

Ibero-American Institute for Law and Finance



Working Paper Series 1/2025

Addressing corporate agency problems in Latin America: Lessons from Ecuador

Paúl Noboa-Velasco¹

¹ Lecturer of Contract Law, Commercial Law and Corporate Governance at San Francisco de Quito University. Academic Coordinator at the Ibero-American Institute for Law and Finance.

Addressing corporate agency problems in Latin America: Lessons from Ecuador

Paúl Noboa-Velasco

Universidad San Francisco de Quito

Ibero-American Institute for Law and Finance

Abstract

Latin American company law, commonly characterized by share concentration, should establish a regulatory framework that protects corporate outsiders from the risks of opportunism by controlling shareholders. In this context, the recent Ecuadorian reforms, which will ensure greater transparency and accountability in corporate decision-making, are a reference for modernizing corporate governance across the region. Also, from a practical standpoint, implementing a combination of *ex-ante* and *ex-post* mechanisms would help mitigate the main agency problem that Latin American companies face during their existence and operation. This paper will analyze the regulatory strategies that could be implemented, based on the recent solutions adopted in Ecuador, to address these conflicts of interest in companies characterized by concentrated ownership structures, both from an *ex-ante* and *ex-post* perspective. By adopting these measures, the region can move towards a more balanced corporate governance framework which, in the end, would promote investment and innovation in our companies.

Keywords: Corporate Governance; shareholder protection; corporate litigation

1. Introduction

Company Law serves a fundamental function: mitigating conflicts of interest among different groups involved in a company.² As legal entities with their own independent legal personality, companies often become points of convergence for interests that frequently collide. Within these corporate conflicts, there will always be a group that controls the company's operation (the corporate insiders), in contrast to corporate outsiders, who do not have the power to make decisions within the corporate structure.

From a functional perspective, these conflicts of interest are known as agency problems.³ Agency problems arise when one person can influence the property rights or well-being of another.⁴ For this analysis, the concept of agency should encompass any relationship

² John Armour, Henry Hansmann and Reinier Kraakman, 'Agency Problems and Legal Strategies', 57. in: Reinier Kraakman *et. al*, 'The Anatomy of Corporate Law, A Comparative and Functional Approach' 3rd Ed, OUP, 2017, 57

³ *Ibid*

⁴ The agency relationships discussed here are not limited to a contractual bond between a principal and an agent, nor the Latin figure of the officious agency, a quasi-contract subject to subsequent ratification. For more information on the officious agency in Ecuador, see: Juan Larrea Holguín, *Manual Elemental de Derecho Civil del Ecuador, Vol. VIII, Contratos II: El Arrendamiento, la Sociedad, el Mandato, el Comodato o Préstamo de Uso, el Mutuo o Préstamo de Consumo, el Depósito y el Secuestro, la Fianza, la Prenda, la Hipoteca, La Anticresis, la Transacción, los Contratos Aleatorios*, Quito, 2008, Corporación de Estudios y Publicaciones, 287

that allows a person to influence another party's well-being, either directly or indirectly.⁵ As a result, agency relationships may emerge in a wide range of legal scenarios, even without a formal legal agreement between the parties.⁶

In this context, the ownership of legal capital appears to have developed into two main patterns. The first one is share concentration, a common trend in emerging economies, like Latin American countries.⁷ The second one is share dispersion, characteristic of Anglo jurisdictions, especially in the capital markets of the United States and the United Kingdom.⁸ This distinction is relevant because each pattern generates different agency problems that require different corporate governance strategies to mitigate them.⁹

A dispersed ownership pattern makes it more difficult for shareholders to engage in the decision-making process of the company.¹⁰ In these systems, each shareholder holds a relatively small number of shares.¹¹ As a result, those shareholders do not have enough incentives or ability to oversee corporate operations. Furthermore, dispersed ownership systems are characterized by highly developed capital markets that provide minority shareholders with an exit strategy when they cannot actively engage in corporate decision-making.¹² As a result, in these jurisdictions, shareholders have little incentive to monitor management entrusted to third parties who operate the company on their behalf.¹³ Therefore, in such models, where ownership of capital is separate from control over the company, corporate directors have a predominant role in making business decisions.¹⁴

On the other hand, jurisdictions with a concentrated share-ownership structure are characterized by a significant number of shares controlled by a dominant shareholder, or by a group of shareholders who, collectively, can make decisions in the general meetings.¹⁵ As a result, controlling shareholders can exercise direct¹⁶ or indirect¹⁷

⁵ Aurelio Gurrea Martínez *et. al.*, 'Propuesta para la mejora y modernización de la legislación societaria en Ecuador', Working Paper Series 2/2019, Instituto Iberoamericano de Derecho y Finanzas, (May 7, 2019), 9

⁶ Zipora Cohen, 'Fiduciary Duties of Controlling Shareholders: A Comparative View', U.a.J.Intl.Bus.L [Vol 12:3], 380.

⁷ The Organization for Economic Cooperation and Development (OECD), *White Paper on Corporate Governance in Latin America*, 48

⁸ John Lowry and Arad Reisberg, *Pettet's Company Law: Company Law & Corporate Finance* (4th edn, Pearson Education 2012), 65

⁹ Armour *et. al.*, *Op. Cit.*, 57

¹⁰ Andrew Keay, 'Company Directors Behaving Poorly: Disciplinary Options For Shareholders' [2007] *Journal of Business Law*, 11

¹¹ Sarah Kiarie, 'At crossroads: shareholder value, stakeholder value and enlightened shareholder value: Which road should the United Kingdom take?' (2006), *International Company and Commercial Law Review*, 2

¹² As John Coffee mentioned, "*liquidity discourages voice*". John Coffee, 'Liquidity Versus Control: The Institutional Investor As Corporate Monitor' (1991) 91 C.L.Rev, p. 1281

¹³ This lack of shareholder activism derives from the collective action problem, where the costs of monitoring a company are greater than the potential benefits for individual shareholders. See: David Kershaw, *Company Law in Context*, OUP 2009, 175. As a result, this problem makes it difficult for companies with dispersed ownership structures to reach consensus-based decisions. See: Stephen Bainbridge, *The New Corporate Governance in Theory and Practice*, Oxford Scholarship Online, 2008.

¹⁴ Francisco Reyes Villamizar, *Análisis Económico del Derecho Societario*, Grupo Editorial Ibañez, Bogotá, 2012, 37

¹⁵ Aurelio Gurrea-Martínez, 'New Agency Problems, New Legal Rules: Rethinking Takeover Regulation in the US and Europe' (October 30, 2019) Ibero-American Institute for Law and Finance, Working Paper Series 3/2016, 24 Available at SSRN: <https://ssrn.com/abstract=2766208>

¹⁶ For example, by requiring corporate information and even through their appointment or removal.

¹⁷ For example, by setting their remuneration. For an analysis of the compensation system for corporate directors, see: Ferrarini, Guido, and Maria Cristina Ungureanu, 'Executive Remuneration,' in Jeffrey N. Gordon and Wolf-Georg

influence over corporate directors. As a result, in this scenario, the risk of managerial opportunism at the expense of shareholders as a class is lower, since controlling shareholders, having full oversight capacity and significant economic interests in the company, have strong incentives to monitor the performance of corporate directors.¹⁸ However, due to their decision-making predominance, controlling shareholders enjoy private benefits of control¹⁹, which are not shared with other shareholders.²⁰

Both models, considering their characteristics, require different regulatory strategies to mitigate the agency problems that arise within their companies.²¹ Generally, in companies with concentrated ownership structures, controlling shareholders appoint and remove directors, approve their remuneration, and control the company's operations. Therefore, managerial and controlling shareholder incentives tend to align in companies with such ownership structures. In fact, controlling shareholders often serve as corporate directors themselves. For this reason, corporate governance in concentrated ownership systems should focus on mitigating the risks of opportunism and abuse of dominant shareholders rather than primarily addressing conflicts between shareholders as a class and corporate directors.²²

In this context, this paper will analyze the regulatory strategies that could be implemented in Latin America, based on the recent regulatory solutions adopted in Ecuador, to address these conflicts of interest in Latin companies, characterized by concentrated ownership structures, both from an *ex-ante* and *ex-post* perspective.

2. Regulatory strategies: *ex-ante* measures²³

In this paper, *ex-ante* measures refer to regulatory strategies designed to prevent conflicts of interest and ensure that those who manage or control a company do not make decisions that are illegal, abusive, or conducted with a conflict of interest.²⁴ Among Ecuador's recent company law reforms, key *ex-ante* measures include regulating related-party transactions, strengthening minority shareholders' voting rights, and granting them certain rights to appoint company directors, under specific conditions.

Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford Handbooks (2018; online edition, Oxford Academic, June 9, 2015)

¹⁸ Gurrea *et al*, *Propuesta...* Op cit., 34

¹⁹ Luca Enriques, Henry Hansmann, Reinier Kraakman and Mariana Pargendler, *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies*, 79. En: Reinier Kraakman *et. al*, 'The Anatomy of Corporate Law, A Comparative and Functional Approach' 3rd Edition, OUP, 2017.

²⁰ Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms Versus Ex Post Transaction Review*, 169 JITE 160 (2013).

²¹ Gurrea *et al*, *Propuesta...* Op cit., 34

²² Gurrea-Martinez, *New Agency Problems...* Op. Cit., 24

²³ For a more detailed analysis of the reasons why both *ex-ante* and *ex-post* measures should be implemented to regulate private benefits of control, see: Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms Versus Ex Post Transaction Review*, 169 JITE 160 (2013).

²⁴ John Armour, Henry Hansmann and Reinier Kraakman, *Agency Problems and Legal Strategies*, En: Reinier Kraakman *et. al*, 'The Anatomy of Corporate Law, A Comparative and Functional Approach' 3rd Edition, OUP, 2017, 37-38

2.1. First *ex-ante* measure: regulating related-party transactions

Latin American company law has to regulate related-party transactions to prevent abuses from those who control a company. Due to their influence and control, corporate insiders may approve transactions unfairly, in less favorable conditions than those obtained if the deal was closed with an external party.²⁵ For example, in Latin American companies, a controlling shareholder may approve, in the company's general meeting, undervalued or overpriced transactions for their benefit. Controlling shareholders might also misappropriate the liquidity of the company, for example, by approving a loan in which the company acts as the lender and the controlling shareholder acts as the borrower. These transactions can harm minority shareholders since controlling shareholders, who are free to set the terms of those operations, can approve those deals under unfair conditions at the expense of the company's interests.²⁶

However, in some cases, related-party transactions are not only acceptable but also necessary, as long as they are conducted under fair conditions.²⁷ For instance, in certain situations (like temporary *financial distress*), corporate insiders may be the only counterparties willing to negotiate a transaction with the company. Also, in some cases, third parties might have to incur in high transaction costs to negotiate a deal with the company, because they do not have access to key business documents to make an informed decision.²⁸ In such cases, a related-party transaction could benefit the company, as insiders, better informed than outsiders, can identify business opportunities and negotiate them in more favorable conditions for both sides.²⁹ Therefore, instead of prohibiting these transactions, Latin American company law should establish clear rules to ensure that any related-party transaction is conducted fairly, transparently and in the best interest of the company.³⁰

Traditionally, Latin American legal frameworks have only restricted related-party transactions when a director enters into a contract with the company he directs.³¹ While Latin American company law should address this issue, this approach is incomplete for two reasons. To begin with, not all related-party transactions harm the company since, sometimes, related parties are the only viable option for a transaction. Also, Latin American company law, from a traditional standpoint, has excluded controlling shareholders from the regulation of related-party transactions, which may be problematic given their dominance in the company's decision-making.³²

²⁵ Vladimir Atanasov, Bernard Black y Conrad Ciccotello, *Unbundling and Measuring Tunneling* (November 20, 2014), as published in 2014 University of Illinois Law Review 1697-1738, ECGI - Finance Working Paper, McCombs Research Paper Series, U of Texas Law, Law and Econ Research Paper No. 117, 1700

²⁶ Johnson, Simon, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer. 2000. Tunneling. *The American Economic Review* 90, no. 2: 22-27

²⁷ Enriques, Luca, 'Related Party Transactions', in Jeffrey N. Gordon, and Wolf-Georg Ringe (eds), *The Oxford Handbook of Corporate Law and Governance*, Oxford Handbooks (2018; online edn, Oxford Academic, 9 June 2015).

²⁸ *Ibid*

²⁹ *Ibid*

³⁰ Gurrea *et al*, *Propuesta...* Op cit., 39

³¹ *Ibid*. For example, see article 261 of the previous Ecuadorian Companies Act (1964).

³² Gurrea Martínez *et al*, *Propuesta...*, Op. Cit., 38

Therefore, Latin American company law should adopt a more flexible approach to allow all related-party transactions, as long as they are fairly negotiated and are not affected by a conflict of interest. In other words, instead of prohibiting all related-party transactions (that, in some cases, may benefit the company), Latin American company law should prevent illegal, abusive, or unfair transactions, focusing on shareholder opportunism.

There are several mechanisms to prevent opportunistic shareholder behavior in related-party transactions.³³ The first of them is requiring the approval of those transactions by disinterested shareholders or, if applicable, by independent directors on the board.³⁴ Therefore, Latin American company law should establish the *majority of the minority rule*, that allows a group of disinterested minority shareholders to approve or, whenever appropriate, deny transactions involving conflicts of interest. In this context, according to Article 261(h) of the Ecuadorian Companies Act, any operation involving a conflict of interest between a company and any of its shareholders, must be approved by the general meeting. However, these transactions can only be approved by shareholders who have no interest in the deal. The Ecuadorian Companies Act states that *"unless the company has a single shareholder, any shareholder with a direct or indirect interest in the transaction cannot participate in the voting process. Therefore, when the general meeting discusses related-party transactions, only shareholders without voting restrictions will constitute 100% of the eligible capital for their approval."*

The Ecuadorian Companies Act also requires this approval process for transactions where a company contracts, either directly or indirectly, with one of its shareholders or directors. This regulation includes direct transactions, where the controlling shareholders or directors enter into a deal without intermediaries, and indirect transactions, where the controlling shareholders or directors use related third parties (either individuals or legal entities) to close an agreement with the company. Furthermore, article 261 of the Ecuadorian Companies Act presumes that an indirect transaction exists if the deal is conducted with a close relative of the controlling shareholders or directors, or if the transaction involves a legal entity in which the controlling shareholders, the directors, or their close relatives, hold 51% or more of the entity's voting rights.

Ecuador has also eliminated the absolute prohibition on transactions between companies and their directors. Instead, the Ecuadorian Companies Act now allows these transactions when they are conducted under fair market conditions. Under Article 261(i), transactions such as equity contributions, free-of-charge agreements benefiting the company and contracts like sales, leases or supply agreements, are permitted as long as they are approved, in the general meeting, by a supermajority of 75% of the votes, and are conducted fairly. In these cases, shareholders who were also appointed as the company's directors, or shareholders related to the interested director, are not allowed to vote. As a

³³ Luca Enriques and Tobias H. Troger, The Law and (Some) Finance of Related Party Transactions: An Introduction, 8-10, in Luca Enriques and Tobias H. Troger, eds, *The Law and Finance of Related Party Transactions*, Cambridge University Press, 2019.

³⁴ Gurrea Martínez *et al*, *Propuesta...*, *Op. Cit.*, 42

result, only disinterested shareholders are called to vote on the transaction, preventing conflicts of interest.

To conclude this analysis, the main agency problem that Latin American companies have to deal with usually derives from the informational asymmetry between controlling and non-controlling shareholders.³⁵ Controlling shareholders may not disclose or share relevant information, leading to suboptimal decision-making³⁶ by minority shareholders. To address this problem, Ecuador has reversed the burden of proof in any legal proceedings involving related-party transactions. Whenever a non-controlling shareholder disputes a related-party transaction, the beneficiaries of the transaction must demonstrate that the deal was conducted under fair market conditions and in the company's best interest. The Ecuadorian Companies Act follows this approach in Article 261(h), stating that, *"when necessary, the burden of proof to justify that the transaction was conducted under fair market conditions (...) will shift to the related parties involved in the transaction."* In conclusion, by implementing these *ex-ante* mechanisms, Ecuador ensures that any related-party transaction is conducted fairly, rather than serving as a tool for corporate insiders to extract value.

2.2.Second *ex-ante* measure: voting rights of non-controlling shareholders

Non-controlling shareholders should have special voting rights in some scenarios.³⁷ This special voting rights will prevent controlling shareholders from making unilateral decisions that could affect the interest of the company as a whole. For instance, as discussed earlier, any transaction conducted with a director or a controlling shareholder, should only be approved by those shareholders who are not interested in the deal.³⁸ Additionally, certain corporate decisions, such as a merger with another company or financial decisions like not distributing dividends, should be approved with an enhanced majority of votes (for example, 75% of the shares with voting rights for mergers³⁹, or 100% of the votes for reinvesting the company's profits⁴⁰). These strategies would prevent a simple majority of shareholders from imposing decisions that may unfairly affect non-controlling shareholders.

In addition, controlling shareholders should be prohibited from reforming the company's by-laws to eliminate non-controlling shareholder rights, without their consent.⁴¹ Any changes that modify or eliminate rights granted to a specific class of shareholders should require approval from all of them. This situation is particularly relevant in Latin American companies, where controlling insiders, like ordinary shareholders, may have incentives

³⁵ Francisco Reyes Villamizar, *Análisis económico del Derecho Societario*, Grupo Editorial Ibañez, 2012, Bogotá, 68

³⁶ Gregory Mankiw, *Principios de Economía*, 6ta edición, Cengage Learning EMEA, 470

³⁷ Luca Enriques, Henry Hansmann, Reinier Kraakman and Mariana Pargendler, *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies*, 84. En: Reinier Kraakman *et. al*, 'The Anatomy of Corporate Law, A Comparative and Functional Approach' 3rd Edition, OUP, 2017.

³⁸ See Ecuadorian Companies Act, article 216 (h)

³⁹ See Ecuadorian Companies Act, article 331

⁴⁰ See Ecuadorian Companies Act, article 297

⁴¹ See Ecuadorian Companies Act, article 170.1

to eliminate the rights of privileged shareholders. As a result, by requiring the consent of non-controlling shareholders for such changes, Latin American company law would ensure that their original rights remain protected.

2.3.Third *ex-ante* measure: non-controlling shareholder appointment rights

Another adequate way to protect non-controlling shareholders is to allow them to designate certain directors or internal actors, such as auditors or fiscal reviewers⁴² (commonly known as *comisarios* or *revisores fiscales* in Latin America). Allowing minority shareholders to designate these members would give them access to essential company information and enable them to monitor decisions made by the executive directors, who are appointed by controlling shareholders.⁴³ In theory, Latin American independent directors are supposed to supervise the actions of executive directors.⁴⁴ However, in many Latin American companies, controlling shareholders, due to their predominant position, have the power to appoint the entire board, including the so-called independent directors.⁴⁵ As a result, these directors are not independent from controlling shareholders.⁴⁶

To address this issue, Latin American company law, especially in publicly traded companies (where a board of directors would be mandatory)⁴⁷, should allow minority shareholders to appoint certain independent directors. This could be achieved by allowing them to directly appoint at least one independent director⁴⁸, following the majority of the minority rule, or by implementing a dual voting system, giving minority shareholders veto power over any designation made by controlling shareholders.⁴⁹

By adopting these measures, Latin American company law would guarantee the presence of genuinely independent directors, who are not influenced or controlled by majority shareholders. These truly independent directors, appointed whenever a board is mandatory, would prevent unfair decisions and ensure adequate corporate oversight. Ultimately, these regulations would help mitigate the main agency problem that

⁴² Luca Enriques, Henry Hansmann, Reinier Kraakman and Mariana Pargendler, *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies*, 80. En: Reinier Kraakman *et. al.*, 'The Anatomy of Corporate Law, A Comparative and Functional Approach' 3rd Edition, OUP, 2017

⁴³ *Ibid*

⁴⁴ See: Corporación Andina de Fomento, *Lineamientos para un Código Latinoamericano de Gobierno Corporativo* (online):

<https://scioteca.caf.com/bitstream/handle/123456789/2239/CAF%2040%20Lineamientos%20Codigo%20Latinoamericano%20Gobierno%20Corporativo%202023.pdf?sequence=1&isAllowed=y>

⁴⁵ Aurelio Gurrea-Martínez, Aurelio y Oliver Horton, *Hacia un sistema creíble de directores independientes en las sociedades cotizadas latinoamericanas* (Toward a credible system of independent directors in Latin American listed companies) (March 19, 2018). Instituto Iberoamericano de Derecho y Finanzas, Working Paper Series 3/2018. Disponible en: <https://ssrn.com/abstract=3144054>

⁴⁶ Lucian A. Bebchuk y Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 *University of Pennsylvania Law Review* 1271 (2017), 1272.

⁴⁷ Gurrea Martínez *et al.*, *Propuesta...*, *Op. Cit.*, 25

⁴⁸ See: Ferrarini, Guido, Gian Giacomo Peruzzo, and Marta Roberti, 'Corporate Boards in Italy', in Paul Davies, and others (eds), *Corporate Boards in Law and Practice: A Comparative Analysis in Europe* (Oxford, 2013; online edn, Oxford Academic, 23 Jan. 2014). Also, see: Ecuadorian Companies Act, article 271.2

⁴⁹ See Ecuadorian Companies Act, article 271.2

Ecuadorian and, more broadly, Latin American companies, have to deal with throughout their existence and operation.

3. Regulatory Strategies: *ex-post* measures

Ex-post measures refer to legal strategies that allow non-controlling shareholders to challenge decisions previously approved by the controlling shareholders, when there is evidence of abuse, fraud, or conflicts of interest.

3.1. First *ex-post* measure: implementation of derivative and direct actions

Shareholder general meetings in Latin America, as common in emerging economies, operate under a democratic principle. According to this principle, whoever holds the majority of voting rights can either approve resolutions that are binding for the company and any dissenting or absent shareholders, or block certain decisions from being approved in general meetings.⁵⁰

In this context, if the directors of a company breach their fiduciary duties, the general meeting may approve, on behalf of the company, a resolution to bring a claim against them.⁵¹ However, since this filing requires shareholder approval, these actions can only prosper if they receive the support of the majority of voting shareholders in the general meeting. Given that, in Latin American companies, the interests of controlling shareholders often align with those of the company's directors⁵², it is common for the controlling shareholders to deny legal actions against directors who act on their interests or, in some cases, against themselves if they also hold executive positions. To address this issue, Ecuador implemented the derivative actions. These actions allow minority shareholders to file a claim, on behalf of the company, against a director, either directly or as a result of the company's inaction to do so.⁵³ These derivative actions ensure that controlling shareholders cannot cover negligent or abusive directors from accountability.

Furthermore, under Ecuadorian law, any shareholder, regardless of his stake in the company, can file a derivative claim when the company fails to do so within one month of the general meeting's resolution, as long as the claim is based on a director's breach of his duty of care.⁵⁴ In addition, Ecuadorian law allows minority shareholders to file direct actions against the directors of a company, even without a general meeting resolution, whenever the directors breach their duty of loyalty. These mechanisms, from a functional perspective, allow negligent or fraudulent directors to be held accountable for their opportunistic behavior.⁵⁵

⁵⁰ See, for example, Ecuadorian Companies Act, article 245

⁵¹ See, for example, Ecuadorian Companies Act, article 272

⁵² Paúl Noboa Velasco, *Problemas de Agencia y su Mitigación en el Contexto Societario Ecuatoriano*, Ibero-American Institute for Law and Finance, Working Paper Series 5/2020, 2020

⁵³ Marco Ventoruzzo *et. al.*, *Comparative Corporate Law*, (American Casebook Series) 1st Edition, 2015.

⁵⁴ See Ecuadorian Companies Act, article 272

⁵⁵ Cfr. Arad Reisberg, *Derivative Actions and Corporate Governance*, Oxford University Press, 2007, 24.

Following the "Anna Karenina Principle", highlighted by Martin Gelter⁵⁶, and inspired by French⁵⁷ and Swiss⁵⁸ law, Ecuador has eliminated the minimum ownership requirement to sue, allowing non-controlling shareholders to file a claim, on behalf of the company. Currently, those claims can be either derivative (if a director breached his duty of care) or direct (if a director breached his duty of loyalty). As a result, any shareholder, regardless of the number of shares he owns, has standing to bring a derivative or direct claim, on behalf of the company, against negligent or disloyal directors. However, to prevent abusive litigation from minority shareholders, the Ecuadorian Companies Act has imposed penalty costs on those shareholders who file bad faith claims. In other words, any shareholder, regardless of their equity in the company, can directly or derivatively bring a claim against a director, depending on the fiduciary duty he breached. At the same time, to discourage opportunistic litigation, shareholders who bring baseless claims that affect the operations of the company⁵⁹ may be required to cover legal costs and to indemnify whoever was harmed by their actions.⁶⁰

In addition, given that the *shareholding agency problem* is the main conflict of interest that Ecuadorian corporate governance has to address⁶¹, Ecuadorian legislation now allows minority shareholders to bring derivative claims against controlling shareholders in specific situations.⁶² This means that a non-controlling shareholder, regardless of his stake in the company, can file a claim, on behalf of the company, when controlling shareholders: (i) abuse their voting rights⁶³; (ii) pass resolutions despite a clear conflict of interest⁶⁴ or (iii) engage in competition with the company they control, as long as the by-laws include a non-competition clause.⁶⁵ According to the Ecuadorian legislation, any shareholder can formally request the company's directors to file a claim against a controlling shareholder who is involved in any of these situations. If the director does not initiate the requested action within one month from the petition, the non-controlling shareholder who made the request gains the right to bring that claim, derivatively and on behalf of the company, against the controlling shareholder. With this reform, Ecuador has become a pioneer in allowing derivative claims controlling shareholders in their capacity as shareholders, and not just under the *de facto* or *shadow directorship* doctrines. These measures have the potential to enhance accountability from those members who really control Ecuadorian companies.

⁵⁶ Martin Gelter, Why do Shareholder Derivative Suits Remain Rare in Continental Europe? Brooklyn Journal of International Law, 37, 3, 2012, Fordham Law Legal Studies Research Paper No. 2000814, ECGI - Law Working Paper No. 190/2012.

⁵⁷ See French Code of Commerce, article L225-252

⁵⁸ Cfr. Gelter, Why do Shareholder Derivative Suits Remain Rare in Continental Europe? *Op. Cit.*, 859

⁵⁹ Reisberg, *Op. Cit.*, 191

⁶⁰ See Ecuadorian Companies Act, articles 272.9 and 272.10

⁶¹ Paúl Noboa Velasco, Problemas de Agencia y su Mitigación en el Contexto Societario Ecuatoriano, Ibero-American Institute for Law and Finance, Working Paper Series 5/2020, 2020

⁶² See Ecuadorian Companies Act, article 272.1

⁶³ See Ecuadorian Companies Act, article 272.8

⁶⁴ See Ecuadorian Companies Act, article 261 (h)

⁶⁵ See Ecuadorian Companies Act, article 262.4

Furthermore, article 272.3 of the Ecuadorian Companies Act has established the so-called “*dynamic burden of proof*” doctrine. Under this principle, a judge can shift the burden of proof to whoever is in the best position to provide evidence during a corporate proceeding. This principle reduces informational asymmetry between minority and controlling shareholders, particularly in cases involving potential conflicts of interest. In this case, the judge may require the defendant director or controlling shareholder to provide evidence that exonerates him from liability, if the non-controlling shareholders, as plaintiffs, require that inversion during these proceedings. This alternative was adopted because minority shareholders don't usually have easy access to corporate records and relevant information to justify their claims. Therefore, this measure was implemented to protect non-controlling shareholders from the opportunistic behavior of those who control the company.

In conclusion, derivative and direct actions are essential to protect non-controlling shareholders, because they allow them to bring a direct or derivative claim against the directors and, in Ecuador, against controlling shareholders of a company. These proceedings will ensure that, from an *ex-ante* perspective, directors and non-controlling shareholders act in the best interest of the company. Also, these new rules, from an *ex-post* perspective, will allow minority shareholders to hold directors and controlling shareholders accountable, which will prevent misconduct within our companies. As a result, these regulations should be established in Latin America to strengthen corporate governance in the region.

3.2. Second *ex-post* measure: regulating the *de facto* and *shadow* directors

In Latin American corporate governance, legally appointed directors are those formally elected by the general shareholders' general meetings, or another body authorized by the company's by-laws.⁶⁶ These directors must voluntarily accept their role, and if they hold legal representation of the company, their appointment must be registered with the appropriate public entity. Depending on their specific responsibilities, legally appointed directors assume their duties either from the moment of their appointment or, if legal representation is involved, from the date of registration.⁶⁷ However, in jurisdictions with high share concentration, legally appointed directors often operate under significant limitations. Since they are typically elected by controlling shareholders, they can directly interfere in the decision-making of the company. To address this problem, Latin American company law should regulate the *de facto* and the *shadow* directors.

The *de facto* directors are individuals who, with no formal designation, perform the functions of a legally designated director.⁶⁸ They present themselves to the company and

⁶⁶ See, for example, Ecuadorian Companies Act, article 231 (1)

⁶⁷ See, for example, Ecuadorian Companies Act, article 15

⁶⁸ Chris Noonan and Susan Watson, The nature of shadow directorship: ad hoc statutory intervention or core company law principle? *Journal of Business Law*, 2006, 5

third parties as if they were official directors and are treated as such in practice.⁶⁹ In contrast, *shadow* directors do not act as legally appointed directors. Instead, they influence legally appointed or *de facto* directors, controlling the company from behind the scenes.⁷⁰

Both types of directors share key similarities. For example, neither of them holds a formal appointment in the company. Also, their involvement reduces the independence of legally appointed directors. In addition, they are subject to the same fiduciary duties and legal liabilities as official directors, meaning they can face corporate liability claims, including derivative actions⁷¹, when they harm the best interest of the company.

However, it should be mentioned that *shadow* directors operate behind the scenes. In other words, they influence corporate decisions without publicly appearing as the directors of the company. While *de facto* directors operate at the same level as legally appointed directors, *shadow* directors act from a superior decision-making position. Therefore, *shadow* directors control the company's affairs without exposing themselves, at least in theory, to the consequences of the decisions executed by legally appointed directors. This difference is key to understand the main characteristics of each figure.

In this context, *de facto* and *shadow* directors have to be regulated to prevent third parties from using companies for their personal gains. This issue is particularly relevant in Latin American companies, where controlling shareholders, due to the control they hold, can easily influence legally appointed directors, from behind the scenes.⁷² That said, this framework should not be misapplied to impede legitimate third-party involvement, like financial, legal, or corporate advisors, acting within their professional scope. As a result, to hold *de facto* or *shadow* directors accountable, three conditions should be met: (i) Unjustified interference in corporate management; (ii) loss of decision-making autonomy by legally appointed directors and (iii) harm caused to the company, shareholders, or third parties.

The Ecuadorian Companies Act regulates these figures within the framework of the simplified corporations, though those rules apply to all corporate entities via article 272.8 of the Ecuadorian Companies Act. According to this provision: “*Any natural or legal person who, without being the company’s legal representative, engages in managerial, administrative, or executive activities within a simplified corporation, or who assumes the role of a director in dealings with third parties despite lacking official appointment, shall be subject to the same responsibilities and penalties applicable to legally designated representatives.*”

⁶⁹ For more reference about the *de facto* directors, see: *Hydrodam (Corby) Ltd*, Re [1994] 2 B.C.L.C. 180.

⁷⁰ According to Millet J, in the *Hydrodam*, “*a shadow director, by contrast, does not claim or purport to act as a director. On the contrary, he claims not to be a director. He lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself. He is not held out as a director by the company.*” Millet J, *Hydrodam (Corby) Ltd*, Re [1994] 2 B.C.L.C. 180 at 183.

⁷¹ See Ecuadorian Companies Act, article 272.8

⁷² Francisco Reyes Villamizar, *la Sociedad por Acciones Simplificada*, Temis, Bogotá, 2020, 180

Under this framework, shareholders who suffer damages due to unauthorized interference in the company's decision-making process can bring claims against those acting as *de facto* or *shadow* directors. In Ecuador, these individuals can be held accountable through classic corporate liability claims or derivative actions. Noteworthy, regardless of his number of shares, any shareholder may file a derivative claim on behalf of the company on cases involving *de facto* or *shadow* directors. This action can be brought against the responsible individual if the company's director fails to bring the claim within one month after receiving the shareholder's request.⁷³ As a result, a derivative claim may be filed against a controlling shareholder who secretly runs the operations of the company from behind the scenes, provided that these actions, taken by someone who does not hold an official position in the company, reduce the autonomy of the formally appointed directors.

Finally, it is essential to ensure that third parties, dealing in good faith with a company, are not affected by decisions taken by *de facto* or *shadow* directors. To protect legitimate transactions and good-faith third parties, the Ecuadorian Companies Act establishes that the company has the obligation to comply with any agreement that these individuals executed, unless it can be proven that the third party was aware that the operation was not negotiated by a legally appointed director.⁷⁴ Additionally, to prevent financial harm caused by unauthorized interference, companies should have the right to bring a claim against *de facto* or *shadow* directors, whenever the company was required to indemnify or cover expenses to anyone who was harmed by their unjustified interference. These claims would allow the company, either directly or through a derivative claim, to recover losses caused by individuals who acted without holding an official position in the company. These regulations, while protecting non-controlling shareholders, also provides legal certainty to good-faith third parties.

In conclusion, Latin American company law would benefit from regulating the *de facto* and the *shadow* directors' figures. Doing so would ensure that those who interfere with the decision-making process of the company, particularly controlling shareholders, are held accountable for their actions. At the same time, this approach, which mitigates the main agency problem that Latin American companies deal with, would also promote responsible and transparent corporate governance in the region.

3.3.Third *ex-post* measure: actions against abusive voting practices

The concept of abusive voting rights allows those affected (usually non-controlling shareholders) to hold accountable those shareholders who, intentionally, misuse their voting rights to harm third parties when they approve or deny corporate resolutions. Under that framework, shareholders will abuse their voting rights when they cast their votes to intentionally harm the company or non-controlling shareholders.

⁷³ See Ecuadorian Companies Act, article 272.8

⁷⁴ See Ecuadorian Companies Act, article 272.8

In general, the concept of abuse arises when a right is exercised with the intent of causing damage or for an illegitimate purpose.⁷⁵ In other words, abusive voting happens when a shareholder exceeds the reasonable limits of his voting rights and prioritizes his benefit at the expense of the best interest of the company. In Latin American companies, characterized by a high concentration of share capital, regulating abusive voting rights is particularly important, because non-controlling shareholders, due to the democratic principle applied within the general meetings, are especially vulnerable to expropriation and opportunistic behavior by corporate insiders.⁷⁶

Under that framework, following the French⁷⁷ rulings on the matter, countries such as Colombia⁷⁸ and Ecuador⁷⁹ have incorporated the concept of abusive voting into their company laws. In both jurisdictions, shareholders must exercise their vote in the best interest of the company. Therefore, voting rights may be considered abusive when they harm the company or unfairly benefit the casting shareholder at the expense of other interests. In other words, a vote will be abusive when issued: (i) with the intent of damaging the company or other shareholders; or (ii) to secure an unjustified advantage for the voting shareholder, or a third party related to him.

Abusive voting proceedings require two elements. The first one of them, the *objective element*, requires that the vote issued abusively must financially harm the company or the financial interests of other shareholders.⁸⁰ On the other hand, the *subjective element* dictates that the abusive vote has to be cast with the intention to harm others. That said, if a voting right harms the company, but the voting shareholder did not have the intent to harm, that vote should not be considered abusive.⁸¹ In other words, this last element differentiates abusive voting practices from other decisions or scenarios that may affect third parties but lack intent to harm, such as claims based on a breach of the duty of care.

According to the Ecuadorian Companies Act, abusive voting can take three forms. The first one of them is the *majority abuse*. According to this type of abusive voting, controlling shareholders can pass resolutions to obtain an unjustified benefit, at the expense of the company or other shareholders.⁸² For example, a controlling shareholder

⁷⁵ Alexis Constantín, *Droit des Societes*, Dalloz, Paris, 2010, 85. In: Reyes Villamizar, *La Sociedad por Acciones Simplificada...*, *Op. Cit.*, 135

⁷⁶ Holger Fleischer, *Comparative Corporate Governance in Closely Held Corporations*, 708, in Jeffrey N. Gordon, and Wolf-Georg Ringe (eds), *The Oxford Handbook of Corporate Law and Governance*, Oxford Handbooks (2018; online edn, Oxford Academic, 9 June 2015).

⁷⁷ Barthélémy Mercadal, *Societes commerciales*, *Mémento pratique*, Paris, Éditions Francis Lefebvre, 1995, 584. In: Francisco Reyes Villamizar, *Derecho Societario: La SAS*, Temis, Bogotá, 2024, 131.

⁷⁸ See Ley 1258-2008 (Colombia), article 43.

⁷⁹ See Ecuadorian Companies Act, articles 272.8 and unnumbered titled “abuse of voting rights”, applied to the Simplified Corporations.

⁸⁰ See Capital Airports Holding Company contra CAH Colombia S.A. (Sentencia 2012-801-029), Superintendence of Companies (Colombia)

⁸¹ Daniel Caycedo-Velosa, *La Prueba del Abuso del Derecho de Voto*, Universidad de los Andes, Semillero de Derecho Societario (blog entry): https://semillerosocietario.uniandes.edu.co/publications/blogs/46-la-prueba-del-abuso-del-derecho-de-voto#_ftn2

⁸² Fleischer, *Comparative Corporate Governance...*, *Op. Cit.*, 708

may approve a resolution to force non-controlling shareholders to reinvest their profits without justification, as long as they want to harm them by reducing their liquidity, or approve a capital increase with the sole purpose of diluting non-controlling shareholders, disregarding their pre-emptive rights to participate on the capital increase.

Minority shareholders can also abuse their voting rights when they intentionally block legitimate corporate decisions that require their approval.⁸³ In some cases, majority shareholders depend on minority votes, for example, when the by-laws of the company require unanimous consent for certain decisions. While *majority abuse* involves approving resolutions to harm the company or dissenting shareholders, *minority abuse* rejects decisions not because they are harmful, but as a deliberate attempt to obstruct the operation of the company.⁸⁴

To conclude, shareholders may also abuse their voting rights when they have equal number of shares in the company. This *deadlock abuse* arises when a shareholder, holding the same amount of shares in the company that other shareholders⁸⁵, decides to deny a legitimate corporate decision, without proper cause and with an intent to harm the company or other shareholders. Similar to *minority abuse*, this type of abuse restricts corporate decision-making, harming the interests of the company or other shareholders.

Under that framework, regulating the three types of abusive voting is essential to prevent majority, minority or equal shareholders from prioritizing their benefit at the expense of the interest of the company. As a result, the consequence of abusive voting should be the reversion of the resolution abusively approved or denied, and to hold the responsible shareholder liable for damages his abuse may have caused to third parties. In Ecuador, these types of abusive voting were first established in the regulation of the simplified corporations.⁸⁶ However, ulterior reforms later extended these regulations to all companies recognized by the Ecuadorian Companies Act.⁸⁷ As a result, both damage and annulment claims, due to abusive voting, can be brought in cases of majority, minority or deadlock abuse, as mentioned above.

Under Ecuadorian law, claims against those responsible, can be filed directly by an affected shareholder, in which case any awarded damages are paid directly to the claimant. Alternatively, the company itself, as a separate legal entity, can initiate legal action against abusive shareholders, either on its own initiative or at the request of non-controlling shareholders.⁸⁸ According to Ecuadorian legislation, any shareholder has the right to request the company's directors to file a claim against a controlling shareholder who has abused his voting rights.⁸⁹ If the directors do not initiate the action within one

⁸³ Fleischer, Comparative Corporate Governance..., *Op. Cit.*, 712

⁸⁴ *Ibid*

⁸⁵ Empirical evidence shows that these *deadlock* scenarios are common in companies with equal shareholders. Cfr. Reyes Villamizar, La Sociedad por Acciones Simplificada, *Op. Cit.*, 138.

⁸⁶ See Ecuadorian Companies Act, unnumbered article titled "abusive voting rights".

⁸⁷ See Ecuadorian Companies Act, article 272.8

⁸⁸ See Ecuadorian Companies Act, article 272.1

⁸⁹ See Ecuadorian Companies Act, article 272.8

month, the non-controlling shareholder who made the request gains the right to bring that claim derivatively, on behalf of the company, against the abusive shareholder. This approach provides several alternatives to protect both the company and minority shareholders and to prevent the misuse of voting power in Ecuadorian companies.

In conclusion, regulating abusive voting practices not only helps mitigate the main agency problem that Ecuadorian companies deal with, but also protects non-controlling shareholders and the company from unjustified resolutions, abusively approved or denied by controlling shareholders.

3.4. Fourth *ex-post* measure: fomenting corporate litigation

Shareholders have the right to appeal resolutions approved in the general meeting when those resolutions were taken illegally, abusively or with a conflict of interests.⁹⁰ The right to challenge corporate decisions is essential to promote an adequate corporate governance framework, because it allows non-controlling shareholders to review resolutions that affect the best interest of the company, or harm their own financial rights.⁹¹ Also, from a functional approach, fostering litigation promotes corporate accountability, because it discourages opportunistic behavior, adopted by controlling shareholders that could reduce the company's value.

Corporate litigation is based in the constitutional principle of effective judicial protection, commonly recognized across Latin America.⁹² As such, shareholders must be able to challenge illegal or abusive corporate resolutions, without facing unnecessary procedural burdens or restrictive time limits.

One of the most restrictive practices has been requiring a minimum ownership of shares to bring a claim. This was the case in Ecuador, where, before the 2023 reform, the Companies Act only allowed corporate litigation when shareholders held at least 25% of the company's legal capital.⁹³ In practice, these requirements left minority shareholders powerless, because they were not allowed to challenge notorious illegal or abusive decisions which, in turn, led to corporate opportunism by Ecuadorian controlling shareholders. Considering that Ecuador has eliminated these barriers, now any shareholder, regardless of his participation in the company's legal capital, is entitled to

⁹⁰ For example, see Ecuadorian Companies Act, article 207 (7)

⁹¹ Baker, Tom, and Sean J. Griffith, 'Shareholder Litigation', *Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation* (Chicago, IL, 2011; online edn, Chicago Scholarship Online, 21 Mar. 2013)

⁹² For example, see Ecuadorian Constitution, article 75

⁹³ See, Ecuadorian Companies Act (1964), articles 215 and 216. Noteworthy, the Ecuadorian Constitutional Court, through ruling 6-22-CN/23 (Judge Karla Andrade-Quevedo), declared unconstitutional Articles 215 and 216 of the previous Ecuadorian Companies Act, which required minority shareholders to hold at least 25% of a company's legal capital to challenge corporate resolutions. According to the Court, "*the application of these articles in the original process is unconstitutional, because it unreasonably restricts the right to effective judicial protection and access to justice.*" As a result, the Court ruled that all shareholders must be allowed to challenge general meeting resolutions, regardless of the percentage of share capital they own. Furthermore, the Court also emphasized that limiting this right prevents minority shareholders from obtaining judicial review of potentially illegitimate corporate decisions, which violates article 75 of the Ecuadorian Constitution. See: <https://buscador.corteconstitucional.gob.ec/buscador-externo/causa/ficha?contexto=CAUSA&uuid=&numero=6-22-CN>

sue. This reform sets an important precedent for corporate governance in the region because, from an *ex-ante* perspective, it democratizes corporate litigation and, from an *ex-post* perspective, protects the interests of non-controlling shareholders through judicial control.

Another restrictive practice that is common in Latin American company law is the short timeframe within a claim must be filed. In many Latin American countries, deadlines to bring a claim against an illegal or abusive corporate resolution are too short⁹⁴, making it difficult for non-controlling shareholders to gather sufficient evidence to support their claims. This was the case in Ecuador, where, before the 2023 reforms, the Companies Act required shareholders to file a claim within just 30 days of the general meeting where the challenged decision was approved.⁹⁵ This requirement left almost no time to access relevant documentation, analyze financial records and prepare a strong case. Recognizing those limitation, Ecuador extended that timeframe to one year, giving non-controlling shareholders enough time to gather evidence and prepare a well-documented strategy against corporate opportunism. Therefore, Latin American company law, based on the Ecuadorian reform, should consider extending these deadlines, ensuring that non-controlling shareholders have a fair chance to defend themselves against corporate opportunism.

As mentioned before, corporate litigation is essential to encourage good faith in the company's decision making. However, the regulation of corporate litigation should be balanced to prevent abuse from claimant shareholders. In this context, no legal framework should open the floodgates to excessive litigation, at the expense of the best interests and stability of the company.⁹⁶ In some cases, opportunistic or extortionist non-controlling shareholders may misuse corporate litigation, by filing frivolous or baseless claims, intended to obstruct the operations of the company instead of protecting their rights. Therefore, Latin American company law should establish a balanced framework that ensures that legitimate claims can proceed while discouraging bad faith litigation.

To begin with, courts should not be allowed to grant preliminary injunctions that disrupts the operations of the company, unless there is a justified and exceptional cause.⁹⁷ This means that, as a general rule, the company should continue its normal operations and the challenged resolution should remain in effect, until the court makes a decision. However, in exceptional cases, courts should have the authority to issue mandatory or prohibitory injunctions, but only under strict conditions established by law. These orders should be allowed only if they do not affect the best interest of the company, do not paralyze its

⁹⁴ For example, in Peru, article 142 of the General Companies Act establishes that "*the challenge referred to in Article 139 expires two months after the date of the resolution if the shareholder attended the meeting, three months if they did not attend, and in the case of resolutions requiring registration, within one month after registration.*" In Argentina, article 251 of the Commercial Companies Act states that "*the action shall be filed against the company before the judge of its registered domicile within three months after the assembly is closed.*"

⁹⁵ Article 215 of the previous Ecuadorian Companies Act (1964) stated that "*the action to challenge agreements or resolutions (...) must be filed within thirty days from the date of the agreement or resolution.*"

⁹⁶ Arad Reisberg, *Derivative Actions and Corporate Governance* (Oxford University Press 2007), 191

⁹⁷ See Ecuadorian Companies Act, article 215

normal operations and do not negatively harm the interests of third parties acting in good faith.

Furthermore, a claim should not proceed, or should be dismissed, if the company's general meeting replaces the challenged decision before the court issues a ruling.⁹⁸ This approach, introduced in Ecuador's 2023 reforms, helps prevent unnecessary litigation, and ensures that court resources are used efficiently. Also, corporate litigation should not be allowed for minor procedural mistakes that do not affect the outcome of the resolution, unless those formal defects affect the rights of non-controlling shareholders.⁹⁹ In this case, Ecuador implemented this reform to prevent legal claims based on technicalities that, in the end, would distract the company from conducting its business. Finally, shareholders who file baseless or bad faith claims should be held financially responsible. This means that those shareholders should assume the litigation costs¹⁰⁰ and, in case of reckless or malicious litigation, they should also face additional financial penalties.¹⁰¹ In conclusion, by implementing accessible and balanced mechanisms that foster corporate litigation, Latin American company law can protect minority shareholders while ensuring that the operations of the company are not paralyzed or affected, without a legitimate cause.

3.5. Fifth *ex-post* measure: regulating shareholder oppression claims

Oppression from controlling shareholders arises when they repeatedly take actions that affect non-controlling shareholders.¹⁰² Therefore, this action is not meant to challenge isolated acts or minor disputes between majority and minority shareholders. Instead, these actions allow non-controlling shareholders to challenge continuous strategies that weaken their position in the company.¹⁰³ In other words, shareholder oppression remedies (also called unfair prejudice remedies in other jurisdictions)¹⁰⁴, prevents majority shareholders from consolidating their control in the company, through unfair or abusive actions.

In this context, the claimant non-controlling shareholder should have to prove two elements when challenging an oppressive corporate resolution. To begin with, the claimant shareholder should prove the existence of a prejudice caused by the ongoing actions of controlling shareholders. Also, the claimant shareholder should demonstrate the unfair nature of those decisions. According to the Ecuadorian regulation, prejudice will arise when a non-controlling shareholder suffers financial losses, due to the actions of controlling shareholders.¹⁰⁵ On the other hand, unfairness will exist when a decision violates the rights of non-controlling shareholders.¹⁰⁶ Notably, this action will not prosper if one of both elements, unfairness or prejudice, is not verified or proven. Therefore, if a

⁹⁸ See Ecuadorian Companies Act, article 215

⁹⁹ See Ecuadorian Companies Act, article 215.1

¹⁰⁰ See Ecuadorian Companies Act, article 272.9

¹⁰¹ See Ecuadorian Companies Act, article 249

¹⁰² Brenda Hannigan, *Company Law*, 4th ed, OUP, 482

¹⁰³ See Ecuadorian Companies Act, article 249.2

¹⁰⁴ See English Companies Act, article 994

¹⁰⁵ Hannigan, *Company Law*..., *Op. Cit.*, 492.

¹⁰⁶ Hannigan, *Company Law*..., *Op. Cit.*, 492

decision is legally justified, it should not qualify as oppression, even if it harms non-controlling shareholders.¹⁰⁷ Also, if a decision technically violates a rule, but does not cause any real harm to non-controlling shareholders, it also should not be considered as oppression.¹⁰⁸

One of the most typical cases of shareholder oppression happens when controlling shareholders approve a capital increase, under unfair conditions. For instance, they may set high issuance prices to make it difficult for minority shareholders to allot new shares. If the controlling shareholders also withhold important financial information, such as the company's balance sheets or the reasons why the company needs new funding, they create a deliberate scheme to dilute the minority's share capital unfairly. In this scenario, minority shareholders may be allowed to bring an oppression case against the controlling shareholders. According to Ecuadorian legislation, another example occurs in simplified corporations (SAS), where controlling shareholders may push for an amendment to company's by-laws, to introduce multiple-voting shares, giving themselves disproportionate control over the decision-making of the company. If they also restrict access to key information, preventing minority shareholders from making an informed decision before voting, this will be a clear case of shareholder oppression. In both scenarios, controlling shareholders are not seeking immediate or short-term financial gains. Instead, they are trying to consolidate their control over the company through their oppressive conduct, against the interest of minority shareholders.

Latin American company law should allow minority shareholders to initiate legal proceedings whenever they are affected by oppressive practices.¹⁰⁹ When a claim is filed, the Ecuadorian Companies Act, depending on the situation, allows the court to issue three different rulings.¹¹⁰ According to the first one of them, a judge could revoke the oppressive decision if the claimant requests so when they file the claim. In addition, the court could order the controlling shareholders to stop their oppressive practices in the future. Finally, the court could require the company to buy-out the shares of the oppressed shareholders, at a fair price. Notably, that fair price should include any financial benefits the controlling shareholders obtained through their oppressive actions.¹¹¹ Furthermore, if the company is forced to buy the claimant's shares, the company should have the right to recover any costs or expenses from the oppressive controlling shareholders directly. For example, the company could file a claim to request that recovery through a judicial

¹⁰⁷ For example, if the by-laws of the company allow controlling shareholders to remove a director appointed by a minority shareholder, this action may be unfavorable to the non-controlling shareholder, but still be legally valid.

¹⁰⁸ This could happen if a minority shareholder voluntarily votes in favor of an illegal decision proposed by the controlling shareholder, and later tries to challenge it in court. In this case, the claim of the non-controlling shareholder would not succeed because, by voting in favor of the resolution, he endorsed the actions of the majority, even if those actions were harmful. However, a shareholder who voted in favor of a resolution can still challenge it in court if he can prove, under the annulment claim, that his consent was given under a mistake, fraud or undue pressure. See Ecuadorian Companies Act, article 216.7

¹⁰⁹ See Ecuadorian Companies Act, article 249.2

¹¹⁰ Hannigan, *Company Law...*, *Op. Cit.*, 512.

¹¹¹ Daniel Caycedo-Velosa, *Finanzas en la corte: un análisis comparado de los derechos de valoración en el derecho societario de América Latina*, *Revista Latinoamericana de Derecho Societario*, Número 3, 2024. <https://ijeditores.com/pop.php?option=publicacion&idpublicacion=1381&idedicion=21881>.

proceeding. Also, the company, when convenient, could withhold any dividends that otherwise would have been paid to the oppressor shareholders.¹¹² Also, to protect non-controlling shareholders, this remedy should allow affected shareholders to seek compensation, for any financial harm, directly from controlling shareholders.¹¹³

These legal protections, introduced in Ecuadorian company law, set an important precedent in Latin America. Other Latin American countries¹¹⁴ would benefit from adopting similar remedies into their corporate legislation, since most of Latin companies share the same pattern of capital ownership that characterize Ecuadorian firms.¹¹⁵

3.6. Sixth ex-post measure: regulating litigation costs and D&O insurance

Company law should ensure that directors and controlling shareholders comply with their duties without facing disproportionate risks. Running or governing a company involves making complex decisions, some of which may lead to corporate litigation, even if the business decision was taken in good faith.

Ecuador, through the recent corporate reforms, now regulates litigation costs and indemnity clauses, to allow companies to cover litigation costs or pay compensation liability incurred by directors or controlling shareholders. However, an Ecuadorian company will only be allowed to cover those expenses when the claim that originated them is based on a breach of the insiders' corporate duties and responsibilities.¹¹⁶ As a result, these protections will ensure that those directing or controlling a company can focus on their responsibilities, without dealing with the consequences of meritless claims filed against them. As a result, these regulations will encourage effective corporate leadership within Ecuadorian companies.

However, these protections should be carefully regulated, since they should not allow corporate insiders to use the company's funds for their benefit, in matters not related to their official duties. Therefore, according to the Ecuadorian legislation, these protections should only apply when there is a direct link between the legal claim and the defendant's official role in the company.¹¹⁷ As a result, these protections should not cover personal legal disputes unrelated to the company's operations, such as a shareholder or director's breach of contract in a personal business transaction.

Also, these protections should not apply to internal corporate disputes, such as claims filed by other shareholders or directors against the defendants these regulations seek to

¹¹² See Ecuadorian Companies Act, articles 249.2 and 272.10

¹¹³ See Ecuadorian Companies Act, articles 249.2

¹¹⁴ Noteworthy, the latest Colombian Corporate Reform Bill, qualified by the Colombian Congress last year, proposes to include the shareholder oppression remedy into Colombian company law. See: Congreso de la República de Colombia (Cámara de Representantes): Reforma Societaria (16/12/2024): <http://camara.gov.co/reforma-societaria>.

¹¹⁵ Paúl Noboa Velasco, Problemas de Agencia y su Mitigación en el Contexto Societario Ecuatoriano, Ibero-American Institute for Law and Finance, Working Paper Series 5/2020, 2020

¹¹⁶ See Ecuadorian Companies Act, article 272.12

¹¹⁷ See Ecuadorian Companies Act, article 272.11

protect.¹¹⁸ Allowing corporate insiders to cover their legal defense with company funds in such cases would affect the balance within a company, benefiting only a group of the company's members while forcing non-controlling shareholders to assume their own litigation costs.

Moreover, to prevent conflicts of interest, decisions regarding the coverage of litigation costs and indemnity clauses should be approved by the general meeting, or be explicitly established in the company's by-laws.¹¹⁹ Furthermore, any resolution approving these protections, or amending the company's by-laws to include a clause for this purpose, should only pass with the majority vote of disinterested shareholders. This means that shareholders with a direct interest in the proceeding (for example, any shareholder who was sued), or any shareholder who is directly connected to the directors involved in the case, should be prohibited from voting.

Furthermore, the company's financial stability may be put at risk if the corporate insiders decided to assume enormous litigation costs or unlimited indemnity clauses. Because of this reason, the approval of these protections should be based on a financial assessment prepared by the company, that certifies that it has enough funds to cover these costs, without compromising its liquidity.¹²⁰ Also, indemnity clauses or the coverage of litigation costs should only apply if the case is resolved in favor of the defendant director or controlling shareholder.¹²¹ In other words, the company should not have to cover their litigation costs if the decision of the court finds them responsible. Also, the company should be forbidden to include or approve an indemnity clause in these scenarios. Furthermore, these protections should not apply when the defendant directors or controlling shareholders engaged acted in bad faith or conducted their duties in a fraudulent or abusive manner.¹²²

In conclusion, these regulations should protect corporate insiders who act diligently and in good faith while complying with their duties. However, these protections should not allow opportunistic behavior or encourage abusive practices at the expense of the best interest of the company. By implementing these rules, and working on implementing additional regulation through new corporate legislation, Ecuador seeks to establish a balanced regulation because, on the one hand, tries to protect the management of the company from baseless corporate litigation while, on the other hand, prohibits these protections when corporate insiders conducted their duties abusively.

While covering litigation costs and setting out indemnity clauses can offer adequate protection to directors and controlling shareholders, these measures could compromise the company's financial stability in the long term. In response to that reality, Ecuadorian

¹¹⁸ See Ecuadorian Restructuring Bill, fourth amendment provision

¹¹⁹ *Ibid*

¹²⁰ *Ibid*

¹²¹ See Ecuadorian Companies Act, article 272.12

¹²² See Ecuadorian Companies Act, article 272.12

legislation also allows companies to purchase D&O insurance, which shifts the financial risk to an external insurance company¹²³, who will be required to pay compensation to affected third parties, when the insured directors or shareholders are held liable for damages.

However, the regulation of D&O insurance should be carefully established, in order to prevent its misuse from corporate insiders. Therefore, its purchase and renewal should be subject to certain conditions. To begin with, before obtaining or renewing a D&O insurance, the company should require a financial statement to confirm that this coverage will not affect its financial stability.¹²⁴ Also, the D&O insurance should only cover liability arising from claims filed by third parties who are not part of the company's structure. Therefore, internal disputes, such as conflicts between shareholders, should not be covered by a D&O insurance paid with the company's funds.¹²⁵ These regulations will ensure that D&O insurance complies with its purpose of protecting directors and shareholders' liability when they comply with their official roles in good faith, without shifting their personal liability to the company when internal corporate conflict arises.

3.7. Conclusion

Latin American company law, commonly characterized by share concentration, should establish a regulatory framework that protects corporate outsiders from the risks of opportunism by controlling shareholders. In this context, the recent Ecuadorian reforms, which will ensure greater transparency and accountability in corporate decision-making, are a reference for modernizing corporate governance across the region. Also, from a practical standpoint, implementing a combination of *ex-ante* and *ex-post* mechanisms would help mitigate the main agency problem that Latin American companies deal with during their existence. By adopting these measures, the region can move towards a more balanced corporate governance framework, which would, in the end, encourage investment and innovation in our companies.

¹²³ See Ecuadorian Companies Act, article 272.11

¹²⁴ See Ecuadorian Restructuring Bill, fifth amendment provision

¹²⁵ *Ibid*