emptive right.*” For pre-emptive right in a joint-stock corporation, see Judgment of the Supreme Court of the Slovak Republic, file No. 1 Obdo 11/2011 (R 32/2016).

³² CSACH, K. In OVEČKOVÁ, O. et al. *Obchodný zákonník. Veľký komentár. Zväzok I (§ 1 až 260)*. 2nd edition. Bratislava: Wolters Kluwer SR s. r. o, 2022, p. 623.

restriction of transfer, in this instance the pre-emptive right, is generally stipulated in the articles of association and is bound to the share rather than the shareholder as a person, it should be construed as a restriction that is corporate in its character, and should also apply to the future share acquiror, unless the wording indicates that the shareholders intended to agree on the pre-emptive right exclusively for the existing shareholders. Clearly, each specific situation requires individual consideration.³³

In addition, the co-existence of a corporate and contractual realm may lead to a possible collision of the provisions on share transfer in the articles of association and the shareholders' agreement. In practice, we could witness situations such as when the articles of association explicitly provides that no transfer restrictions exist, while in a shareholders' agreement, certain transfer restriction was explicitly agreed between the shareholders. In such case, the collision would not lead to the invalidity of the rules on share transfer as agreed in the shareholders' agreement.³⁴

3. Modification of the terms of share transfer restrictions

The terms of shareholder's right to transfer its shares may be modified during the company's existence. A question arises whether the same rules for an amendment to the articles of association will apply in the event that (i) the share is freely transferable and the transfer restriction is introduced in the articles of association, and (ii) where the *ab initio* share transfer is prohibited or significantly restricted by the articles of association, and an amendment to the articles of association seizes the exclusion of transfer or lifts the transfer restriction, whereby a closely held or a quasi closely held corporation becomes an open company. It shall also be answered what method and what voting majority of the shareholders may alter the restriction contained in the articles of association.

If rules are to be introduced to the effect of restricting share transfers in a company, an amendment to the articles of association must – in our opinion – be subject to the consent of all those shareholders affected by such modification (Section 141 (2) of the Slovak Commercial Code), as their right of free transfer of shares will be limited thereby. But the provisions on a limited liability company lay down the requirement of consent by all shareholders affected by such change only in situations where their obligations imposed by the articles of association are being extended, or their rights vested by the articles of association are being narrowed. Therefore, when lifting the restrictions for the benefit of a right to freely transfer a share, we cannot speak of any narrowing or restricting of rights or any extension of obligations. Despite that, it is obvious that a modification for the benefit of free share transferability significantly intervenes with the shareholders' status in the company and their mutual relationships, as upon allowing share transfers,

³³ From a comparative point of view, the perspective of viewing the nature, enforceability and the penalties may differ, see VENTORUZZO, M. MALBERTI, C. *Limitations on the Shareholder's Right to Transfer Shares*. In SIEMS, M., CABRELLI, D. (eds.) *Comparative Company Law. A Case-Based Approach*. Oxford: Hart Publishing, 2013, p. 327 et seq.

³⁴ CSACH, K. In OVEČKOVÁ, O. et al. *Obchodný zákonník. Veľký komentár. Zväzok I (§ 1 až 260)*. 2nd Edition. Bratislava: Wolters Kluwer SR s. r. o., 2022, pp. 623 – 624.

the position of one of the shareholders may be strengthened, and the entry of a third party into a “closed” circle may be allowed. In the context of permitting transfers towards *extranea*, the Supreme Court of the Slovak Republic held that although the articles of association failed to provide for the option of share transfer to a third party, but the transfer occurred with the consent of all shareholders, such share transfer shall be valid.³⁵ In a later ruling, the Supreme Court of the Slovak Republic also allowed to overrule closeness with the consent of all shareholders, however, it also stated that if the shareholders grant consent to the transfer of a share by such majority as is capable of amending the articles of association, it shall mean that, for the case at hand, a legal arrangement in deviation from that of the articles of association has been adopted, hence such transfer to third parties shall be valid.³⁶ In lifting the restrictions for the benefit of free share transferability, the Supreme Court of the Slovak Republic thus admitted that for an amendment of the articles of association and a transition of a fully closed entity to an open one, the majority required for an amendment to the articles of association to be passed shall suffice. However, it remains to be answered, whether in such case, the rules pertaining to the protection of (minority) shareholders should not be also discussed. In our opinion, the current law is insufficient in reflecting the need for protecting (minority) shareholders in such modification of rights that cannot be clearly classified as their restricting or narrowing. As the legal status and interests of the shareholders may be directly affected by the permission of free transfer and a transition from a closely held corporation to an open corporation, in our view, the protective rule laid down in Section 141 (2) of the Slovak Commercial Code requires to be reviewed.

4. Efficiency of various types of transfer restrictions in relation to a shareholder’s exit

Individual share transfer restrictions may determine different shareholder’s exit strategies. Firstly, the efficiency of the restrictions with respect to the shareholder’s exit

³⁵ Judgment of the Supreme Court of the Slovak Republic, file No. Obdo 79/2003. Zo súdnej praxe 2/2006. If the transfer to a third party is approved by all shareholders “[...] such transfer cannot be invalid alone for the reason that the articles of association does not allow so. Articles of association are a demonstration of the shareholders’ will and all shareholders together have the right to amend it so as in a particular situation, they will proceed in deviation from such provisions [...] To require that in such a case, the shareholders first formally amend the articles of association and then, after carrying out their intention, reinstate its previous status [...] would be a manifestation of an improper formalism.”

³⁶ Judgment of the Supreme Court of the Slovak Republic, file No. 3 Obo/19/2016 of 26 October 2016 „By adopting resolutions of the general meeting by which shareholders were granted permission to transfer their shareholdings, a decision to adopt the amendment to the articles of association was passed in line with Section 125 (1) (d) of the Slovak Commercial Code in conjunction with Section 141 (3) of the Slovak Commercial Code. The transfer of a business share in a company to third parties was not excluded as contemplated by Section 115 (2) of the Slovak Commercial Code, as due to adoption of a later decision to amend the articles of association (decision to grant permission to the share transfer to third parties), the transfer of shareholders’ shares to third parties was not prohibited by any provision of the full wording of the articles of association. The appellate court elaborates that since the transfer of the shareholding to third parties was executed with the consent of all shareholders, it is not possible to deem the agreements at issue to be concluded in conflict with the articles of association or the law.”

may be examined from the point of view of their selection and wording. If the share transfer is subject to the permission of a company body, it must always be examined if the articles of association contains terms under which a company body may consent or dissent and what safeguard mechanisms are available for the affected shareholders. Currently, provisions of the Slovak law on the limited liability company do not provide for a statutory period in which the competent body (e. g. general meeting) must decide to grant or not to grant the approval, or other safeguard mechanisms that would be triggered by the lack of activity on the part of the decision-making body. Therefore, the general meeting may refuse to grant approval even without relevant cause. We believe that (recurring) refusal to grant permission to a share transfer without reasonable cause could constitute an admissible ground in seeking to exercise the shareholder's right to dissolution of their participation in the company by a court order. However, the test of whether it can be fairly expected from the shareholder to remain in the company is not successful in all circumstances, and could be costly and lengthy process. Therefore, possible solutions may include to stipulate a period in the articles of association in which the general meeting or other company body must decide on the consent or dissent to the share transfer. Should the body fail to decide within the fixed period, it could be agreed that the consent is considered to have been granted. Furthermore, the articles of association could include grounds for which the company body may, must or is obliged to grant approval.³⁷ Such arrangements would prevent groundless lock-in of a shareholder in the company. The safeguard mechanism in the form of share buy-back by the company for the event of dissent to a share transfer is not allowed in a limited liability company, as acquiring own shares is strictly restricted. Nowadays, by dissenting to the share transfer, the shareholder of limited liability company remains locked in the company without any exit option by way of a unilateral act.³⁸

Secondly, the exit efficiency may be assessed by comparing several types of restrictions. As long as the primary motive should be the closing of the company and safeguard against third-party entry, the pre-emptive right as a control mechanism for third-party entry to the company appears to be more efficient than the consent of the general meeting for which a simple majority of the present shareholders' votes suffices.³⁹ That, however, only under the condition that the beneficiary of the pre-emptive right is interested and has the funds necessary to acquire the leaving shareholder's share. Comparing several types of restrictions, we may further observe that some of them are

³⁷ What may serve as a model are the provisions on grounds and time limits in Section 220m (1) of the Slovak Commercial Code applicable to a simplified joint-stock company. More in MRÁZOVÁ, Ž. *Korporačné obmedzenia prevoditeľnosti účasti na spoločnosti a súhlasy orgánov spoločnosti s prevodom účasti*. In HAVEL, B. NEVOLNÁ, Z. et al. *Prevody obchodných podílů a akcií* Praha: Wolters Kluwer ČR, 2022, pp. 70 – 71.

³⁸ For available exit mechanisms to protect shareholders locked-in in a company in other jurisdictions, see FLEICHER, H. *Comparative Corporate Governance in Closely Held Corporations*. In GORDON, J. N., RINGE, W.-G. (eds.) *The Oxford Handbook of Corporate Law and Governance*, Oxford: Oxford University Press, 2018, p. 697.

³⁹ Section 125 (1) (k) and 127 (3) of the Slovak Commercial Code, unless the articles of association provide otherwise.

primarily seen as shareholder exit mechanisms. A shareholder's exit from a company must not necessarily be seen negatively, as for some shareholders (investors), terminating further continuance of the shareholding in the company may be desirable from a business point of view. This involves, for instance, the tag-along right allowing a shareholder (the beneficiary) to join another shareholder's share transfer, or the drag-along right allowing the shareholder to request the transfer of the other shareholder's share along with the transfer of his own share. Deadlock situations in a corporation can be addressed by a shoot-out clause or the Russian roulette, *i. e.* arrangements between shareholders based on one shareholder being authorised to offer to purchase the other shareholder's share and determine its price. If the other shareholder fails to accept the share purchase offer, such shareholder shall be bound to acquire the share from the proposing shareholder at identical terms.⁴⁰ However, information and financial asymmetries between the parties to such arrangements may lead to significantly unfair results.⁴¹ An issue might also occur if investors transfer their share to a third party without offering the other shareholder the option to join the transfer. For potential obligation breaches, we often see a combination of these arrangements used in practice – the tag-along right is extended to include the put option clause with a view of ensuring the enforceability of the co-sale right.

5. Restrictions on passage of shares to shareholders' legal successors

In our opinion, every act of disposing of a share leading to its transfer should follow the same terms as the articles of association or the law provides for the voluntary transfer. It means that the establishment of a lien shall be subject to the same terms as the law, or a corporate contract imposes on a share transfer. For these purposes a share cannot be subject to a lien where the articles of association does not allow a share transfer. Where the articles of association requires to obtain the consent of the general meeting or other term as precondition of a share transfer, such consent or observation of the term is also required for the lien to be established.⁴²

But what is the situation when the share passes by operation of law? Unlike a voluntary (contractual) share transfer, a passage of the business share to heirs (legal successor) takes place by virtue of law. Where the articles of association seek to prohibit both the voluntary transfer as well as the passage of the share, this must be explicitly provided for. The articles of association may exclude the passage of the business share under Section 116 (2) of the Slovak Commercial Code, provided the entity is not a sole shareholder company. However, it is unclear whether it is possible to not only exclude the passage of the share in the articles of association, but also to restrict it. If the law allows the exclusion

⁴⁰ Effective from 1 January 2017, the tag-along right, the drag-along right and the shoot-out clause are explicitly provided for in the Slovak Commercial Code for a simplified joint-stock company. For more on individual rights in the Slovak jurisdiction, see JANÁČ, V. *Výbrané druhy akcionárskych dohôd*. Prague: Wolters Kluwer ČR, 2019.

⁴¹ GOMTSIAN, S. Exit in Non-Listed Firms: When and How to Use Share Transfer Restrictions? In *European Business Law Review*, Vol. 27, No. 6, 2016, p. 732.

⁴² Section 117 a (3) of the Slovak Commercial Code.

of an involuntary transfer of a share, *i. e.* allows an heir to be deprived of the right to inherit the share, the more it is necessary to allow the option to stipulate certain terms for inheriting a share. The *a fortiori* argument thus brings us to the conclusion that if the passage of a share can be prohibited *per se*, it may also be restricted or conditioned as well.⁴³ Although the articles of association may limit the passage of the share, it cannot determine the person to which the share shall pass.⁴⁴ Inheriting may also be excluded for those shares that can be voluntarily transferable. Where the business share is not passed to an heir or a legal successor, by operation of law, such loose share shall pass to the company that may transfer it to another shareholder or a third party. When transferring such a share, the company – as contracting party to the share transfer agreement – shall make a transfer under observance of the corporate requirements provided for in the articles of association. The transfer of the loose share is at all times subject to the decision of the general meeting, even if the articles of association does not require a consent of the general meeting to share transfers in general.⁴⁵

As we have stated, share transfer restrictions will not apply where the shareholding is a part of a business being transferred. In this respect, the articles of association may stipulate that the share does not pass to the buyer as legal successor even where it is being transferred within the framework of a sales of business.⁴⁶

Conclusion

As the restriction or exclusion of a share transfer constitutes a severe intervention in the shareholders' rights, provisions to this effect in the articles of association or another contract should be drafted carefully, clearly and concisely. Their primary purpose is to prevent disruptive third parties from entering the company, attempt to frustrate a key shareholder's exit from the company, or to safeguard against the position of one of the shareholders being strengthened to the detriment of other (minority) shareholders. Individual types of restrictions may be drafted in a variety of ways, either as positive or negative requirements. As no organisational structure is as perfect as it appears at the first glance, individual shareholder values and personal goals may diverge considerably over time. It is both breaking of personal and family relationships and differences in

⁴³ Identical conclusions were made in Czech court decisions, see Resolution of the Supreme Court of the Czech Republic, file No. 29 Odo 573/2006 of 22 August 2007. "*Allowing such a term to be incorporated in the articles of association is more favourable for the heirs to a deceased shareholder, rather than fully excluding the inheriting of a business share.*"

⁴⁴ Resolution of the Supreme Court of the Czech Republic, file No. 29 Odo 1080/2011 of 22 May 2012: "*The passing of a share cannot be effected by the decision of any entity, as such option – as is the case with inheritance – would have to be provided for by law.*" But the contingency of the passage only to certain heirs is admissible, see Resolution of the Supreme Court of the Czech Republic, file No. 29 Cdo 1006/2009 of 1 October 2009.

⁴⁵ BLAHA, M., GRAMBLIČKOVÁ, B., BARKOCI, S. In PATAKYOVÁ, M. et al. *Obchodný zákonník. Komentár*. 1st edition. Bratislava: C. H. Beck, 2022, p. 538.

⁴⁶ PALA, R., FRINDRICH, J. PALOVÁ, I. In OVEČKOVÁ, O. et al. *Obchodný zákonník. Veľký komentár. Zväzok I (§ 1 až 260)*. 2nd edition. Bratislava: Wolters Kluwer SR s. r. o, 2022, p. 1090.

determining the company's direction and strategic development that become key reasons for conflicts between shareholders and lead the affected shareholder to seeking opportunities to end their stake in the company.

It is therefore crucial to draft the restrictions so as to take into account the shareholder's interest not wanting to remain locked in the company. When forming the company, shareholders should pay more careful attention to the drafting of individual share transfer restrictions and amend them accordingly to their primary intentions. As we have pointed out in the paper, the current legal provisions on share transfer restrictions for limited liability companies shows several problematic aspects that should become a subject of a deeper assessment, specifically in the context of the ongoing work on the recodification of the Slovak corporate law.

Corporate law should constitute a set of default rules which should not increase the costs for the stakeholders associated with the drafting of the articles of association.⁴⁷ We therefore are of the opinion, that if the transfer of a share is subject to the approval of a company body, exit mechanisms should be available to shareholders in the event of inactivity or refusal to grant consent without a reasonable cause.

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⁴⁷ EASTERBROOK, F. H., FISCHER, D. R. *The Economic Structure of Corporate Law*. Cambridge: Harvard University Press, 1991, p. 34.

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