

Challenging Shareholders' Resolutions in German and other European Privately-Held Corporations

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The global financial crisis has made it difficult to raise funds for the acquisition of a company. Acquiring a minority interest is an option to reduce the amount of funds required and may put an opportunity within reach that one would otherwise have to let go.

Acquiring a minority interest, however, makes the investor dependent on the majority shareholder. That is acceptable if the Investor has the opportunity to enter into an agreement with the majority shareholder, ensuring board representation and a veto for the Investor on certain important issues.

But what if no agreement can be made? Or if an agreement has been made that is being violated by the majority shareholder?

German law has a feature that would offer some protection even to a small minority investor in a German corporation. This is the right to have a wide range of shareholder decisions reviewed and, if need be, declared null and void by a court of law. This right is called, roughly translated, **Right of Avoidance**¹ and is the subject of this presentation. I thought it would be interesting for you, because as far as I know, neither Delaware law nor the law of the other States provide for a similar right. Some other European countries have similar rights, which we will also consider.

We will explore how the Right of Avoidance works, what effect it has on corporate governance and whether it should make a non-German minority investor (**Investor**) feel more at ease. The answer to the last question is yes, making it worth your while to get to know this Right of Avoidance, so you may remember it when the opportunity arises.

We will not go into other aspects of minority investments, such as disclosure requirements and take-over regulations. We will focus on the minority Investor who has no board representation and no veto right and is unhappy with the direction the company is taking.

A. About German Corporations

German **Corporations** basically come in two forms:

- **Stock Corporations**, in German *Aktiengesellschaften*, may list their shares on a stock exchange. Buying such shares is not much different from buying stock in a U.S. listed corporation. However, setting up a stock corporation requires proof that its registered capital has been paid in; the statutory minimum is Euro 50,000. The structure of a Ger-

¹ *Anfechtungsrecht* in German

man stock corporation is different from that of a U.S. corporation: It has two boards, a management board and a supervisory board. The supervisory board is elected by the shareholders, but cannot manage the corporation itself. It, in turn, appoints and supervises the management board, which manages the corporation with certain discretionary powers. As a result, the shareholders have no direct influence on the management of the corporation. They are not, however, relegated to passivity; there are a number of cases where well-advised Investors have been able to steer corporations in certain directions. One legal tool for such moves is the Right of Avoidance. In addition, minority shareholders have certain information and audit rights. They may even cause the corporation to claim damages from the management personally, comparable to shareholder derivative rights in the United States. The mere fact that shareholders have these rights may cause the management of a German corporation to listen to them.

- Most German corporations are limited liability companies, in German *Gesellschaften mit beschränkter Haftung* or *GmbH*. We will call them **Limited Liability Companies** or just **Company** for this presentation. Limited Liability Companies must have a minimum capital of Euro 25,000, with certain exceptions. Most Companies have a simple structure consisting of just one or more shareholders and one or more managing directors. Thus, as a rule, Limited Liability Companies do not have a board, which makes board representation irrelevant for Investors.

Stock Corporations may be publicly or privately held. Limited Liability Companies are normally privately held.

Most Investors intending to invest in a German Corporation tend to look at listed Stock Corporations, because it is relatively simple to gather information about them and to acquire shares. However, shares in listed Stock Corporations represent the low end of investment opportunities, because they are relatively expensive. Also, if the Investor acquires, or intends to acquire, 30% or more of the stock in a listed Stock Corporation, it may have to submit a take-over offer for the remaining stock. Most importantly for our topic today, Stock Corporations have a rather complex structure, as we have just seen, and the shareholders' meeting does not have much of a say, so the management of a Stock Corporation is fairly independent.² Therefore, it matters less whether the Investor can invalidate shareholders' resolutions.

The discerning Investor, also known as a *truffle pig*, will therefore look at Limited Liability Companies. Here is most of the opportunity, if one is willing to get in early. In Limited Liability Companies, the shareholders can tell the management what to do, so the shareholders' meeting is an important decision-making body. Thus, it matters a lot whether the Investor can invalidate shareholders' resolutions.

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This statement is contrary to public perception, which is fed by stories of shareholders in listed Stock Corporations holding one share or two and using their Invalidation Right to block decisions on relatively unimportant issues to blackmail the Corporation. For years, legislative attempts have been discussed (and some made) to curb this practice, but no lasting solution has been found yet. We will not go into this here, because I do not believe that any of you would be advising a client on how to blackmail a foreign company.

B. The Right of Avoidance

The Right of Avoidance works with any Corporation, Stock Corporation or Limited Liability Company, whether publicly or privately held.

The idea of creating the Right of Avoidance came up in the nineteenth century, when corporate and commercial law was codified, along with other areas of law, in the course of the German unification. Originally, the legal scholars preparing the ground for the Commercial Code had thought that rules of contract law were sufficient for dealing with the issue of questionable shareholders' resolutions. In contract law, a distinction is made between declarations that are void and thus have no legal effect whatsoever and those that are voidable, i.e. that have a legal effect unless they are avoided. A contract offer made by a person of unsound mind would fall into the former category and would thus be regarded as void *ab initio*. Declarations made under duress or in error would fall into the latter; these could be avoided if the individual concerned chose to do so and observed certain formalities.

A similar distinction was and still is made in corporate law: Shareholders' resolutions may be void or voidable. Shareholders' resolutions are void if they have been passed in a fashion that disregards basic tenets of the legal process. For instance, a resolution would be void if passed by a meeting that has not been properly convoked. Such a meeting may be regarded as a non-meeting; because it has not been properly convoked, resolutions passed by it cannot have any legal effect. These non-resolutions are not very interesting for our purposes. An Investor who does not like the direction the Corporation is taking would not be well advised to wait until the shareholders start producing resolutions that are void *ab initio*.

Voidable resolutions are interesting. As indicated, in contract law a declaration would be voidable if made under duress or in error. In such a case, the person having made the declaration is entitled to decide whether she wants the declaration to stand and have legal effect. If she does not want to let it stand, she will have to avoid it by making another declaration to that effect, observing certain formalities. As early as the nineteenth century, it became apparent that corporate law had to be more formal than contract law: A shareholders' resolution could be avoided only if the dissenting shareholder objected to – or at least did not agree with – the passing of the resolution in the shareholders' meeting. In addition, a simple declaration was not going to be sufficient to avoid a shareholders' resolution. Rather, the shareholder would have to apply within a period of one month to the court for a declaration that the resolution was in fact void. Resolutions that were passed without an objection or that were not challenged in court before the one-month period was up were regarded as valid. Even if an objection against a resolution was recorded in the minutes and the resolution was challenged in court, it would be regarded as valid until the court declared that it was not.

These principles have survived until this day.

C. The Voidable Resolution

Shareholders' resolutions are voidable if they (i) violate a provision of the law³ or of the Charter of the Corporation,⁴ except for provisions which provide mere recommendations⁵ or procedural rules and guidelines⁶ and (ii) are, of course, not already void *ab initio*.

What are typical situations in which voidable resolutions are produced?

1. The Unfair Supply Contract

The Investor in a Limited Liability Company receives an invitation to a shareholders' meeting. One agenda item is the vote on a resolution approving a supply contract (**Supply Contract**) between the Company (in which the Investor holds a few shares) and another legal entity controlled by the majority shareholder (**Supplier**). The Charter provides that any contract between the Company and a shareholder, a relative of a shareholder or a legal entity controlled by a shareholder requires the approval of the shareholders' meeting.

The Investor, upon receipt of the invitation, contacts the management, reviews the Supply Contract and finds that the terms of supply are highly unfavorable to the Company and not at all arm's-length. The Investor attends the shareholders' meeting and, when the vote on the approval of the contract is called, votes against the approval. Nevertheless, the motion is carried, because the majority shareholder votes in favor of the approval. The Investor objects to the resolution and has the objection registered in the minutes of the meeting. Then, within a period of one month, the Investor files a complaint with the court, asking for a declaration that the resolution is void. The majority shareholder defends itself arguing that the vote, if it had to be repeated, would be the same, because it, the majority shareholder, would again vote in favor of the approval of the contract. Will the complaint be successful?

The answer is yes. By voting in favor of the Supply Contract, the majority shareholder violated a fiduciary duty towards the other shareholders, including the Investor. Therefore, the court will declare the resolution void.

2. Failure to Provide Information

Let's change the story a bit: Again, the Investor in a Limited Liability Company receives an invitation to a shareholders' meeting, which is asked to approve the Supply Contract. When the Investor contacts the management to obtain a copy of the Supply Contract, it

³ **Law**, as used in this context, means any statutory provision, not just the provisions of the German Act regarding Companies with Limited Liability (**LLC Act**), *Karsten Schmidt in Scholz, GmbHG*, 10. Aufl. 2007, § 45 GmbHG, Rdnr. 93. All articles in *Scholz, GmbHG*, l.c., include citations to relevant case law.

⁴ The term **Charter** is used here to denote the articles of association, in German *Gesellschaftsvertrag* or *Satzung*, i.e. the constituent document of a Corporation.

⁵ in German: *Sollbestimmungen*, i.e. provisions that state that they are not intended to be strictly enforced.

⁶ in German: *Ordnungsvorschriften*, e.g. provisions dealing with the form of the minutes

receives no response. The Investor again attends the shareholders' meeting and, when the vote on approving the contract is called, votes against the approval. As before, the motion is carried and the Investor objects and files a complaint with the court. In the court proceedings, the management produces a copy of the contract. It turns out that the terms of supply are at arm's-length. Again, the majority shareholder argues that the vote, if it had to be repeated, would be the same, because it, the majority shareholder, would again vote in favor of the approval of the contract. Will the complaint be successful?

The answer is again yes. The reason is that the Investor was entitled to see the Supply Contract when it asked for it. Shareholders in Limited Liability Companies have far-reaching statutory⁷ information rights. Therefore, the Investor should have been given a copy of the Supply Contract, or at the very least, been given the opportunity to see the Supply Contract.

The failure to honor the Investor's statutory information right is deemed to have tainted⁸ the shareholders' resolution even though it may have turned out the same if the information right had been honored. In other words: Even if there is only a formal issue with the resolution, the Investor would prevail in court even if it cannot show that the vote would have been different in the absence of the formal issue.

However, *respice finem*: While the majority shareholder could not enforce the consent of the shareholders' meeting to a Supply Agreement that is not at arm's length, it could remedy the violation of the Investor's statutory information rights by repeating the vote after the Investor's statutory information rights have been satisfied. In a Stock Corporation, it may not be so easy to repeat a vote because holding a meeting of a large number of shareholders is costly and time-consuming. In a Limited Liability Company, it is easier and cheaper to convoke another shareholders' meeting or to bring about a shareholders' resolution in a written process.

3. The Unfaithful Manager

The Investor in a Limited Liability Company learns that the managing director has caused the company to suffer a few million dollars in losses by disregarding some very basic tenets of the trade. The Investor would like the Company to request indemnification from the director. The majority shareholder, who proposed and voted for the appointment of the director, would prefer to leave the matter alone.

The managing director of a Limited Liability Company is a powerful individual. She reports directly to the shareholders' meeting and there is – normally – no board in between. The procedure for holding a managing director liable for mistakes is to appoint, by resolution of the shareholders, a special attorney who is charged with asserting such claims on behalf of the company.⁹ If the managing director is a shareholder, she would have no vote in such resolution, but the majority shareholder who proposed and voted for the appointment of the director would have such a vote.

⁷ § 51 a *et seq.* of the LLC Act

⁸ in German: *Relevanztheorie*

⁹ § 46 no. 8 of the LLC Act

The Investor's motion is denied because the majority shareholder votes against it. The Investor objects to the resolution and files a complaint with the court, asking for a declaration that the resolution is void. The majority shareholder defends itself but fails to justify the mistakes made by the managing director and thus its objection to the motion. It appears that the majority shareholder merely wants to protect the managing director for reasons running counter to the Company's best interest. Based on that, the court finds that the majority shareholder violated its fiduciary duty against the other shareholders by voting against the motion.

Now, would it help the Investor if the resolution denying the motion were set aside? No, because the Investor needs a resolution positively carrying the motion; anything less would be short of the mark. Under German law, the Investor could therefore ask for a declaration that the motion be deemed carried if it can show that any decision of the shareholders other than carrying the motion would amount to a breach of fiduciary duties.¹⁰

4. The Shareholders' Agreement

The Investor has entered into an agreement with the majority shareholder pursuant to which the Investor's consent is needed to appoint the managing director of the Company. The majority shareholder then pushes through a resolution appointing a managing director against the Investor's vote.

In such a case, it would be pointless for the Investor to try to invalidate the resolution, because the Right of Avoidance only works with shareholders' resolutions that violate a provision of the law or of the Charter. An exception might apply if the shareholders' agreement has been elevated to an amendment to the Charter, which would require that it has been signed by all shareholders and makes explicit reference to the Charter.¹¹

However, the Investor could achieve a similar result by suing the majority shareholder for breach of the shareholders' agreement. This might result in a declaration that the majority shareholder needs to participate in a new vote dismissing the managing director at issue and appointing a new one with the Investor's consent.

D. The Fiduciary Duty

Rather than going on with more examples of situations in which shareholder assemblies produce voidable resolutions, I propose using the limited time we have to discuss fiduciary duties in German corporate law. Such fiduciary duties are implied in the relationships both among the shareholders and between each shareholder and the Corporation.¹²

¹⁰ in German: *positive Beschlussfeststellungsklage*, Karsten Schmidt in Scholz, GmbHG, I.c., Rdnr. 180 ff.. All articles in Scholz, GmbHG, I.c., include citations to relevant case law.

¹¹ In addition, such a shareholder agreement should also be notarized.

¹² H. Winter/Seibt in Scholz, GmbHG, I.c., § 14 GmbHG, Rdnr. 52

The effect of the existence of fiduciary duties is best illustrated in a few practical examples:¹³

- The majority shareholder may propose the approval of annual financial statements that have been cooked to disguise the fact that the company had lost money on a deal that favored a business partner affiliated with the majority shareholder. If the resolution were taken as proposed, the Investor should be able to go to court and have it invalidated alleging a breach of the majority shareholder's fiduciary duties.
- Likewise, the Investor would probably be able to challenge successfully a resolution pushed through by the majority shareholder appointing a statutory auditor, if such auditor has in the past failed to notice attempts by the management to cook the books to suit the majority shareholder. In addition, the Investor should be able to have the Company's books checked by its own auditor.¹⁴
- Another area where fiduciary duties play a role is the distribution of profits: Pushing for dividends when the Company actually needs the liquidity may well violate fiduciary duties.
- Even mere factual behavior of the majority shareholder may violate fiduciary duties, for instance if the management violates its duties because the majority shareholder has requested it, perhaps intimating that the management might be replaced if it does not follow the majority shareholder's instructions. This might happen, for instance, if the management neglects to assert claims for payment against the majority shareholder or commences litigation on behalf of the company against a third party which the majority shareholder wants to hurt. In such cases, the Investor could move for a resolution of the shareholders instructing the management to do the right thing, i.e. assert the claims or stop the litigation, and then invalidate the resulting resolution if its motion is not carried. Alternatively, the Investor could move for a resolution appointing a special attorney for the company to assert claims against the management.¹⁵

As a rule, the majority shareholder may not use its votes to push a resolution through that benefits itself or its affiliates if and to the extent that the resolution is not justified by the interests of the Corporation.¹⁶

On the other hand, fiduciary duties work both ways: The minority shareholder may not use its position either to push a resolution that benefits the minority shareholder or its affiliates if the resolution is not in the interest of the Corporation as determined by an objective third party. This could happen, for instance, if the majority shareholder is seeking a resolution, such as a capital increase, which could only be validly taken only with the minority shareholder's consent.

¹³ H. Winter/Seibt in Scholz, GmbHG, l.c., § 14 GmbHG, Rdnr. 56

¹⁴ This might also be achieved if the Charter provides that minority shareholders have the right to ask for a special audit, in German *Sonderprüfung*, of certain events. The LLC Act does not provide for such right, so if it is not in the Charter, it does not exist. In contrast, the Act regarding Stock Corporations (*Aktiengesetz*, short *AktG*) does in §§ 142 *et seq.* provides for such a right, which may be exercised by shareholders holding shares equivalent to one percent of the registered capital of the Stock Corporation concerned or having a par value of Euro 100,000.

¹⁵ See above at footnote 9.

¹⁶ BGHZ 65,15,20; 89,162

In such a case, the minority shareholder might be tempted to condition its consent on obtaining an unrelated benefit, such as a dividend. In such a case, the majority shareholder should be able to use the Right of Avoidance to obtain a resolution to increase the capital as planned.

E. The Law in Other European Countries

Some other European Countries have similar rules:

- Swiss law expressly provides for an Right of Avoidance which is based more or less on the same premises as the Right of Avoidance under German law. It applies if the rights of shareholders are being curtailed by a resolution which violates a provision of the law or of the Charter, limits shareholder rights in an improper¹⁷ fashion, discriminates against certain shareholders in a fashion not justified by the object of the Corporation or runs counter to the purposes of the Corporation. However, in Swiss practice, making use of this Right of Avoidance appears to be considered difficult and costly.¹⁸
- French law also provides for an Right of Avoidance which is based more or less on the same premises as the Right of Avoidance under German law. It has developed the notions of *abuse of majority rights*¹⁹ and of *abuse of corporate assets*²⁰, which permit the minority shareholder to have the offending shareholder resolutions set aside and to claim damages from the majority shareholder.²¹
- English law has a different system: Any shareholder – regardless of the size of its holding – could seek to object to a resolution. Where a resolution is alleged to have failed for a technical reason, e.g. the correct period of notice was not given, the resolution will not be effective. However, as regards substantive issues, a shareholder would not owe any other shareholder a fiduciary duty when voting. A minority holder could bring an action for unfair prejudice from the majority, but the result would not be a declaration of invalidity of the resolution. Rather, the court would order other remedies, e.g. that the majority shareholder acquire the shares of the minority at a determined price. As a result, when investing in an English company, an Investor would be well advised to enter into an agreement with the majority shareholder, ensuring board representation and a veto for the Investor on certain important issues.²²

¹⁷ in German: *unsachlich*

¹⁸ Art. 706 of the Law of Obligations (*Obligationenrecht, OR*) for stock corporations, which according to Art. 808 c of the OR for companies with limited liability. The author is grateful to Dimitri Papadopoulos of Müllhaupt & Partner, Zurich, for this information.

¹⁹ in French: *abus de majorité*

²⁰ in French: *abus de biens sociaux*

²¹ Art. L 235-1 et seq. of the French Commercial Code (*code de commerce*). The author is grateful to Ulrich Zschunke of Zschunke Avocats, Paris, for this information.

²² The United Kingdom still has a system of voting where resolutions are originally put to shareholders on a show of hands (each shareholder present has one vote regardless of the size of his shareholding). The vote then only goes to a poll vote (where each share carries one vote) if a poll is demanded. Historically it was unclear what a chairman should do if a vote is carried on a show of hands but the chairman knows it would fail on a poll. It is now common practice, at least for listed

- Dutch law would give the minority Investor a right to have a special audit performed, but does not appear to deal with invalidation issues.²³

companies, that all votes are conducted by way of poll. However, the issue could remain relevant for unlisted companies with significant numbers of shareholders. The author is grateful to Andrew Watkins, trowers & hamlins, London, for this information.

²³ Art. 344 et seq. and in particular Art. 346 of the Dutch Civil Code (Burgerlijk Wetboek). The author is grateful to Albert Dreese, Houthoff Advokaten, Rotterdam, for this information.

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