Government Draft (Regierungsentwurf) of Amendment to the German Stock Corporation Act.

On 20 December 2011, the German Government, based on a working draft by the Federal Ministry of Justice as of November 2010, published the draft of an amendment to the German Stock Corporation Act (Aktiengesetz). The main objectives of the amendments are:

> enhancing the flexibility for financing of a stock corporation (see below section 1),
> improving the transparency of shareholdings in non-listed stock corporations (see below section 2), and
> further developing the laws on actions against the validity of shareholders’ resolutions (see below section 3).

Further amendments concern the confidentiality obligations of supervisory board members appointed by Municipal Authorities and clarifications/corrections of some editorial mistakes.

It is expected that the proposed amendments will be adopted by the parliament in spring 2012.

More flexible financing

> Non-cumulative preference shares without voting rights

Currently, sec. 139 para. 1 of the German Stock Corporation Act provides that voting rights for preference shares may only be excluded if the shares are cumulative, i.e. any skipped dividends must be paid in full once the company generates sufficient profits. Thus, under the current regime, non-cumulative preference shares can only be issued if they grant voting rights.

However, under current bank regulatory laws and the current proposals for the implementation of Basel III in the European Union and for the establishment of an own funds regime for insurers, preference shares must be non-cumulative in order to be eligible as Tier-1 capital for regulatory purposes. Therefore, in particular financial institutions are interested in issuing non-cumulative preference shares without voting
rights. Acknowledging this, the proposed amendment provides that stock corporations may exclude voting rights both for cumulative and non-cumulative preference shares. In case the preferred dividend is not paid in full for non-cumulative preference shares without voting rights, the relevant preferred shareholders shall have voting rights, though, until in one of the following years the preferred dividend for such year (not for the previous year(s) in which no preferred dividend was paid) is paid in full (proposal for revised version of sec. 140 para. 2 of the German Stock Corporation Act). It should be noted under the current laws, preference shares as defined in sec. 139 para. 1 of the German Stock Corporation Act require that a preferential dividend is granted to the preferred shareholder, i.e. dividend payments for preferred shareholders are to be paid before any dividends are paid to ordinary shareholders. The mere attribution of a higher dividend (e.g. a multiple of the dividend paid on the ordinary shares) without such preferential rights is not sufficient for a share to qualify as a preference share and to allow for the exclusion of voting rights.

> “Reverse” convertible bond

Under the current law, convertible bonds are defined as “bonds providing holders with a right to obtain shares via conversion or subscription” (sec. 221 para. 1 of the German Stock Corporation Act). Because of this wording, it is unclear whether mandatory convertible bonds providing only for mandatory conversion in certain circumstances, but not for a conversion right of the bondholders, qualify as convertible bonds as defined by the German Stock Corporation Act. The same applies to bonds providing only for a conversion right of the issuer. Consequently, it is also uncertain whether shares from a conditional capital may be issued upon conversion of such bonds, because the law requires that the conditional capital is used to issue shares to “holders of convertible bonds” within the meaning of the German Stock Corporation Act.

By amending sec. 221 para. 1 of the German Stock Corporation Act, the legislator now intends to explicitly include bonds providing only for a conversion right of the issuer into the definition of the term “convertible bond”, so companies may in future issue bonds either with conversion rights (i) either of the issuer, or (ii) of the bondholders, or (iii) of both, and to use conditional capital to deliver shares upon conversion. The issuance of convertible bonds providing for a conversion right of the issuer in substance corresponds to a mandatory convertible bond where the bondholder is obliged to convert in certain cases but has no conversion rights to exercise at his discretion, and can be used as an alternative in practice. Whether a mandatory convertible bond without a conversion right of the issuer or of the bondholders will qualify as a “convertible bond” within the meaning of the German Stock
Corporation Act — and therefore allow for the use of conditional capital to issue shares upon conversion — remains uncertain for the time being. Unless explicitly clarified in the final amendment act, legal literature and jurisprudence may hold the view following the amendment that this is the case, because the explanatory notes to the proposed amendment state that the Government intends to “clarify” by way of the amendment that conditional capital may be used to issue shares upon conversion of mandatory convertible bonds. This statement seems to indicate the Government’s view that convertible bonds with conversion rights of the issuer and mandatory convertible bonds are identical.

A further amendment to the legal framework for convertible bonds and the underlying conditional capital shall grant companies flexibility in preparing a debt-to-equity swap in case of financial distress: Under the current regime, a conditional capital may amount up to max. 50 per cent of the company’s share capital (cf. sec. 192 para. 3 of the German Stock Corporation Act).

The proposed amendment provides that this threshold shall not apply if the sole purpose of the conditional capital is to enable the company to exercise a conversion right (or a right to substitute a cash payment with the delivery of shares) in case of “impending inability to pay” (bevorstehende Zahlungsunfähigkeit).

An additional exemption from the 50 per cent threshold is proposed with respect to companies qualifying as credit institutions or financial institutions within the meaning of the German Banking Act. These companies may provide for a conditional capital in excess of 50 per cent of their share capital, if it is used for the satisfaction of a conversion right of the company arising in the event of a “distress” (Belastungssituation) or if the German Federal Financial Supervisory Authority (Bundesananstalt für Finanzdienstleistungsaufsicht – “BaFin”) instructs the company to exercise the conversion right. According to the explanatory notes to the proposed amendment the term “distress” (Belastungssituation) refers to sec. 10 para. 4 sent. 9 of the German Banking Act (Gesetz über das Kreditwesen – “KWG”) and captures a situation where the development of the assets, financial position and results of operations (Vermögens-, Finanz- und Ertragslage) of the institution justifies the assessment that it will not be able to permanently meet the statutory regulatory requirements as regards own funds, liquidity or its risk-bearing capacity (Risikotragfähigkeit). The explanatory notes to the proposed amendment acknowledge that future requirements for regulatory capital instruments (e.g. the requirements set forth
in Art. 49(1)(n), 51 of the proposed regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms (COM(2011) 452 final) may require further amendments in this respect.

In contrast, the initial working draft by the Ministry of Justice as of 2010 had aimed at even more flexibility, providing that the 50 per cent limit shall not apply in general if the conditional capital is used to issue shares under convertible bonds that grant a conversion right to the company. The Government proposal now narrowed that down to conversion in the two cases described above in order to avoid “excessive” dilution of existing shareholders.

**Increased transparency of shareholdings in non-listed stock corporations**

In order to increase transparency of shareholdings in non-listed stock corporations, which are not subject to the transparency rules of the Securities Trading Act (Wertpapierhandelsgesetz), the Ministry working draft as of 2010 provided that non-listed stock corporations should be obliged to issue registered shares. Reacting to heavy criticism by literature, the Government draft now provides that non-listed stock corporations may continue to choose between registered shares and bearer shares, but sets forth certain requirements to increase transparency if bearer shares are issued:

According to the proposed rewording of sec. 10 para. 1 sent. 2 of the German Stock Corporation Act, a stock corporation shall only be allowed to issue bearer shares if it is either listed (no. 1) or the articles of association exclude the shareholders’ claim to individual securitisation of his shares (no. 2). In the latter case, a global share certificate has to be deposited with the central depositary for securities (Wertpapiersammelbank, as defined in sec. 1 para. 3 sent. 1 of the German Securities Deposit Act (Depotgesetz)) or with a foreign depositary (ausländischer Verwahrer) that fulfil the requirements of sec. 5 para. 4 sent. 1 of the German Securities Deposit Act.

**Further restriction for actions against shareholder resolutions**

Every shareholder of a stock corporation who claims a shareholders’ resolution was unlawful has the right to challenge the validity of such shareholders’ resolution by lawsuit. The law provides for two kinds of lawsuits in this respect: In most cases, a resolution can only be challenged by an action aiming for the resolution to be declared void (so-called Anfechtungsklage), which has to be filed within one month following the shareholders’ meeting; otherwise, the resolution becomes valid despite its legal defects. In certain cases of severe defects of a resolution, however, an action aiming to acknowledge its nullity (so-called Nichtigkeitsklage) can be filed without any time restrictions.
In order to increase transaction security for the concerned companies, the amendment provides that, in case an action for a resolution to be declared void has been filed, an action to acknowledge the nullity of the same resolution can only be filed within one month from the date the company has published the fact that the first action has been filed (pursuant to sec. 246 para. 4 of the Stock Corporation Act, if a shareholder has filed an action against a shareholders’ resolution, the company shall publish this fact without undue delay in the Electronic Federal Gazette).