




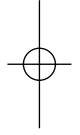
Capital Increase and Exclusion of the Subscription Right in the German Joint-Stock Company

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 Allotment of shares; Germany; Joint stock companies; Share capital; Shareholders

Introduction



The German law on the joint-stock company (*Aktiegesetz*; hereinafter, “AktG”) provides for a subscription right for current shareholders in the case of a capital increase. In certain special situations this power can be excluded. The exclusion of the subscription right requires the fulfilment of specific formal and procedural requirements and must be objectively justified. This article focuses on these requirements which must be fulfilled in order for the financial operation to be valid. The paper also concentrates on the substantial conditions that justify the sacrifice of the current shareholders. It is a topic of great practical relevance for all those who operate as consultants of shareholders involved in capital operations in Germany.

According to AktG, §186(1), each shareholder shall receive upon request, in the context of a capital increase, a number of new shares in proportion to the participation already held.¹ The principle expressed by this rule is that the shareholders have a subscription right on the financial instruments issued during the company’s life. In this way, the shareholders can keep the same level of power after the capital increase. The power finds its main expression in the voting right in the company’s general meeting.



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¹ On the subscription right, see Kallmayer, “Bezugsrecht und Bezugsrechtsausschluß” (1993) *Die Aktiengesellschaft* 249; Kübler, “Sind zwingende Bezugsrechte wirtschaftlich sinnvoll?” (1993) *Zeitschrift für Bankrecht und Bankwirtschaft* 1; Kübler/Mendelson/Mundheim, “Die Kosten des Bezugsrechts—Eine rechtsökonomische Analyse des amerikanischen Erfahrungsmaterials” (1990) *Die Aktiengesellschaft* 461; Schlitt/Seiler, “Aktuelle Rechtsfragen bei Bezugsrechtsemissionen” (2003) *Wertpapier-Mitteilungen* 2175; Wymeersch, “Das Bezugsrecht der alten Aktionäre in der Europäischen Gemeinschaft: eine rechtsvergleichende Untersuchung” (1998) *Die Aktiengesellschaft* 382.

If there were freedom to increase the capital and, at the same time, freedom to decide to whom to assign the new shares without considering the expectations of the current shareholders, these shareholders would be damaged. The damage would consist, first of all, in the reduction of the voting power. If a shareholder holds 10 per cent of the shares and the capital is doubled with exclusion of the subscription right, that shareholder would hold—after the capital increase—only 5 per cent of the capital and his or her importance in the general meeting has decreased. The damage can also be of an economic nature. This happens if the new shares are offered with favourable conditions only to certain subjects, i.e. in a discriminatory way. If the financial instruments of the company have a value of €100 each, but the shares issued in the context of the capital increase with exclusion of the subscription right are offered at the price of €50, the old shareholders are joined by new shareholders who have underpaid the entrance into the company. The buyers of the new shares become owners of the net worth of the company in proportion to the shares they have subscribed, even if they have paid for these shares a price inferior to their real value. This result is unfair.

A capital increase with exclusion of the subscription right changes the power relations in the company and could be used in order to increase the power of certain persons and, at the same time, to decrease the power of others.² The shareholders who are excluded from the subscription right can see their holdings falling under certain thresholds that grant specific rights, while other persons, on the other side, see their holdings increasing. Imagine the case of a company composed of three shareholders: A (75 per cent of the capital), B (20 per cent) and C (5 per cent). Without the law providing for the power of the current shareholders to buy the new shares in proportion to the old shares, certain persons would be advantaged, whereas other persons would be disadvantaged. Those advantaged might be some of the shareholders (to the disadvantage of the other shareholders) or even subjects who are outside the company (to the disadvantage of the old shareholders).

In the example above, A holds a percentage of the capital that is sufficient to resolve on the capital increase with exclusion of the subscription right (said percentage is 75 per cent). He or she could decide to double the capital by granting the new shares to himself or herself or to a favoured external investor. In both cases, B and C undergo a reduction of their holdings (B from 20 per cent to 10 per cent and C from 5 per cent to 2.5 per cent). The exclusion of the subscription right changes the power relations inside the company with damage for all or some of the old shareholders and with an advantage for only some of the old shareholders and/or for the new shareholders. Some shareholders can, as a consequence of the capital increase, fall under certain thresholds and lose specific qualified minority holdings. In the example made above, C falls under 5 per cent and in this way loses the capacity to exercise certain rights that the law only recognises to those holding said percentage. An example is the power to require the convocation of the general

² Bezzemberg, “Das Bezugsrecht der Aktionäre und sein Ausschluss” (2002) *Zeitschrift für Wirtschaftsrecht* 1917; Peifer, *Münchener Kommentar zum Aktiengesetz* (Kropff/Semler eds, 2th edn, München, 2005), Vol.6, §186, Rn. 58; Rodloff, “Zum Kontrollmaßstab des Bezugsrechtsausschlusses” (2003) *Zeitschrift für Wirtschaftsrecht* 1076.

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meeting and to add new topics to the discussion themes (AktG, §122(1)). These rights are granted by the law only to those shareholders holding at least 5 per cent of the capital.³ As a consequence of the exclusion of the subscription right, C loses the aforementioned right, because it falls under the threshold of 5 per cent. Other persons, meanwhile, could be able to hold a consistent number of shares and thus have even the possibility to define the political choices of the company.

The subscription right aims at protecting the value of the shares. Its exclusion can be the occasion for discriminating against certain shareholders. The new capital could be offered to only some of the current shareholders and/or to third persons on conditions that are particularly advantageous. If the price of the shares is low, the person subscribing them enters into the company after having paid an amount that does not reflect the real value of participation. Since the financial instruments express a quota of the net worth of the company, the person underpaying the new shares enriches himself of a part of the value that before was distributed on the other shares.

One simple example can help understand the matter in question.⁴ One can imagine a company composed of 10 shareholders, each of them holding one share (10 shares corresponding to a net worth of the company of €1,000). In this situation, each financial instrument incorporates a value of €100. If 10 new shares are issued in order to allow the entrance of 10 new shareholders against a capital contribution of €50 per share, the net worth of the company becomes €1,500 (€1,000 before the capital increase plus €500 coming from the new capital contribution). However, considering that there are now 20 shareholders holding altogether 20 shares, to each financial instrument corresponds an underlying net worth of €75, which is less than before the capital increase. The value of the shares held by the old shareholders has decreased after the capital operation from €100 to €75. The contrary has happened for the new shareholders who, having contributed only €50, now hold shares whose value, after the operation, is €75 per share. In fact, value has been transferred from the old to the new shareholders, without there being a substantial reason justifying this transfer.

Something similar happens when a contribution in kind is over-evaluated. In this situation, the number of shares granted in the context of the capital increase does not reflect in a correct way the value of the contributed asset. Equality of treatment among the shareholders is not guaranteed. The person entering into the company paying a lower price than the value of the participation is enriched without justification. The new shareholders obtain an advantage in comparison with the old ones that is not justified. As a consequence of this privilege, the subscribers of the capital increase will participate in the future distribution of

³ On the regulation of this minority's power in the German joint-stock company, see Tronti, "Corporate governance e convocazione dell'assemblea di società per azioni su richiesta della minoranza: il par. 122 Aktiengesetz" (2001) *Contratto e impresa* 325 (in Italian). With regard to the same power in the German limited liability company, see Sangiovanni, "Il diritto delle minoranze di convocare l'assemblea e d'inserire punti all'ordine del giorno nella GmbH tedesca" (2002) *Rivista del diritto commerciale* 813 (in Italian).

⁴ This example is taken from Bezzemberg, cited above fn.2, p.1918.

dividends and in the quota assigned at the time of the liquidation of the company in a way that is not proportionate to the investment made.

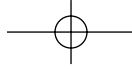
In order to avoid all risks illustrated, German law provides for a subscription right. However, it must be taken into account that there are situations in which the company does not take advantage from the fact that the new shares are subscribed by the old shareholders. There are circumstances in which the company's interest justifies an exclusion of the subscription right. In said situations, the shares are not offered indistinctly to all old shareholders, but specifically to certain persons. The law presumes that there is an "interest of the company" that is clearly separated from the "interests of the shareholders". This superior need is linked to the financing of the enterprise. In exchange for being granted the shares, the new shareholders pay a contribution. This contribution becomes part of the net worth of the company and is used by the directors for achieving the company's purpose.

The exclusion of the subscription right is an exception to the rule providing for the power of the old shareholders to buy new shares before external investors. Considering the negative effects illustrated above arising out of an exclusion of the subscription right, the exclusion cannot depend on the discretion of the management board (*Vorstand*). If the subscription right is excluded and the new shares are assigned to persons other than the old shareholders, the participation quotas to the capital of the old shareholders decrease. The result of the operation is similar to a partial exclusion from the company. It is therefore understandable that the legislature felt the need to put some limits on the possibility of excluding the subscription right. These limitations affect, on the one hand, the formal and procedural requirements and, on the other hand, the substantial reasons that make the exclusion legitimate.

According to German law, the subscription right can be excluded, totally or partially, in the resolution concerning the capital increase. In this case, the decision of the general meeting requires, in addition to the conditions set forth in the law and in the byelaws, a majority of at least three-quarters of the capital present in the meeting. The byelaws can impose a higher majority and can set forth other conditions (AktG, §186(3)). A resolution with which the subscription right is totally or partially excluded can only be adopted if the exclusion has been expressly made public. The management board shall submit to the general meeting a written report on the grounds of the total or partial exclusion of the subscription right. This report also has to give the reasons for the issue price that is proposed (AktG, §186(4)).

Formal and procedural requirements

The possibility of excluding the subscription right in the German joint-stock company depends on the fulfilment of certain formal and procedural requirements. These aim at protecting the current shareholders in the face of a financial operation that reduces their participation in the capital.



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The general meeting's resolution to exclude the subscription right shall be taken together with the resolution increasing the capital

First of all, German law provides that the subscription right can be excluded only by means of the general meeting's resolution concerning the capital increase (AktG, §186(3)). The resolution excluding the subscription right is taken by the company's general meeting. This is the only body authorised to adopt such a decision. Given that the exclusion of the subscription right involves a reduction in the participation in the capital and in the corresponding rights of the old shareholders, the German legislature deems it proper that the same shareholders resolve the question. Bodies or persons other than in the general meeting are not authorised to adopt a resolution excluding the subscription right. In particular, neither the management board nor the supervisory board (*Aufsichtsrat*) can take such a decision.⁵ The law provides that only the general meeting is competent to make the decision excluding the subscription right. The byelaws cannot derogate from this competence.

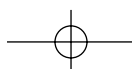
The law also defines the time for adopting the decision excluding the subscription right. This is only possible in the general meeting deciding on the capital increase. There is, therefore, a strong link between the resolution on the capital increase and the resolution on the exclusion of the subscription right.

Large majority

For the resolution that excludes the subscription right, the German law requires a particularly large majority (AktG, §186(3)). The positive vote of three-quarters of the capital present in the meeting is necessary to pass the decision. Since the resolution that excludes the subscription right can be disadvantageous for the current shareholders, the legislature demands that a large number of shareholders express their consent to the operation.

It is beyond doubt that three-quarters of the capital present in the meeting is a high threshold. However, it should be taken into account that only the shares of those shareholders participating in the meeting are counted. The effective participation in general meetings is variable according to several circumstances. An important factor is the number of shareholders making up the company. If there are few shareholders, perhaps members of the same family or friends, they all tend to participate in the meetings. These shareholders are often involved in the administration of the company. They do not want to miss the opportunity to express their vote. By participating in the meetings, the shareholders can contribute to the definition of the basic choices of the company. The situation is different if there is a high number of shareholders. In this situation, the majority of shareholders are small ones and they are generally not interested in

⁵ Hüffer, *Aktiengesetz* (6th edn, München, 2004), §186, *Rn.* 20; Wiedemann, *Großkommentar Aktiengesetz* (Hopt/Wiedemann eds, 4th edn, Berlin, 1995), §186, *Rn.* 108.



active participation.⁶ Normally they do not attend the general meetings. In such situations, it is easier for a single shareholder or a group of shareholders to achieve the percentage required by the law.

The byelaws can provide for a higher majority than the majority required by the law (AktG, §186(3)). It might be necessary, for example, to achieve the unanimity of the shareholders present in the general meeting. As an alternative, it could be required that at least three-quarters of the capital vote in favour of the exclusion of the subscription right, without regard to the percentage of shareholders taking part in the meeting. In this case if less than three-quarters of the capital appear in the meeting, the resolution cannot be adopted, even if all those present want to pass it. On the other hand, the byelaws cannot reduce the threshold required by the law.⁷ The high percentage is the expression of a compulsory rule protecting the minority shareholders. The legislature deems it necessary that a consistent number of voters approve the exclusion of the subscription right. In the light of the serious consequences of such a resolution for the current shareholders, a simple majority can never legitimate the operation.

Openness of the operation

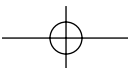
The intention to pass a resolution on the capital increase with exclusion of the subscription right must be expressly publicised (AktG, §186(4)). The reason for this obligation to publicise is the necessity to adequately inform the shareholders. As the exclusion of the subscription right heavily affects the shareholders' rights, it is important for them to decide, fully informed of the consequences of the resolution. Having gained the necessary information, the shareholders can consider the advantages and disadvantages of the financial operation.

The publication of the operation of capital increase with exclusion of the subscription right takes place in the company's bulletin (*Gesellschaftsblättern*).⁸ AktG, §124(1) provides that the agenda of the general meeting must be published in the company's bulletin. German law requires that the publication of the capital increase with exclusion of the subscription right be express. It is not necessary to mention the "exclusion of the subscription right" explicitly. However, it is important that the notice convening the shareholders' meeting makes it clearly understood that said operation is planned and describes its main features. It is not

⁶ On the differences between the small and the big investor, see Sangiovanni, "Documento d'offerta pubblica e responsabilità civile nel nuovo diritto tedesco" (2004) *Rivista di diritto civile* I 157 (in Italian).

⁷ Henn, *Handbuch des Aktienrechts* (7th edn, Heidelberg, 2002), p.667; Hüffer, cited above fn.5, §186, Rn. 21; Peifer, cited above fn.2, §186, Rn. 62; Sickinger/Kuthe, *Münchener Anwaltshandbuch Aktienrecht* (Schüppen/Schaub eds, München, 2005), p.983; Wiedemann, cited above fn.5, §186, Rn. 111.

⁸ According to AktG, §25, when the law or the byelaws require that publication takes place in the company's bulletin, publication must occur in the Federal Electronic Register (*elektronischer Bundesanzeiger*). The byelaws may identify as "company's bulletin" other means of information.



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sufficient to vaguely indicate that there will be a resolution on the exclusion of the subscription right, as in this way the shareholders are not appropriately informed of the content of the financial operation.

Written report of the management board

The last of the formal/procedural requirements for a legitimate exclusion of the subscription right is that the management board produce a written report (AktG, §186(4)). In this document the reasons for the operation have to be illustrated. Furthermore, the management board has to give the reasons for the proposed price for the new shares. The obligation to produce a written report is an absolute rule. A different regulation cannot be set forth in the byelaws, nor can the shareholders relieve the management board of the obligation to produce a written report.

The legislative provision demanding the production of the management board's report on the exclusion of the subscription right has several aims. The first objective is to adequately inform all shareholders in order for them to make an informed decision. The exclusion of the subscription right must be justified by an interest of the company that is prevalent over the interests of the single shareholders. The management board has to explain why it is necessary in the specific case to negatively affect the shareholders' rights in order to satisfy a superior exigency of the company. The provision of information to the shareholders makes the operation transparent. In this way, a relationship of confidence can be established between the management board, on the one hand, and the shareholders, on the other. The report can become the most important document for any judge who may be called to examine whether the resolution excluding the subscription right has been taken in accordance with the law. The shareholders who deem that their right to subscribe the new shares has been violated can impugn the resolution in front of the judicial authority. The aim of this initiative is a declaration that the resolution is invalid. In such a context, the management board's report is an important source of information for the judge. Crucially, by examining the document, the judicial authority can verify if the exclusion of the subscription right was really justified.

From a formal point of view, German law requires that the report of the management board be in writing. A written document allows the shareholders a deeper examination of the features of the planned financial operation. Once they have a copy of the report, they have all the necessary time to study the details of the transaction and to reflect on how to vote in the general meeting. In the meeting, the shareholders can ask for clarifications and more information. Thus the management board has the opportunity to better explain certain aspects of the operation. However, if the report is reticent or full of significant gaps, such faults cannot be remedied during the general meeting by simply giving oral information.⁹ If this remedial would be possible, the requirement would cease to make sense.

⁹ Hüffer, cited above fn.5, §186, *Rn.* 24; Peifer, cited above fn.2, §186, *Rn.* 68; Sickinger/Kuthe, cited above fn.7, p.984; Wiedemann, cited above fn.5, §186, *Rn.* 122.

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From the point of view of the content, the aim of the management board's report is to enable the shareholders to evaluate the advantages and disadvantages arising out of the capital increase with exclusion of the subscription right. The document must explain the substantial reasons that, in the opinion of the company's directors, justify the financial operation. It is not sufficient to use vague expressions, such as "the exclusion is in the interest of the company". On the contrary: it is necessary to indicate precisely what interest of the company is to be satisfied through an operation financed by persons other than the current shareholders. The written report also has to explain if there are alternatives to the planned operation. If there are other means that damage the shareholders less and, at the same time, allow the company to achieve the aim of the financial transaction, the operation proposed by the management board will not be lawful.

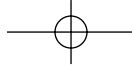
The report should indicate the negative consequences for the shareholders deriving from the exclusion of the subscription right. It is also necessary to explain why the new shares are assigned to certain persons. The management board has to give the reasons for the issue price, indicating how it has been calculated and the evaluation criteria that have been followed. This information is important in order to reduce the risk of patrimonial discriminations to the disadvantage of those who are excluded from the subscription right. The current shareholders are owners of company shares that have a certain market value. If the new financial instruments are offered to other people for a lower price, the old shareholders get colleagues who have paid little for new shares that grant the same rights as old shares. A German court recently held that mention in the report of a certain issue price with the reference only to "evaluations of the management board" is insufficient and lacking precise figures and other specific elements.¹⁰ If the price is not adequate, the resolution can be impugned.

The German law is quite terse on procedural aspects. It provides only that the management board's report has to be presented to the general meeting in written form. Nothing is said with regard to the moment at which the document has to be presented to the shareholders' meeting. Since the report has an informative function, it is important that the shareholders know it before the general meeting is held. Shareholders must have sufficient time to read the management board's report and to evaluate the features of the operation. AktG, §175(2) finds analogous application in this context. The management board's report shall be deposited in the company's offices immediately after the convocation of the general assembly, where the shareholders can view the document. Upon request, each shareholder has the right to receive a copy of the report free of charge.

The company's interest

AktG, §186(3) and (4), regulating the exclusion of the subscription right, contains procedural rules. The law does not specify whether the exclusion must be

¹⁰ *Landgericht Frankfurt am Main*, Decision of October 13, 2003, *Der Betrieb*, 2003, at 2541.



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justified by certain substantial reasons. It is, however, common opinion both in the jurisprudence and in the literature that such a decision needs an objective justification. The fact that the law requires the management board to produce a report on the capital increase with exclusion of the subscription right is proof that specific reasons must justify the operation.

The basic condition for excluding in a legitimate way the subscription right is that the operation is in the company's interest.¹¹ This happens when the effects of the transaction promote the achievement of the company's purpose.¹² In this context, there is a conflict between a superior interest of the company and the interests of single shareholders. Only the former may justify the exclusion of the subscription right. The needs of the company have to be clearly separated from the needs of the management and supervisory boards. The expectations of these boards or of their members cannot justify an exclusion of the subscription right.

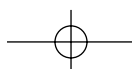
The exclusion of the subscription right must ensure that the aim of the operation is achieved. The exclusion must also be necessary in order to obtain the objective. This happens when the pursued aim cannot be achieved in another way or when the exclusion of the subscription right constitutes the best way to obtain the result. If there are reasonable alternatives, the operation is not lawful. The exclusion of the subscription right also involves a proportionality judgment. The management board has to compare with attention the interests that are involved in the operation. The exclusion of the subscription right is lawful when the advantages for the company are bigger than the disadvantages for the shareholders. The shareholders are certain to be damaged as a consequence of the financial operation. Their interest is to keep a certain percentage of the capital and voting right. The company's needs that justify the exclusion of the subscription right must be prevalent over the shareholders' expectations to keep their position undiminished.

The management board has the task of justifying the proposal to exclude the subscription right. Said body must show that the operation is in the company's interest; that the financial transaction is adequate and necessary in order to obtain the pursued objective; and that the disadvantages for the shareholders are less important than the advantages for the company. The management board has to make a prognosis on future events.¹³ For this reason, the objections that can be later moved against the board are limited. If there is an impugnation against the resolution increasing the capital, the judge will decide whether the resolution is lawful or not taking into consideration only the information that was available at

¹¹ On the company's interest as a condition for excluding the subscription right in Italy and in other jurisdictions, see Mucciarelli, "Interesse sociale ed esclusione del diritto d'opzione: spunti di riflessione sulla logica dell'argomentazione del giudice" (2002) *Giurisprudenza commerciale* I 455 (in Italian).

¹² Hüffer, cited above fn.5, §186, *Rn.* 26; Peifer, cited above fn.2, §186, *Rn.* 75; Sickinger/Kuthe, cited above fn.7, p.984.

¹³ Hüffer, §186, *Rn.* 36; Peifer, §186, *Rn.* 73. On prognosis in decisions of the management board, see Sangiovanni, "Die Ad-hoc-Publizität im deutschen und italienischen Recht" (2003) *Frankfurt am Main* 48, and also Sangiovanni, "L'informazione c.d. continua o permanente nel diritto tedesco del mercato dei capitali" (1998) *Banca, borsa e titoli di credito* I 609 (in Italian).



the time at which the report was written. Not having considered elements that were not known at the time of decision does not imply negligence on behalf of the management board.

Examples of situations in which the exclusion of the subscription right is justified

The typical situation in which the subscription right can be lawfully excluded is when the contribution is made in kind. In this case, the superior company's interest is the need to obtain the asset—an enterprise, for instance—that is exchanged for the new shares. It must be an object that cannot simply be bought on the market. More generally, it could be the necessity to co-operate with other enterprises that justifies the exclusion of the subscription right.¹⁴ In this case, the new shares are offered in exchange for the financial instruments of another company. In this way, cross-participations are created in order to reinforce the underlying industrial co-operation.

The issue of new shares for the workers or directors of the company can justify the exclusion of the subscription right (AktG, §192(2), no.3). The operation is in the company's interest because its aim is to link said persons to the company.¹⁵



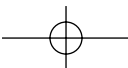
One of the most important reasons that justifies the exclusion of the subscription right is the company's recovery. The intervention of a new investor who subscribes to capital might be necessary in order to avoid insolvency. The operation aims at raising new funds that can be used to overcome the financial difficulty and to achieve the company's purpose. The person prepared to finance the company can subordinate his or her consent to the acquisition of a certain percentage of the capital.¹⁶ The investor taking the risks of recovery has in this way at least the guarantee that they can manage the operation autonomously. In the aforementioned decision, it was held that the exclusion of the subscription right was not really justified by the necessity to recover the enterprise.¹⁷ In that case, the new shares would have been fully underwritten by the main company's shareholder already holding 75 per cent of the capital. According to the decision of the judges, in such a situation an exclusion of the subscription right is not allowed. The old shareholder is already able to manage the company's crisis in an autonomous way, because they hold the majority of the capital. Contrast this with the case of a new investor entering into the company or of an old shareholder growing from a minority to a majority participation. In these latter situations, the exclusion of the subscription right needs to be justified by the exigency to independently manage the company's crisis. When the issue price is particularly high, the operation has to be normally considered as objectively justified. The new investors are obliged to pay a high price in order to become shareholders. This is an advantage for the old shareholders. They experience a reduction of their rights,

¹⁴ Hüffer, §186, *Rn.* 31; Peifer, §186, *Rn.* 97; Sickinger/Kuthe, p.985.

¹⁵ Hüffer, §186, *Rn.* 29; Peifer, §186, *Rn.* 92.

¹⁶ Hüffer, §186, *Rn.* 31; Peifer, §186, *Rn.* 95.

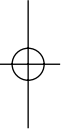
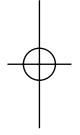
¹⁷ Cited above fn.10.



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but—at the same time—it is ensured that new assets enter into the company. This money can be used to re-launch the enterprise.

The need to list the shares on the stock exchange can justify an exclusion of the subscription right. The issue of financial instruments can be finalised to sell them on the market. Shares must be sufficiently diffused among the investors. It may be that such a diffusion is achieved only if the old shareholders renounce to their right to subscribe the new shares.¹⁸ The listing has to be in the company's interest. Furthermore, this interest must be prevalent over the shareholders' interests.



¹⁸ Hüffer, §186, *Rn.* 31; Peifer, §186, *Rn.* 96.