

# Why Germany needs shareholder reform

Extortive challenges to shareholders' resolutions might soon end, as Germany prepares a new stockholder law. Konstantin Günther and Barbara Roth explain why reform can't come soon enough

In late 2004, Germany's largest department-store operator, KarstadtQuelle, was ailing. The company's finances urgently needed restructuring. The company risked bankruptcy without an increase in capital by more than €500 million (\$655 million) combined with an additional credit line of €1.75 billion from 16 banks. The crisis spiralled out of control after a small group of just six shareholders representing only 0.24% of the entire stated capital took legal action to challenge the shareholders' resolution to increase the stated share capital of the corporation urgently required to rescue the company. KarstadtQuelle was forced into lengthy negotiations it could ill-afford before finally reaching a settlement with the minority shareholders to move forward with the desperately needed restructuring.

## Too much of a good thing

The KarstadtQuelle case once again highlighted shortfalls under German stock corporation law that mean just one minority shareholder can hold a company to ransom and even ruin a company, a unique situation in Europe. Under the laws in Germany, a shareholder with only one share is able to block the implementation of shareholders' resolutions and put major decisions at risk by delaying plans by months or even years through filing lawsuits challenging the validity of the resolutions.

Under German law, capital increases and decreases, profit-and-loss pooling or control agreements, mergers, changes of legal form, squeeze-outs of minority shareholders, and delistings all require an amendment to the articles of association of a corporation. To become effective, any change to the articles of association requires a registration in the corporation's commercial register. The competent registrars of the commercial registers usually refuse registration of shareholders' resolutions that are challenged by shareholder lawsuits, as long as a suit is pending. Some courts even wait the one-month period during which an action may be initiated after the shareholders' meeting in cases where an objection against a certain resolution has been recorded in the minutes of

the shareholders' meeting. If these shareholders' suits are fought through all instances until the Federal Court of Justice, it can be up to five years before a resolution becomes effective. This is simply not an option when new capital is urgently needed, or business opportunities have to be taken.

Even if a resolution is successfully registered before the suits have been terminated, the registration would not remedy any faults: if the court finds a challenged resolution invalid, the registration has to be cancelled and any measures have to be reversed. In the case of a capital increase, for instance, a successful challenge would mean that all shares issued in connection with the invalid capital increase are deemed non-existent and have to be redeemed. In practice, it would be impossible for a listed company to trace and redeem millions of publicly traded shares years after having issued such shares, and the effects on the company's share price would be disastrous.

The subject has also become increasingly relevant for foreign investors. Germany is experiencing increased takeover activity by both foreign strategic investors and private equity funds, which are entering the German market by acquiring undervalued listed German corporations with the objective of a subsequent squeeze-out of minorities, combined with a delisting. A prominent example was the public takeover of the listed cosmetics company Wella by The Procter & Gamble Company.

## Professional minority shareholders

Over the years a culture has developed in Germany where a number of professional minority shareholders, often with a portfolio of only one share in almost all German list-

ed corporations, are systematically attending AGMs of listed companies. The objective of this AGM tourism is to challenge shareholders' resolutions with the ultimate aim of negotiating comfortable compensation packages from companies in return for the termination of lawsuits or the withdrawal of objections.

These self-styled professional investors claim to be Robin Hoods of the investment world, protecting minority shareholder rights while making a good living out of systematically challenging resolutions of shareholders' meetings of German listed companies. However, the cases in which litigating shareholders have enforced a better appraisal and raised compensation payments for all minority shareholders, or have detected a fault in the meeting procedures, are rare compared to the total number of pending actions. In the past 15 years, the numbers of shareholders' suits has increased tenfold. Around half of the suits are initiated from the same club of professional minority investors, who bring about a hundred actions each year.

## Possibilities for blackmail

A shareholders' resolution can be challenged on various grounds. These range from non-compliance with mere formalities to substantive reasons. Substantive grounds are for instance any appraisal and evaluation issues in intercompany agreements, squeeze-outs or takeover agreements. Unfortunately, under German law

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only in a limited number of transactions has the legislator provided for an accelerated appraisal rights procedure (*Spruchstellenverfahren*) in which the validity of the resolution cannot be claimed and so its implementation cannot be blocked where only the monetary compensation is at stake focusing on evaluation principles. To free itself from these procedures, the corporation has to pay compensation to the litigating shareholders after implementing the resolution. In all other cases, the shareholders will challenge the resolution on which the compensation or exchange ratios are based if they deem the value too low. The corporation may only implement the resolution after the claimants have settled and withdrawn their action against payment of compensation to the litigating shareholders.

Attempts have been reported where foreign hedge funds start to learn the lessons from German so-called greenmailers in the context of a public takeover coupled with a subsequent squeeze-out and a delisting. Funds have begun claiming the protection of minority shareholders' rights to obtain a better exit for their stake.

Under German law a shareholder may also challenge the validity of a shareholder resolution on the grounds of lack of sufficient information required to exercise their voting rights. Any unjustified denial of an information request by a minority shareholder could lead to a risk of the shareholders' resolution being challenged. To provoke grounds for a shareholders' suit it is not uncommon for minority shareholders to bombard the executive board with hundreds of questions on details of finances, firm's proprietary information and other types of information to create a breach of information rights. To answer all questions from shareholders, companies are increasingly forced to maintain a large back-office staffed with numerous lawyers, auditors and experts from the various departments of the company to deal with the flood of questions, and to make sure that all formalities and information rights have been duly observed.

### Hush money and settlements

Many corporations have concluded that, in the present legal environment, the only chance to reach a settlement with litigating shareholders and plaintiffs is to pay hush money to any objecting shareholders. As direct payments would represent a hidden distribution, corporations often use majority shareholders to pay large amounts of money to the plaintiffs for settlements and revocation of claims.

Although courts are aware of the increasing amount of extortion, penal procedures against professional minority shareholders on the grounds of blackmail are rarely successful since the methods of such investors have become more and more sophisticated over the years. Pure cash payments to the litigating shareholders are rarely requested. Instead, the investors' lawyers often render (unnecessary) legal opinions for high fees, force the

company to agree on increased legal fees for the advice in settlement negotiations or expensive consultancy agreements with the minority shareholders.

### Legislation brings hope

The German government is reacting to the phenomenon of extortive shareholder suits. In a general effort to broaden investor rights and to create more transparency in the stock market, the government is expected to amend the existing Stock Corporation Act (*Aktiengesetz*, AktG) and other laws pertaining to stock corporations in the middle of 2005. A new so-called Act on Corporate Integrity and Investor Protection in Corporations and on Modernizations of Shareholder Suits (*Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechtes*, UMAG) is expected to partly remedy the problem of shareholder suits, as the situation is so difficult not only for German

companies, but also for global companies operating in Germany, or companies that have subsidiaries in Germany.

Shareholders' rights to challenge resolutions taken at the general meeting will be reformed. The Act provides for more clear-cut

regulations on the shareholders' right to question and speak. This will help to stop shareholders provoking formality faults and subsequently challenging resolutions on the basis of those formalities.

Additionally, the Act will introduce a clearance procedure similar to the existing procedures for transformations in Germany for cases in which the corporations have a special interest to quickly execute the resolutions of the shareholders' meetings, such as during a financial crisis. The executive board may initiate a clearance procedure with respect to resolutions relating to capital measures or enterprise agreements at the competent court of justice. The court will, in a reduced procedure, review the challenged resolution and weigh the interest of the corporation against the interests of the litigating minority shareholder. If clearance is granted, the resolutions will be immediately effective and can be executed. Even if the action is decided in favour of the plaintiff later on, the execution of the resolution will not be revoked but the plaintiff may receive compensation.

As the clearance procedure is an accelerated summary procedure, the court will have a restricted period of three months to decide upon the matter.

Furthermore, for cases in which pure evaluation questions are disputed, the matters will be treated only according to the decision procedure. A shareholders' suit would be completely excluded, as no double legal protection needs to be granted. This would limit the number of admissible claims.

The chairman of the meeting will have the right to limit the time for speech and the adequate time to ask questions to structure a meeting more efficiently, and to avoid questions that would provoke an error in form. Some of the questions will be put in writing before a meeting takes place and will be answered on the website of the company, which will free time to focus on strategic discussions as opposed to answering numerous questions. Frequently asked questions will also be answered on the website for the same reason. These reforms will make the execution of resolutions much more efficient.

The protection of investors and minority shareholders will be improved in two ways. Firstly, the shareholders' right to bring derivative actions against the corporation's board of management and supervisory board will be reinforced by lowering the minority quorum necessary to institute the action. Presently, the minority quorum requires shareholders representing at least 5% of the registered share capital to bring an action. This threshold is lowered to 1% of the registered share capital or shares to the market value of €100,000. However, to prevent unnecessary or extortive actions being filed, the trial court will conduct a preliminary examination of the admissibility of each action. Secondly, shareholders, by the same minority quorum, may initiate a special audit to examine the execution of corporate measures. To enhance the communication between shareholders and enable the shareholder to form a quorum, the corporation will provide a forum for minority shareholders who intend to file derivative and appeal claims against the corporation in the German electronic federal gazette.

The new Act will have interesting ramifications across the business community and will modernize the whole issue of shareholder suits. ■

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