

Condition of Approval as a Contractual Restriction on the Trading of Shares in a Joint Stock Company

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Abstract:

Among the contractual restrictions on the trading of shares in a company's articles of association, the approval condition occupies an important place. Under this condition, the company can require that shares may not be traded without its approval - through the consent of the relevant authority. These conditions have found application in certain types of public limited companies, such as family businesses.

Keywords: Joint-Stock Company, Contractual Restrictions, Approval Condition.

INTRODUCTION

Like any other commercial enterprise, a public limited company can only flourish in a legal environment that reflects economic and social realities, both nationally and globally. This has attracted large savers and investors to such companies. The commercial awareness that commercial companies¹, including joint stock companies are experiencing as a result of global economic changes has led many countries to amend their legal systems to keep pace with these developments and to provide greater guarantees for the protection of conflicting interests, thereby creating an atmosphere of reassurance and trust in the commercial and economic environment.

Among the guarantees established by legislation for the benefit of shareholders is the protection of their rights, including the right to trade their shares, under the principle of the free movement of shares. While the establishment of this principle is one of the most

¹- Ammarna Mohammed Ahmed Mahmoud, Capital Market Authority Oversight on Joint-Stock Companies - A Comparative Study, National Center for Legal Publications, 1st edition, Cairo, 2014, pp. 39-42.

Basyouni Abdel Awal, The Principle of Freedom to Trade Shares in Joint-Stock Companies – A Comparative Jurisprudential Study, Dar Fikr Al-Jami'i, Alexandria, 2008, p. 61.

important legal mechanisms that the law has always sought to protect in order to prevent shareholders from being trapped by their shares, the objective behind the trading of these shares is also to attract investments², in particular those with substantial capital, through the purchase of shares and the investment of new funds³.

Since the principle of freedom to trade in shares is considered to be a matter of public policy, it is prohibited to provide that a share is non-transferable or to deprive its holder of the right to sell his shares at any time if he wishes to withdraw from the company⁴. This freedom has led the legislator to intervene, firstly by imposing legal restrictions, in order to eliminate the pitfalls arising from this freedom. In addition, the legislator has also given shareholders the right to impose certain restrictions in the company's articles of association, known as contractual conditions.

Contractual conditions are a manifestation of the contractual idea in company law. This law has a wide scope in terms of the conditions that can be imposed within it, relying on a contractual basis, despite the intervention of legislative and regulatory texts⁵ that always seek to establish rules and controls to protect the various interests, regardless of their multiplicity or conflict.

Among the contractual restrictions on the trading of shares provided for in the company's Articles of Association, the condition of approval occupies a prominent position. By means of this condition, the company can stipulate that shares may not be traded without the company's approval - through the consent of the competent authority. These conditions have found application in certain types of public limited companies, such as family-owned companies.

The condition of approval relates to a fundamental feature of the public limited company, which is the freedom to trade⁶. This allows shareholders to trade their shares and exit the company whenever they wish. However, despite the rights conferred on shareholders by their status in the company, they are not free to leave the company whenever they wish, especially if they cannot find a buyer for their shares⁷. Even if a

²- Samir Alia, *Principles of Commercial Law*, University Foundation for Studies, Publishing, and Distribution, 2nd edition, Lebanon, 1996, p. 238.

Mohammed Farid Al-Arini and Hani Mohammed Dowidar, *Principles of Commercial and Maritime Law*, Dar Al-Jami'a Al-Jadida for Publishing, Egypt, 2003, p. 181.

³- Al-Hanawi Mohammed Saleh, *Analysis and Evaluation of Stocks and Bonds - An Introduction to Financial Engineering*, University Press, Alexandria, p. 267.

⁴- Mohammed Farid Al-Arini, *op. cit.*, p. 264.
M. Sallah, *op. cit.*, p. 42.

J. Bonnard, *Business Law*, Hachette, 5th ed., 2008-2009, p. 104.

⁵- D. Airault, M. Anne Frison-Roche, and J. Revuz, *The Effectiveness of Transfers of Registered Shares Against the Issuing Company*, *Rev. Dr. Bancaire et de la Bourse*, 1993, p. 65.

⁶- Y. Guyon, *Business Law*, Vol. 1, 9th ed., Paris, 1996.

⁷- Farouk Ibrahim Jassim, *Rights of the Shareholder in Joint-Stock Companies*, Halabi Legal Publications, 1st edition, 2008, p. 43.

buyer is found, the company is not obliged to accept it because of the condition of approval laid down in the company's Articles of Association, which requires its consent to the identity of the transferee for the transaction to be valid⁸.

The condition of approval was imposed for many reasons. In addition, this condition can only be applied in accordance with a set of procedures that ensure its legality.

Chapter One: The concept of the eligibility condition and its main characteristics

In order to discuss the meaning of the condition precedent and what it entails, it is necessary to define the characteristics that distinguish it from other restrictions on the freedom to trade shares.

Section One: Definition of the Eligibility Condition

Definitions of the eligibility condition vary. It is defined as: "A written agreement in the company's articles of association between the founders or between them and the shareholders that a shareholder may not transfer his shares to others unless the board of directors or the general meeting of the company has previously approved such transfer; otherwise, the transfer rejected by the competent authority cannot be enforced against the company"⁹.

Some also define the approval condition, or what is known as the reliance condition, as: "A technique introduced by the founders in the company's articles of association whereby a shareholder wishing to transfer his shares must present the proposed transfer and the proposed transferee to the competent company bodies in accordance with specified procedures for the approval of this new shareholder, which may then be accepted or rejected, after which the shares must be returned in the manner prescribed by law"¹⁰.

In this context, it can be said that the approval condition is a mechanism, formulated as a clause in the company's articles of association, which gives the company the right to accept or reject the proposed transferee when shares are traded to others.

Section Two: Characteristics of the Certificate of Incorporation

The company's Articles of Association serve as the basis for regulating everything that has to do with the life of the company. Therefore, the competent bodies strive to implement everything that serves its interests and achieves its objectives. This state of affairs is characterised by several features that can be outlined as follows:

J.P. Le Gall, *Commercial Law: Commercial Groups, Commercial Companies, and G.I.E., Banking and Stock Exchange*, 11th ed., 1987, p. 114.

⁸- Jérôme Bonnard, *Business Law*, Hachette, 2nd ed., Paris, 2002, p. 87.

⁹- Hamdallah Mohammed Hamdallah, *op. cit.* p. 78.

Ben Omar Qilili, *Regulatory Restrictions on the Principle of Freedom to Trade Shares in Algerian Legislation*, Vol. 7, No. 1, *Comparative Legal Studies Journal*, University of Chelif, June 2021, p. 1766.

¹⁰- Zahra Nawasria, *Condition of Approval for the Transferee When Transferring Shares*, *Communication in Human and Social Sciences*, Vol. 19, No. 34, University of Badji Mokhtar Annaba, June 2013, p. 108.

Branch One: The Approval Condition is a Binding Agreement for Both Parties

Since the company, before it is a legal entity in its own right, is essentially a contract based on the agreement of the parties who have consented to its formation, when the shareholders accept the company's memorandum and articles of association, this acceptance includes all the conditions contained therein, including the consent condition. The contract is formed only by the coincidence of the offer and the acceptance, without undermining the object, the consent and the cause¹¹.

Branch two: the condition of consent is binding on both parties

In addition to the feature of mutual consent derived from the voluntary nature of the formation agreement, another feature of the consent condition is that it is binding on both parties¹². While it is mandatory for the shareholder wishing to transfer his shares to obtain the company's consent, the company is also obliged to find another purchaser within two months from the date on which the transferring shareholder is notified of the company's rejection of the proposed purchaser.

If the company remains silent and the time limit expires, it is deemed not to have fulfilled its obligation¹³, with the result that the transfer to the third party is validated as a penalty for failure to comply with this condition, which illustrates the mandatory nature of the consent condition within contractual restrictions.

Branch Three: The personal nature of the condition of consent

In corporations, the personal nature of the shareholder is generally not taken into account¹⁴. This type of company, including companies limited by shares, requires primarily financial values rather than personal considerations, which means that the personal attributes of the shareholder are not paramount, but rather their financial ability or commercial skills are emphasised¹⁵. However, the requirement of the approval condition leaves the company free to accept or reject the proposed transferee suggested by the shareholder wishing to transfer his shares¹⁶, which is sufficient evidence of the personal nature of the approval condition.

Thus, the condition of acceptance is a manifestation of personal consideration in public limited companies. This consideration may be based either on the articles of association, on the fact that the shareholder joins the company and contracts with others on the basis

¹¹- Baghdadi Khaled Abdul Aziz, *Trading Shares and Legal Restrictions Thereon*, 1st edition, Library of Law and Economics, Riyadh, 2012, p. 362.

¹²- *Ibid.*, p. 362.

¹³- Article 715 bis 57 of the Commercial Code.

¹⁴- Khaled Abdul Aziz Baghdadi, *op. cit.*, p. 360.

¹⁵- Mohammed Kamel Darwish, *Advanced Fundamentals and General Provisions in Partnerships, Corporations, and Insurance Companies*, 1st edition, Dar Al-Khulood for Printing, Publishing, and Distribution, Lebanon, 1993, p. 331.

¹⁶- Hamdallah Mohammed Hamdallah, *The Freedom of the Shareholder to Dispose of Their Shares*, Dar Al-Nahda Al-Arabiya, 1997, p. 240.

of trust or familiarity¹⁷, or on the basis of financial competence. It may also be based on legal texts prohibiting the transfer of shares held by the founders, or on the company's statutes, which may restrict the entry of undesirables or require shareholders to share the nationality of the company's country¹⁸.

The principle of personal consideration also serves to distinguish contractual restrictions from legal restrictions. The latter are characterised as temporary and may be lifted after a certain period of time or on completion of a certain act or transaction¹⁹, whereas contractual restrictions based on personal consideration remain with the shares and affect their holders throughout the life of the company²⁰.

Section Four: The condition of approval as a suspensive condition

The inclusion of the condition of approval in the company's by-laws requires its implementation whenever necessary; it is a suspensive condition, meaning that its implementation depends on one of three scenarios²¹. The first scenario is that the condition is satisfied if the company approves the proposed transferee named by the transferring shareholder. The second scenario occurs if two months pass without the company announcing its decision to accept or reject the proposed transferee. In the third scenario, the condition is deemed to be fulfilled if the shareholder wishing to transfer his shares accepts the transferee proposed by the company.

Chapter Two: Conditions for the implementation of the condition of approval

In order to implement the condition of approval, it is necessary to comply with a number of rules to ensure its validity and guarantee its legal effects. The condition of approval derives its binding nature and legitimacy from the company's Articles of Association. It applies to a specific class of shares, always taking into account the interests of the company. In addition, this condition falls under the jurisdiction of a specific authority legally responsible for approving the transfer of shares, which will be discussed below.

Requirement One: Include the condition of approval in the company's articles of association

The principle of freedom to trade shares is a fundamental feature of shares. In principle, a shareholder has the right to transfer his shares whenever he wishes. However, for the reasons mentioned above²², this freedom is restricted by the condition of approval in

¹⁷- Ali Fawzi Ibrahim Al-Mousawi, Personal Consideration in Joint-Stock Companies - A Study in Iraqi Company Law, Iraqi Academic Journals, College of Law, University of Baghdad, pp. 310-315.

¹⁸- Ali Fawzi Ibrahim Al-Mousawi, Personal Consideration in Joint-Stock Companies - A Study in Iraqi Company Law, Iraqi Academic Journals, College of Law, University of Baghdad, pp. 310-315.

¹⁹- Abdel Awal Basyouni, op. cit., p. 241.

²⁰- Ibid., p. 265.

²¹- J.L. Beaufort, The Right of Approval in Press Companies, Rev. Soc., 1994, p. 438.

²²- Abdel Awal Basyouni, op. cit., p. 269. Khaled Abdul Aziz Baghdadi, op. cit., p. 350. Aziz Al-Akili, The Mediator in Commercial Companies, Dar Al-Thaqafa for Publishing and Distribution, 2007, p. 249. Tibar Mohammed Ammar, The

order to prevent a shareholder from becoming trapped in his shares. Achieving this effect could result in shares resembling the shares of partners in a partnership²³. For this reason, most legislators, including the Algerian legislator, have expressly included this condition in the company's articles of association, either at the time of incorporation or subsequently by a decision of the Extraordinary General Meeting, which has the power to amend the articles of association²⁴.

In this respect, the Algerian legislator has given the Extraordinary General Meeting the power to amend the company's articles of association without increasing the obligations of the shareholders²⁵. The Egyptian legislator's position on this matter is also clear, as stated in Article 68, Paragraph 1 of the Companies Law No. 159 of 1981, which states: "The Extraordinary General Assembly is responsible for amending the company's articles of association, taking into account the following: it is not permissible to increase the obligations of the shareholders, and any decision taken by the General Assembly that affects the essential rights of the shareholders as partners is null and void". Thus, the Extraordinary General Meeting has the power to amend the company's articles of association, either to implement contractual restrictions not previously mentioned or for other purposes, provided that it does not infringe the essential rights of shareholders, including their freedom to trade shares, nor increase their obligations.

In the meantime, the French courts have taken the view that this condition must be laid down in the company's articles of association and that it does not constitute an increase in the burden on shareholders but rather a reduction in their rights within the company. If the general meeting abuses its right and seeks to eliminate the trading rights of minority shareholders, for example in order to retain shares for the company at an undervalued price, such a decision would be subject to annulment²⁶.

French jurists have argued that it is necessary to include this restriction in the company's statutes, since it is not possible to do so after the incorporation procedures have been completed. However, if the company's articles of association allow it, the extraordinary general meeting is entitled to impose this restriction²⁷.

Requirement two: the condition of approval must apply to nominal shares and serve the interests of the company

The condition of approval is closely linked to the company's interest and derives its legitimacy from the benefit it provides. Even if it also serves the personal interests of

Theory of Fundamental Rights of the Shareholder in a Joint-Stock Company (A Comparative Study), Doctoral Thesis, Faculty of Law, Ain Shams University, 1998, p. 436.

²³- Aziz Al-Akili, *The Mediator in Commercial Companies*, Dar Al-Thaqafa for Publishing and Distribution, 2007, p. 249.

²⁴- M. Sallah, *op. cit.*, p. 45.

²⁵- Article 674 of the Commercial Code.

²⁶- J. Hemard, F. Terre, P. Mabilat, *Commercial Companies*, Vol. 3, DALLOZ, Paris, 1978, p. 38.

²⁷- J. Bonnard, *Business Law*, 2nd ed., Hachette, Paris, 2002, p. 105.

the directors, provided they act in good faith, the interest served by the condition of approval must be legitimate²⁸. Conversely, if the contract serves an illegitimate interest, it is void, including any conditions it may contain. Moreover, for this interest to be legitimate, it must not involve any abuse or infringement of legitimate rights, ensuring that it does not harm other interests²⁹, such as the rights of shareholders, which the law protects by guaranteeing their freedom to withdraw from the company at any time through the principle of free trading of their shares, or the interests of the company's creditors or third parties.

The legislator has based this condition on an objective criterion based on the nature of the shares. In essence, the shares subject to the condition of approval by the board of directors or the general meeting for transfer to others must be nominal shares. This requirement is laid down by law and, according to French legal doctrine, even includes capital securities, since they confer the right to participate in the company's capital, such as partially paid-up cash shares, guarantee shares, shares with superior voting rights, shares with preferential subscription rights and voting or investment certificates, since their incorporation constitutes a share by law. Alternatively, shares may be nominal by virtue of the company's Articles of Association, which provide for this form for all shares, which is permissible since each shareholder is entitled to a nominal certificate³⁰. On the other hand, bearer and registered shares are not subject to the approval requirement. The former transfer ownership by delivery, while the latter are traded by endorsement, making it impossible to monitor their transactions. Although in practice they facilitate trading, the condition of approval does not apply to bearer shares for two reasons: firstly, bearer shares are not subject to supervision or registration;³¹ secondly, they may not represent more than a small percentage of the company's capital in order to prevent their holders from monopolising the majority³², which could influence the company's policies and interests. It is therefore necessary to prohibit the approval of holders of bearer shares³³.

In view of these considerations³⁴, it is likely that agreements between holders of bearer shares to freeze them by forming a union or association in order to ensure their non-

²⁸- Smiha Al-Qalyubi, *Commercial Companies*, Dar Al-Nahda Al-Arabiya, 3rd ed., 1993, p. 297 and onwards.

²⁹- According to the general rule in civil law, the legality of the subject matter in a contract is required under penalty of nullity, as stated in Article 93 of the Commercial Code.

³⁰- Cash shares remain nominal shares until their full value is paid. Based on Article 715 bis 52 of the Commercial Code. In this sense, see Article L.228-9 of the Commercial Code.

³¹- Articles 715 bis 44 of the Commercial Code.

³²- Articles 715 bis 67-68-71 of the Commercial Code.

³³- G. Ripert and R. Roblot, *op. cit.*, par M. Germain, *op. cit.*, p. 318. In this regard, see also Article 715 bis 34, paragraph 2 of the Commercial Code.

³⁴- The bearer share is a document issued to the order or permission of a specific person, traded by endorsement like other commercial papers, allowing the owner to transfer ownership through writing on the back of the document without referring to the company. Mohammed Farid Al-Arini, *op. cit.*, p. 290. Nadia Fadhel, *Capital Companies in Algerian Law*, University

transferability would be outside the company's system³⁵. Such an agreement would effectively trap the shareholder in his shares³⁶, which would make it absolutely null and void³⁷, as it would violate the shareholder's right to trade his shares, which is a matter of public policy³⁸, as confirmed by Article 715 bis 57 of the Commercial Code³⁹.

The Algerian legislator's position on the application of the condition of approval to nominal shares is explicit and limits its application to nominal shares only, as stated in Article 715 bis 55, paragraph 2 of the Commercial Code: "...this condition cannot be imposed unless these shares have exceptionally acquired nominal form by virtue of the law or the company's articles of association...".

One of the essential requirements for the validity of the authorisation condition is that it must be imposed in order to protect the interests of the company⁴⁰. The rationale behind this condition is to prevent it from becoming arbitrary or an absolute right⁴¹. If the condition adversely affects the company's interest, it cannot be considered valid, for example, if the company's interest is to prevent outsiders or competitors from entering or to exclude undesirable persons, as in family businesses. For example, if the company is engaged in a particular activity (such as publishing), it would not be in its interest to allow opponents of its activities to acquire shares⁴². Moreover, serving the interests of other companies is often in conflict with its own interests.

To say that the interests of the company must be taken into account in determining the condition for approval does not mean that other interests, such as the desire of shareholders to trade their shares, will be harmed. However, if the purpose is to serve the personal interests of directors, such conditions would be considered invalid⁴³.

In a related context (the financial counterpart of the consent condition), Article 715 bis 57 of the Commercial Code states: "In the event of disagreement on the share price, the competent judicial authority shall decide on the matter". The phrase "in case of disagreement" implies that the norm and general rule is that the price of the shares is

Publications, Algeria, 2008, p. 198. Shafik Mohsen, *The Mediator in Egyptian Commercial Law*, Part One, Library of Egyptian Renaissance, 3rd ed., 1957, p. 460. V. Dominique, *Business Law*, L.G.D.J., Paris, 1993, p. 386.

³⁵- Abdel Awal Basyouni, *op. cit.*, p. 270.

³⁶- It is difficult to monitor them due to their non-registration in company records, based on the principle of possession in movable property ownership stated in Article 835 of the Commercial Code. Shoukri Ahmed Al-Sabahi, *The Mediator in Maghreb and Comparative Law*, Vol. 2, 2nd ed., Rabat, 1980, p. 343. Hamdallah Mohammed Hamdallah, *op. cit.*, p. 92.

³⁷- Abdelfi Bassiouni, *op. cit.*, p. 571.

³⁸- Kamal Taha Mustafa, *Commercial Law, Commercial Contracts and Banking Operations*, University Press, Egypt, 1993, p. 513.

³⁹- Amal Haloush, *op. cit.*, pp. 242-243. Mohammed Farid Al-Arini, *Commercial Companies, The Collective Commercial Project Between Legal Framework Unity and Multiple Forms*, Dar Al-Jami'a Al-Jadida, Egypt, 2003, p. 187.

⁴⁰- Khaled Abdul Aziz Baghdadi, *op. cit.*, p. 351. Samiha al-Qulioubi, *op. cit.*, p. 297.

⁴¹- Hamdallah Mohammed Hamdallah, *op. cit.*, p. 91.

⁴²- Khaled Abdul Aziz Baghdadi, *op. cit.*, p. Abdul I Bassiouni, *op. cit.*, p. 267-268.

⁴³- Fattahi Mohammed, *Trading Shares in Joint-Stock Companies in Algerian Law - A Comparative Study*, Doctoral Thesis, University of Sidi Bel-Abbes, 2007-2008, p. 258.

agreed between the parties in the company's articles of association. If there is no agreement, the legislator has empowered the judiciary to determine the price. Therein lies the problem: the legislator has not specified the basis for appointing the expert, nor the criteria for assessing the price, whether for direct trading or trading on the stock exchange. It is therefore necessary for the legislator to intervene in order to establish a legal framework that addresses these issues, in order to avoid violating rights or interests.

Conclusion

Although the condition of approval is one of the most important provisions in the articles of association of a public limited company, it is also the most regulated contractual restriction in terms of legal texts. However, this does not mean that it is the only condition or contractual restriction affecting the trading of shares; there are other conditions that may be imposed or invoked to protect specific interests, in particular those of the company or the shareholders.

In order to implement the condition of approval, the prevailing legal doctrine suggests that, if it is not included in the statutes, it can be added by means of an amendment to the statutes. In addition, the condition of approval applies only to nominal shares, as it does not apply to bearer shares due to the difficulty of monitoring their trading.

One of the conditions for the application of the condition of approval is that the shareholder must receive a fair price for his shares. Both French legal doctrine and jurisprudence assert that a fair price represents the true value of the shares. French courts have held that if the shareholder and the company cannot agree on the price, it should be determined by an expert. This approach has not been adopted by the Algerian legislator, who has left the question of valuation to the judiciary. On the other hand, the Egyptian legislator has entrusted the company's articles of association with the task of determining the appropriate method for determining the value of the shares being traded. Contractual restrictions, in particular the condition of approval, reflect the personal consideration in a joint stock company, which is an exception to the norm of financial consideration. Requiring the company's approval of the transferee proposed by the shareholder wishing to transfer his shares emphasises the importance of personal qualities over financial contributions or ownership.

It can be said that the incorporation of a personal character in a joint-stock company, even if of a political or family nature, does not deprive it of its financial character or give it a personal character, as this would be contrary to its existence and purpose.