German Corporate Law in Constitutional Perspective: The Squeeze-Out Reviewed

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[1] It might be just another facet of the recent euphoria over shareholder-value, which dominated global capital markets and the corporate world, that we are now hearing cries for adequate regulation of so-called *squeeze-outs* of minority shareholders. Yet, it is far from evident whether such an explicit regulation would actually provide effective protection of small, *i.e.* minority groups of shareholders. A squeeze-out is often desired by the majority shareholder in order to gain full control of the firm. The courts, in trying to balance the conflicting interests of majority and minority shareholders in a squeeze-out procedure, have so far resorted to analogies or wide interpretations of the existing law governing mergers. Presently the debate is focused on establishing stable and clear standards for the proper procedure for forcing the minority shareholders out of the corporation, including guarantees that they are paid adequate share prices in cash. The existing corporate law does not explicitly allow for the majority to force or squeeze-out the minority, even when it is willing to pay the minority an adequate share price. The governing law only enables the minority to buy themselves into the majority, when their company share is bought by the majority company. This prospective is least desired by the majority, especially when the majority is closely organized and united.

[2] Three of the issues that arise when trying to craft a regulatory regime applicable in squeeze-out procedures include: (1) determining the size of a minority share-holder group deserving legal intervention/protection; (2) how to measure the adequacy of the price offered for the minority's shares; and (3) how to set up a suitable procedure for a squeeze-out.

[3] Regarding the first of these issues (the size of a minority deserving legal protection), the defenders of squeeze-out procedures suggest that the majority's interest in the minority's exclusion should be the controlling priority, regardless of the size of the minority. This proposal, however, merely purports to justify the squeeze-out by its desired end: the majority's interest in excluding the minority cannot be the singular standard controlling the process as it is that interest that raises the questions about legal protection for minorities. The same is true in reverse: the mere existence of a small or a large minority does not tell us whether the minority is in need of protection against the moves of the majority. Existing laws regarding specific minority shareholders' rights provide protection for a minimum percentage of shares of (10% for example) while other laws recognize the rights of a single share.

[4] As to the second issue, it would be surprising in a capital market, which is propelled by the competing views of how much a company is actually worth, if it were possible to fix the price of the minority's shares in a squeeze-out at the "shares' value" without consideration of the firm's value. The known difficulties in establishing a company's (and thus, a share's) value only resurface when attempting to pay the shareholders the *equivalent worth* of their shares. The Federal Constitutional Court, in a decision of April 27, 1999, considered adequate a price related to the firm's valuation. An alternative might be to give the squeezed-out minority an average of the price the majority has been paying for the company's shares during the 12 months preceding the squeeze-out.

[5] The last of these issues concerns the procedure that should be employed when a squeeze-out takes place. It has been proposed that squeeze-out procedures follow the strict rules governing the merger of two firms. This proposal has been criticized because the merger rules are quite rigid. Indeed, a merger must be accompanied by a full evaluation of the merged or acquired firm. The typical squeeze-out procedure, however, does not involve an exchange of shares (as is the case in a merger) but rather is carried out solely exclude the minority from continuing to hold shares in the firm.

[6] A recent decision of the Federal Constitutional Court (FCC) is likely to have significant impact on the future practice of squeeze-outs. The FCC had to decide on constitutional complaints brought by a former minority share holder in the close corporation "Moto-Meter." Moto-Meter had been owned to 99% by a Limited Liability Company (LLC) that made the 1% minority shareholders an offer to pay them an amount slightly above that which analysts (who had been contracted by the LLC) had previously established. The LLC attempted to buy the minority's shares and then to dissolve Moto-Meter. The former minority shareholder's attempt to declare the action void failed before the civil courts, which found this form of squeeze-out to be in conformity with existing law governing mergers. (Sect. 320 *et seq.* Stock Corporation Act – Aktiengesetz).

[7] The FCC's rejection of the complaints is interesting because, in its decision, the Court addressed what it called "constitutional worrisome issues" connected with the procedure employed in Moto-Meter. The Court found that no decision was required in the Moto-Meter case because the constitutional issues had been decided in its April, 1999, decision. Nevertheless, the Court found that the squeeze-out procedure used in the Moto-Meter case touched upon

both the shareholders' status as members of the shareholding body as well as the material value embodied in their shares. Both aspects, according to the Court, are connected with the constitutional provisions concerning private property. (Art. 14 German Basic Law).

[8] Article 14, the Court said, does not protect against the loss of membership that results from the exclusion from the corporation. The Court outlined the law governing the minority shareholder's rights within the corporation and contrasts these rights with the majority's interest in the smooth governance of the firm. The Court noted that there are a number of legal provisions that allow a single shareholder to effectively delay (if not obstruct) majority decisions. The FCC concluded that the majority's discretion is constitutionally valid under Art. 14 Basic Law as long as certain protections of the minority's interests are guaranteed. The Court located the minority interests requiring protection in the fairness of the share price and not in the governing status of share ownership. The degree of protection necessary for the membership interests of a minority, according to the court, is even less important when the number of shares is small. Therefore, the Court did not derive its conclusion that the shareholder's Art. 14 property rights do not provide him or her with a right to some fixed value for the shares bought in a squeeze-out from the shareholder's membership status with its attending rights to participate in the governance of the firm. The FCC went on to say that, as seen from the capital market perspective of owning shares, the exclusion of minority shareholders does not raise constitutional difficulties as long as they are adequately compensated.

[9] The FCC, however, expressed doubts as to whether the existing forms of adequate compensation as applied in practiced squeeze-outs are in conformity with the constitutional protection of private property. Seen in the light of the eminent importance attributed to the material value embodied in the shares owned, the Court rejects a simple valuation of the shares carried out by an analyst, generally contracted by the firm desiring to buy the minority shares. The FCC instead demanded that this valuation be carried out by the courts. The FCC concluded that this judicial control of the share's valuation is in conformity with the existing law on close corporations. The FCC went on to outline the procedure for obtaining such a judicial valuation. In this case for example, the squeeze-out procedure ought to be halted by a claim of recision brought by a single or a group of minority share holders. This is necessary, the FCC explained, to provide for effective protection of the minority's rights.

[10] The decision is quite intricate in its concrete application: the FCC, after having engaged in a thorough discussion of the constitutional requirements with regard to a squeeze-out procedure, found that the civil courts in the Moto-Meter case did not fully observe these requirements. Yet, the Court found no need to grant judgment for the complaints because: (1) the lower court decisions did not lead to any actual (the material loss incurred was a negligible DM 300); and (2) the complaint does not raise new constitutional issues not yet resolved by the FCC.

[11] In so ruling, the Court provided a straight-forward example for the application of the priority that should be given to the material value at risk in a squeeze-out as compared to the lesser interest in membership. The value protected under Art. 14 is material. In only incurring a minor material loss, the Moto-Meter minority share holder could not, the Court concluded, claim the loss of membership as the basis of an objection to the squeeze-out. The important constitutional measure, the Court concluded, is the minority's protection based on the capital market, i.e. material value, of the shares held. The Court's decision can be seen as falling in line with those voices in the debate that favor the discretion of the firm's majority, limited only by the obligation to adequately compensate for shares purchased.

For more information: Bundesverfassungsgericht, NEUE JURISTISCHE WOCHENSCHRIFT (NJW), 2000, p. 279.

Bundesverfassungsgericht, NEUE JURISTISCHE WOCHENSCHRIFT (NJW) 1999, 3769.