Discriminating Shareholders through the Exclusion of Pre-emption Rights?

– The European Infringement Proceeding against Spain (C-338/06) –

by

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This article addresses a European infringement proceeding against Spain, which was joined by other Member States in 2007, including Finland, the United Kingdom and Poland. The European Commission alleges a violation of the Second Company Law Directive through a discrimination of shareholders. It argues that Spanish companies are allowed to issue shares below the market value and exclude the pre-emption rights of the existing shareholders. Such share issues result in a wealth transfer from old to new shareholders (often referred to as a "dilution" of shareholdings), contrary to the equal treatment clause of the Second Directive. This article shows that the dispute is partly due to a misunderstanding of Spanish law, including legal culture. It also finds that the allegations have merit to some extent but crucially depend on the fact finding of the European Court of Justice.

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I. Introduction: the dispute arises

In December 2004, the European Commission decided to call on Spain to change its corporate law for listed companies.[2] The Commission alleged that the Spanish Act for Public Corporations of 1989 (*Ley de Sociedades Anónimas*, abbr. LSA)[3] in its current version violated articles 42 and 29 of the Second Company Law Directive[4]. According to the Commission, Spanish corporate law facilitated a "dilution" of the holdings of existing shareholders by allowing listed companies to issue new shares to third parties at a discount. Since existing shareholders can be exempted from purchasing the new shares, their holdings would decrease in value. Spain considered the Commissions assertions erroneous and decided not to introduce any changes. In August 2006, the Commission brought an action against Spain before the European Court of Justice.[5] Ironically, the "dilution" problem arose as a consequence of implementing the Second Directive in Spain. For under the old Corporate Law Act of 1951 a withdrawal of pre-emption rights was prohibited.[6] After the action was brought, first Finland, then the United Kingdom and finally Poland applied to join the proceeding in defense of

2 Press release of December 14, 2004 (IP/04/1474).

3 Real Decreto Legislativo nº 1564/1989, de 22 de diciembre, por el que se aprueba el Texto Refundido de la Ley de Sociedades Anónimas.

4 Second Company Law Directive 77/91/EEC of the Council; Dec. 13, 1976, OJ L 26 of Jan. 31, 1977 p. 0001–0013.

5 Case C-338/06, 2006/C 261/12, October 28, 2006, Official Journal of the European Union. The decision to bring an action was already made in mid-2005, see Press release of July 15, 2005 (IP/05/939). Further communications between the Commission and Spain in early 2005 did not yield any positive results. See also Iglesias & Paz-Ares, "Obligaciones Convertibles y Exclusión del Derecho de Suscripción Preferente", InDret 1/2007, 1–33.

6 Vázquez Albert in Arroyo/Embid, *Comentarios a Ley de Sociedades Anónimas, Vol. II* (2001) 1632; García Luengo & Soto Vázquez, El Nuevo Régimen Jurídico de la Sociedad Anónima (1991) 715; Alonso Espinosa, "Wandel- und Optionsanleihen in Spanien" in Lutter & Hirte, *Wandel- und Optionsanleihen in Deutschland und Europa* (ZGR Sonderheft 16, 2000) 300, 319. Regarding the several changes of Spanish law in this respect see infra page 6.

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Spain. They were admitted in January 2007, rendering this dispute an issue of general European importance.[7]

This article discusses the dispute between the European Commission and Spain. It focuses on the different conceptual approaches of the two parties and shows how the divergence of opinion goes deep into questions of legal culture, including the "shareholder value versus stakeholder value" debate and the use of general clauses. Moreover, it discusses policy implications which seem to be central to the dispute. It shows that the Commission's arguments have some merit but are not entirely sound and that important questions remain unsolved.

II. A potential infringement: the Commission's arguments and implications

The European Commission argues that shareholders are not sufficiently protected under Spanish corporate law. According to the Commission, Spanish companies are allowed to issue new shares at a price below their market value, and concurrently, exclude existing shareholders from purchasing those shares through their pre-emption rights. Consider a simple example: The entire share capital of a company is worth 1,000 and there are 100 shares, so that each share is worth 10. The company issues 10 new shares at a price of 8 that are purchased by someone different from the existing shareholders. The consequence is that the share price will decline to 9.82 (1,080/110) and the shares of the existing shareholders will only be worth 982 (9.82 × 100) instead of 1,000. The existing shareholders lose 18.[8]

The Commission asserts that the Second Directive includes a minimum protection of shareholder rights in relation to certain transactions, including the issue of new shares. This protection is expressed in terms of an "equal treatment clause", made explicit in article 42 and in the recitals. Precisely, article 42 states: "For the purposes of the implementation of this Directive, the laws of the Member States shall ensure equal treatment to all shareholders who are in the same position." According to the Commission's explicit state-

7 Resolution January 18, 2007 of the European Court of Justice.

8 For numerical examples see also Hirte, Kapitalgesellschaftsrecht (5th ed. 2005) n. 6.28; Ferran, *Company Law and Corporate Finance* (1999) 606 et seq. The second, though seemingly less important aspect is the loss of voting power; see Davies, *Principles of Modern Company Law* (7th ed. 2003) 631–32. Compare also Zöllner, "Gerechtigkeit bei der Kapitalerhöhung", AG 2002, 585, 586, 591 et seq. who emphasizes justice in this respect.

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ment in the lawsuit,[9] the clause implies that companies may not issue new shares below the "fair value", understood as the market value, when pre-emption rights are excluded. In contrast, Spanish corporate law sets the minimum limit for newly issued shares of listed companies at the "net asset value of the company"; this provision departs from the general Spanish rule applicable to non-listed corporations that sets the minimum limit at a "reasonable price" or "reasonable value". According to the Commission's interpretation, the consequence is that listed companies may issue shares at a (large) discount.[10]

The European Commission brings forward a second violation of the Second Directive. Article 29(1) and (6) allocates pre-emption rights regarding both newly issued shares *and* convertible bonds *exclusively* to shareholders, while Spanish corporate law confers the pre-emption rights for both shares and convertible bonds to shareholders *and* bondholders (that hold conversion rights). Consequently, especially due to the large number of persons holding pre-emptive rights, the rights of existing shareholders do not include a right to purchase shares according to their shareholdings but only to an amount somewhat lower. The Commission implies that bondholders are favored even though there are other mechanisms better suited to protect them (e.g. through contracting and market mechanisms).

Finally, the Commission finds that, other than as provided for in article 29(6) and (4) of the Second Directive, pre-emption rights of bondholders may not be excluded under Spanish law. On the face of it, article 293(3) LSA refers only to article 158 LSA (pre-emption rights) and not to article 159 LSA (exclusion of pre-emption rights), meaning that investors holding convertible bonds have an indefeasible right to a pre-emptive subscription of shares and convertible bonds.

The allegations of the European Commission go beyond a mere protection of investors. If the rights of investors could be violated in the sense that wealth could be transferred (ex post) from investor A to investor B without any agreement (moral hazard), investor A would demand a higher price for his capital ex ante. In the example mentioned above, investor A would not

9 OJ C 261 of October 28, 2006, p.12.

10 The fact that the Second Directive does not distinguish between listed and non-listed companies has been attacked by several authors; especially by Hirte, "Kapitalerhaltung (Gläubiger- und Eignerschutz) und Strukturmaßnahmen" in Grundmann, *Systembildung und Systemlücken in Kerngebieten des Europäischen Privatrechts* (2000) 211, 227; for further references see Hirte, "Bezugsrecht, Berichtspflicht, genehmigtes Kapital und europäisches Recht", DStR 2001, 577, 579.

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have bought a share at 10 but only at 9,82, even if the company was worth 1,000 (and there were 100 shares). In other words, investor A would anticipate a subsequent dilution of his shares. If all the money could be transferred ex post, then investors would not invest at all.

This has important policy implications for the efficient allocation of capital within the European Union. If investors were not protected in Spain (ex post, i.e. after their investment decision), they would invest less than the socially optimal amount (ex ante). Maybe, there are some shareholders who find their rights better protected through extra-legal mechanisms (such as a close business relationship, family ties etc.), so that they are prepared to buy the shares for 10 and thereby effectively exclude other shareholders from participating. Capital would not flow to the companies that have the most promising investment opportunities because some investors would not participate in Spanish companies.

At this point, it is important to note that the legal capital system cannot entirely solve the moral hazard problem because it cannot prevent all transfers of wealth from one group of investors to another. The question quite differently answered under the various European jurisdictions is what kind of wealth transfers constitute an illegal distribution of capital to shareholders. This is also a much disputed issue under the Second Directive and can only be alluded to in this article.[11]

III. Why are shares issued below market value?

Clearly, one reason for issuing new shares at a discount may be to facilitate collusive agreements, whereby wealth is transferred from one group (old shareholders) to another (new shareholders). However, under some, maybe most circumstances, new shares *may have to be issued* at a discount for technical reasons (where the price below market value is in the interest of the firm).[12] This includes the problem that offers have to remain open at a fixed

11 See Grundmann, *Europäisches Gesellschaftsrecht* (2004) 153 et seq., Enriques & Gelter, "Regulatory Competition in European Company Law and Creditor Protection", EBOR 2006, 417, 425 et seq., Enriques & Gelter, "How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law", Tulane Law Review, Vol. 81 (2007) 602 et seq. (each with further references).

12 Schlitt & Seiler, "Aktuelle Rechtsfragen bei Bezugsrechtsemissionen", WM 2003, 2175, 2176; Hirte, Kapitalgesellschaftsrecht, n. 6.33; Lutter in Kölner Kommentar zum Aktiengesetz § 186 n. 59 et seq.; K. Schmidt in Großkommentar zum Aktiengesetz § 255 n. 12; for a brief discussion with further references see also Brealey & Myers, Principles of Corporate Finance (2003) 410 et seq.

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price for a specific period of time. Price drops, e.g. due to exogenous shocks, may then make it impossible for the company to sell their stock. Of course, if the new capital is needed for a positive net present value investment (that increases the value of the firm), then investors may anticipate this and pay a higher price so that a (large) discount may not be needed. How strong these effects are is an empirical question[13] and may vary across firms, investment decisions, countries etc. Moreover, there is a variety of arguments (signaling effects, winner's curse etc.) that render the main question unsolved. The point is that some issues may have to be below market value.[14]

A closely related question is what reason there may be to exclude pre-emption rights in the interest of the firm. A typical justification is that a certain investor is only willing to buy a specific amount of shares that entitles him to certain control rights. Other justifications for issues below value and the exclusion of pre-emption rights include the selling of shares through underwriters and special procedures, like bookbuilding.[15]

IV. Spanish Corporate Law and the Second Directive

1. Pre-emption rights at an increase of capital

Companies may increase their legal capital according to articles 151 et seq LSA. In principle, an increase in capital must be decided upon by the general meeting; however, the general meeting may delegate its authority to the board to a lesser or greater degree.[16] First, it can authorize the board to determine the exact date of an increase strictly specified; in this case, the time period may not exceed one year.[17] Second, it can authorize the board to decide on an

13 Cf. Davies, *Company Law* 632. German corporate law accounts for this by means of a test of "proportionality" and "adequacy"; see e.g. Wiedemann in *Großkommentar Aktiengesetz* § 186 n. 137 et seq.; Lutter in *Kölner Kommentar* § 186 n. 63–64; Hüffer, *Aktiengesetz (7th ed., 2006)* § 186 n. 25 et seq, § 255 n. 5; Henze, "Das Richtlinienrecht und der Schutz von Minderheitsgesellschaftern und Gläubigern im deutschen Aktienrecht" in Grundmann, *Systembildung und Systemlücken in Kerngebieten des Europäischen Privatrechts* (2000) 235, 246 ("means-ends relation").

14 Schlitt & Seiler, WM 2003, 2176; for further references see N. 12. On the signaling effect of share issues see Brealey & Myers, *Corporate Finance* 418.

15 See e.g. Cornelli & Goldreich, "Bookbuilding and Strategic Allocation", Journal of Finance Vol. 56 (2001) 2337 et seq.; Schlitt & Seiler, WM 2003, 2180 et seq.

16 Arlt, Bervoets, Grechenig & Kalss, "The Societas Europaea in Relation to the Public Corporation of five Member States (France, Italy, Netherlands, Spain, Austria)", EBOR Vol. 3 (2002) 733, 759 et seq.

17 Article 153.1 lit a LSA.

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increase autonomously. In this case, the pre-determined maximum amount of the share issue may not exceed 50 % of the subscribed capital, the time period for which the authorization is valid may not exceed five years and the shares must be issued exclusively for consideration in cash.[18]

According to the text of article 158.1 LSA, newly issued shares have to be offered to the existing shareholders according to their holdings. Pre-emption rights are valid up to 15 days in listed companies, and one month in non-listed companies.[19]

The percentage of the share capital held by an investor does not only influence his cash flow rights (e.g. dividend rights) but also his decision rights, often called "political rights" within a company. For example, under the existing Spanish law, companies may exclude shareholders from participating in the general meeting if their holding does not exceed 1/1000 of the legal capital. Hence, due to an increase in capital, it may happen that a shareholder loses his right to participate in the general meeting.[20] In the case of a listed company, however, such political rights seem less important because an investor who falls short of the required number of shares can typically buy additional shares on the market. The core of the dispute is a potential violation of the "economic rights" of shareholders.

2. *Withdrawal of pre-emption rights of shareholders: at what price?*

The right to pre-emptive subscription may be withdrawn by the general meeting. In this case, the convocation of the general meeting must include a proposal which mentions the intended withdrawal of pre-emption rights and the kind of shares to be issued. Moreover, the board must issue a report that justifies the proposal (including the kind of shares) and names the investors that will acquire the new shares. A second report has to be issued by the auditor of the company, addressing the price and verifying the accuracy of the board's statements.[21] The requirement of a second report goes beyond the safeguards provided for in article 29(4) of the Second Directive, which merely demands that the management body presents to the general meeting a report indicating the reasons for withdrawing the pre-emption right and justifying the proposed issue price.

According to the first sentence of article 159.1 lit c LSA, the minimum price for newly issued shares of non-listed companies is the *valor razonable,* or

18 Article 153.1 lit b LSA.

19 Article 158.1 LSA; compare article 29 of the Second Directive.

20 S Grechenig, *Spanisches Aktien- und GmbH-Recht* (2005) 121-22, 137.

21 Article 159.1 lit b LSA.

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"reasonable value", respectively (which is intended to be a literal translation of "fair value"), when pre-emption rights are withdrawn: "[for the validity of the decision it is indispensable …] that the nominal value of the shares to be issued and, as the case may be, the premium of the emission correspond to the reasonable [/fair] value according to the report of the company's auditor …"[22] Traditionally, this clause has been interpreted as a value determined by the auditor.[23]

For listed companies, article 159.1 lit c LSA goes on to provide that the *valor razonable* shall be interpreted as the market value and that, as long as the opposite is not justified, the market value shall be interpreted as the stock price.[24] However, the general meeting may agree to issue new shares at a lower price, as long as it is higher than the net asset value *(valor neto patrimonial)* of the company which results from the auditor's report, and decide which evaluation method should be used to determine such value.[25] This unfortunate wording seemed crucial to the Commission, as companies seem to possess wide discretion in determining the price, including below the stock price without further justification. By allowing companies to set a price below the "reasonable" or "fair" value, companies were given the discretion to determine a price which by the Spanish law's own definition was unreasonable! How can a price below the "reasonable value" be reasonable? How can a price below the "fair value" be fair?

Under the initial terms of the LSA 1989, listed and non-listed companies were treated alike, according to the first sentence of article 159.1 lit c.[26] The

22 "[Para la validez de este acuerdo … será imprescindible]: Que el valor nominal de las acciones a emitir, más, en su caso, el importe de la prima de emisión, se corresponda con el valor razonable que resulte del informe de los auditores de cuentas …" Article 159.1 lit c LSA, as amended by law 44/2002.

23 Vázquez Albert in Arroyo/Embid, *Comentarios S.A. II* 1666. Vázquez himself seems to opt for an inclusion of other criteria (at 1669).

24 "Tratándose de una sociedad cotizada, el valor razonable se entenderá como valor de mercado y éste se presumirá, salvo que se justifique lo contrario, referido a su cotización bursátil." Article 159(1) lit c LSA, as amended by the law 44/2002.

25 "No obstante, en el supuesto de sociedades cotizadas, la Junta de Accionistas … podrá acordar la emisión de nuevas acciones a cualquier precio, siempre que sea superior al valor neto patrimonial de éstas que resulte del informe de dicho auditor, pudiendo dicha Junta de Accionistas limitarse a establecer el procedimiento para su determinación." Article 159(1) lit c LSA, as amended by the law 44/2002.

26 Vázquez Albert in Arroyo/Embid, *Comentarios S.A. II* 1670. Few argued that the law was different; e.g. Salinas Adelantado, "Cambios en el Derecho de Suscripción Preferente" in García-Cruces, *La(s) reforma(s) de la Ley de Sociedades Anónimas* (2000) 179 et seq.

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reform of 1998[27] introduced a minimum price limit equal to the face value (or nominal value) of the shares, according to the absolute minimum limit provided for in article 8(1) of the Second Directive. This clause was changed the same year, in order to substitute "net asset value" for the typically lower "face value".[28] It remained clear that issuing shares at a price below face value was still illegal. The reform of 1998 was a response to the need for acquisitions through the exchange of shares where a premium was paid. If the shareholders of the target company are to receive a price above the market price of their shares, and the payment consists of shares of the acquiring company, it follows necessarily that the shares of acquiring company must be worth more than the shares of the target company, according to the price at which shares are traded on the market. Hence, if new shares are issued by the acquiring company for this purpose, the price must be below the current share price.[29] In 2002, article 159.1 lit c LSA was amended once more; this time in order to include a benchmark for listed companies: the share price at the stock exchange.[30] The "net asset value" clause remained.

The difference between listed companies and non-listed companies with regard to the minimum issue price is sometimes said to be due to the possibility of purchasing shares that are traded on a capital market. If shareholders can freely purchase shares on the market, then the withdrawal of their pre-emption rights does not impinge on the interest of a shareholder to hold a certain amount of shares in the company.[31] This argument, however, does not protect the existing shareholders from wealth transfers to new shareholders if shares are issued at a price below the market value. The better argument refers to the special need for "flexibility" in listed companies that is due to the fact that funds are sometimes needed at short notice and special techniques, such as bookbuilding,[32] to place the shares in the market.

3. The "company's interests" and equal treatment

In addition to the rules on the minimum issue price, Spanish corporate law explicitly provides for a "company's interests clause", i.e. any withdrawal of pre-emption rights and any price set for this matter has to be in the com-

27 Ley 37/1998.
28 Ley 50/1998.
29 Cf. Iglesias & Paz-Ares, InDret 2007, 14 et seq.
30 Ley 44/2002. The amendment introduced several other changes that referred to the auditor's report.
31 Salinas in García-Cruces, *Las reformas* 175–76.
32 See above p. 4.

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pany's interests: "If the interests of the company require it, the general meeting may agree to exclude pre-emption rights totally or partially, when deciding for an increase in capital."[33] Conceptually, this clause assures that certain investors are not expropriated to the benefit of others.[34] The emphasis of Spanish corporate law on a general clause (rather than on a strict minimum price) demonstrates a belief in flexibility. It puts the explicit minimum threshold of the net asset value into perspective because it sets a second boundary on the possible price of the new shares.[35]

According to some authors, the company's interests do not only include the shareholders interests *(teoría contractualista)* but also the interests of other stakeholders, like employees, creditors, consumers, the state etc. *(teoría institutionalista).*[36] A withdrawal of pre-emption rights is in the company's interests if it passes a "proportionality test" under which there must be at least some necessity for the withdrawal.[37] Exactly what degree of necessity is required remains disputed.[38]

In addition to the strict minimum price and the company's interest clause, there is a third restriction on the withdrawal of pre-emption rights: the principle of equal treatment. Even though this principle is not explicitly mention-

33 "En los casos en que el interés de la sociedad así lo exija, la Junta General, al decidir el aumento del capital, podrá acordar la supresión total o parcial del derecho de suscripción preferente." Article 159(1) LSA. Cf. Grechenig, *Spanisches Aktien- und GmbH-Recht* 135 et seq.

34 Salinas in García-Cruces, *Las reformas* 175, 181.

35 Through a test of "proportionality" and "adequacy" German corporate law uses a similarly flexible approach as a specification of the "interests of the corporation"; see the seminal decision "Kali und Salz" BGHZ 70, 41 = NJW 1978, 1316, follow-up decisions (including BGHZ 83, 319 = ZIP 1982, 689 = NJW 1982, 2444) and the extensive scholarly discussion; Hirte in *Großkommentar zum Aktiengesetz* § 203 n. 63 et seq.; Wiedemann in *Großkommentar Aktiengesetz* § 186 n. 134, 137 et seq.; Hüffer in *Münchener Kommentar* § 255 n. 4; Lutter in *Kölner Kommentar* § 186 n. 59 et seq.; Martens, "Die Bewertung eines Beteiligungserwerbs nach § 255 Abs. 2 AktG" in *Festschrift Bezzenberger* (2000) 267, 271 et seq.; Bayer, "Kapitalerhöhung mit Bezugsrechtsausschluss und Vermögensschutz der Aktionäre nach § 255 Abs. 2 AktG", ZHR 1999, 505, 509 et seq. For the historical development see Hirte, *Bezugsrechtsausschluß und Konzernbildung* (1986) 11 et seq.

36 For a discussion of the company's interests in relation to the withdrawal of pre-emption rights see Fernández Pérez, *La Protección Jurídica del Accionista Inversor* (2000); and Vázquez Albert in Arroyo/Embid, *Comentarios S. A. II* 1662 et seq. See also Paz-Ares, "La responsabilidad de los administradores como instrumento de gobierno corporativo", InDret 4/2003, 53 et seq.

37 Alonso Ledesma, "La reforma de la sociedad cotizada", RdS 12/1999, 48.

38 Vázquez Albert in Arroyo/Embid, *Comentarios S.A. II* 1665f; Salinas, in García-Cruces, *Las reformas* 174.

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ed in the Spanish Act, it is widely accepted as part of the law. According to the dominant opinion, this principle does not require an identical treatment of all shareholders but a sufficient justification of an unequal treatment.[39] The European equal treatment clause remains similarly vague. It says that shareholders have to be treated equally only if they are "in the same position".[40] With respect to pre-emption rights, article 29(1) of the Second Directive allows Member States, not to grant shareholders the right to pre-emptive subscription in the case of an increase by consideration in kind,[41] even though, economically, both types of increases in capital are capable of transferring wealth from one group of shareholders to another.[42] Moreover, it seems that through an increase by consideration in kind, shareholder rights may be violated more easily because, in addition to determining the value of the issuing company, the consideration in kind must also be valued.[43] Clearly, there is no close-to-absolute equal treatment of shareholders under European law but a general clause in order to prevent obvious inefficiencies.[44]

4. Challenging the withdrawal of pre-emption rights and the price

Spanish corporate law seems to focus on general clauses to protect investors. The primary remedy is the right to challenge (ex post) the resolution that withdraws pre-emption rights and/or sets an unfair price, according to the criteria mentioned.[45] The law mentions several potential violations of norms, including the company's interests: "Decisions of the general meeting may be challenged if they are contrary to the law or incompatible with the company's constitution, or if they harm the company's interests for the benefit of one or more shareholders or third parties".[46] As practice shows, the remedy to

39 Vázquez Albert in Arroyo/Embid, *Comentarios S.A. II* 1671.

40 Some argue for a mere prohibition of arbitrariness; for references see Grundmann, *Europäisches Gesellschaftsrecht* (2004) 145–46.

41 Siemens AG v Henry Nold, C-42/95 [1996] ECR I-06017; see infra pages 9 & 11.

42 Cf. Grundmann, *Europäisches Gesellschaftsrecht* 159. Hirte in Grundmann, *Systembildung* 288 has put forth strong arguments against the distinction between consideration in cash and consideration in kind. Under German law, shareholders are protected from dilution in both cases; see e.g. Martens in *Festschrift Bezzenberger* 267, 268 et seq.

43 See article 27(2) of the Second Directive.

44 Consequently, authors have suggested to apply principles of other directives; e.g. Hirte, DStR 2001, 579, 581, with reference to the merger directive; compare also Bayer, ZHR 1999, 527 (discussing German law).

45 Compare Salinas in García-Cruces, *Las reformas* 175 f.

46 Podrán ser impugnados los acuerdos de las juntas que sean contrarios a la Ley, se opongan a los estatutos o lesionen, en beneficio de uno o varios accionistas o de terceros, los intereses de la sociedad." Article 115.1 LSA.

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challenge such decisions has been used by investors to protect themselves.[47] For example, a court declared a resolution void for lack of sufficient justification; according to the court, the company did not explain sufficiently why its decision was in the company's interests, and the price of the newly issued shares did not correspond to the auditor's valuation.[48] In addition, directors may be held personally liable.[49]

5. Pre-emption rights attached to convertible bonds

Article 293 LSA states, by reference to article 158 LSA, that holders of convertible bonds have the same pre-emption rights as shareholders. This is understood as granting bondholders pre-emption rights when new shares are issued *and* when new convertible bonds are issued.[50] In contrast, according to the wording of article 29 of the Second Directive, pre-emption rights for the issue of convertible bonds seem to be allocated to the shareholders only; paragraph 6 of article 29 reads: "Paragraphs 1 to 5 shall apply to the issue of all securities which are convertible into shares …". Given that paragraph 1 of article 29 accords pre-emption rights to shareholders, bondholders have no pre-emption rights under the Directive, neither with regard to newly issued shares nor with regard to newly issued convertible bonds. The question is whether the European rule allocates the right *exclusively* to shareholders or whether the Member States may create additional pre-emption rights.

From a comparative point of view, both Germany and Austria have allocated the pre-emption rights exclusively to shareholders. That is, bondholders have no pre-emption rights, neither with regard to shares nor with regard to convertible bonds.[51] Bondholders may be granted contractual pre-emption rights, but they are strictly subordinated to the pre-emption rights of shareholders by mandatory law.[52]

47 See e.g. Sánchez-Crespo Casanova, *Ley de Sociedades Anónimas* (1999) Article 115, p. 276 (summarizing the case law).

48 SAP (Sentencia de Audiencia Provincial = Decision of the Appellate Court) de Oviedo of 13 May 1993 [cited in Salinas in García-Cruces, Las reformas 174 footnote 14.]

49 Salinas in García-Cruces, Las reformas 176.

50 Alonso Espinosa in Arroyo & Embid, *Comentarios a Ley de Sociedades Anónimas, Vol. III* (2001) 2820.

51 Sections 186 and 221(4) of the German Act for Public Corporations; sections 153 and 174 of the Austrian Act for Public Corporations; see Hüffer, *AktG* § 221 note 38.

52 Section 187 of the German Act for Public Corporations; section 154 of the Austrian Act for Public Corporations. See Hirte in Lutter & Hirte, *Wandel- und Optionsanleihen in Deutschland und Europa* (ZGR Sonderheft 16, 2000) 1 et seq. and the whole collected edition for an extensive comparative analysis.

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From an analytical point of view, pre-emption rights of shareholders are clearly narrowed when other investors have equivalent rights.[53] On the other hand, the Second Directive does not regulate the rights of bondholders at all, which suggests that the rights of bondholders may be regulated by national legislation, even when they conflict with the rights of other investors.[54] In *Siemens v. Nold*,[55] the European Court of Justice had to decide on the extension of article 29 of the Second Directive by national law. The question was whether a national jurisdiction is allowed to provide for a pre-emption right in the case of a consideration in kind.[56] As the court noted, the text of article 29(1) referred only to an increase in capital by consideration in cash. Consequently, for an increase by consideration in kind, the Second Directive provided for no pre-emption right. Since "the Second Directive [is] refraining from laying down rules on the complex situation ... where the right of pre-emption is exercised in the event of increases in capital by consideration in kind, it left Member States at liberty to provide or not to provide for a right of pre-emption in the latter case." Germany had provided for a pre-emption right in both cases. The Court held that national legislators were free to grant additional pre-emption rights in the case of an increase by consideration in kind[57] and the directive established a minimum protection.[58] Even though the decision did not involve a conflict of interests between shareholders and bondholders, it did allow for an extension of the pre-emption rights explicitly mentioned in the Directive.

From a policy point of view, which plays an important role in this dispute, the dilution argument brought forth with respect to shareholders can also be made with respect to convertible bonds. If new shares are issued at a price below the market value and shareholders purchase these shares through the exercise of their pre-emption rights, then the shares to be obtained through the conversion right will lose value; consequently, the bond will be worth less than before.

53 See also Spanish authors with similar conclusions, e.g., García Villaverde, La constitución y el capital de las sociedades en la CEE in García de Enterría, González Campos & Muñoz Machado, *Tratado de Derecho Comunitario Europeo. Estudio sistemático desde el derecho español I* (1986) 255; Vázquez Albert, "El derecho de suscripción preferente en el derecho comunitario", Revista de Derecho Mercantil 1988, 1698.

54 In fact a European rule for the rights of bondholders was urged; see Cavallo Borgia, Le obbligazioni convertibili in azioni (1978) 295.

55 Siemens AG v Henry Nold, C-42/95 [1996] ECR I-06017.

56 Id., at paragraph 15.

57 Id., at paragraph 16.

58 Id., at paragraph 13. For further cases and literature on whether the Second Directive provides for a minimum protection independent from pre-emption rights see Grundmann, *Europäisches Gesellschaftsrecht* 140–41.

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Consider a simple example. There is one convertible bond and the only right attached is the right to convert the bond into one share with no additional payment (other rights seem irrelevant in the current dispute). The current share price stands at 10. Is the next time period, when the conversion right may be exercised, the share price has either increased or decreased by 5 with a probability of 50 % each. Assuming for simplicity that the bondholder is risk neutral and that future value equals current value, the bondholder will value the conversion right at 10 ($5 \times 0.5 + 15 \times 0.5$). Before the bondholder exercises his conversion right, new shares are issued at a price below value under the same conditions as in the first example. The share price declines to 9.82. Given that the price may increase or decrease by 5, the conversion right will be worth only 9.82. The same dilution argument that is due to moral hazard applies under a more complex setting, where a discount factor, volatility, risk aversion and other criteria are taken into account. As the discussion on the dilution of shares showed, bondholders will anticipate a potential wealth transfer and capital will be sub-optimally allocated. If one believes in the protection of shareholders through pre-emption rights, there are good reasons for protecting bondholders as well.

Of course, one may argue that bondholders can protect themselves from ex post wealth transfers through contractual provisions (or that issuers have to offer such provisions due to market pressure). However, the same argument can be made with respect to shareholders (e.g. through a provision in the company's constitution). In both cases, transaction costs may be lower if pre-emption rights are regulated by statute. Why the two types of security should be treated differently remains an open question.

6. *Withdrawal of pre-emption rights attached to convertible bonds*

Article 293.3 LSA refers only to article 158 LSA, but not to article 159 LSA, which regulates the withdrawal of pre-emptive subscription rights. Under a strictly literal interpretation, the right to pre-emptive subscription may not be withdrawn. Indeed, in the past, some authors interpreted the law in this way.[59] Today, the almost unanimous opinion of Spanish authors opts for a systematic and teleological interpretation, i.e. an extension by way of analogy of article 159 LSA to pre-emption rights of bondholders.[60] The Spanish (commercial) registrar and the Spanish Financial Market Supervisory Agency have never questioned this reading. The Spanish courts have gone even further and

59 E.g. Vicent Chuliá, *Compendio crítico de Derecho mercantil, Vol. I-2* (3ª ed. 1991) 800.
60 E.g. Alonso Espinosa in Arroyo & Embid, *Comentarios S. A., Vol. III* (2001) 2819–20.

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held that an analogy is not necessary, because the possibility to exclude pre-emption rights of bondholders follows logically from the system.[61] Other cases in Spanish private law exemplify that the legislator has made references to only one paragraph when in fact a reference to a number of paragraphs, systematically connected to each other, was intended and has become the unanimous opinion among Spanish lawyers.[62]

Under European law, an adequate implementation of EU law requires precise, clear and transparent provisions that satisfy the requirement of legal certainty.[63] The Commission argues that current Spanish law leaves the investors with uncertainty as to their exact rights. Of course, it is likely that a more explicit provision would reduce uncertainty. In this sense, Spain is incentivized to substitute analogical applications of legal norms for explicit laws. At the same time, the Commission's interpretation seems hostile to "teleological" lawmaking because certainty could always be increased through explicit rules if one leaves aside the large amount of rules this may create (and the costs of informing oneself about the rules). The European Court of Justice does not support such an extreme point of view. It held that a "transposition of a directive into domestic law does not necessarily require that its provisions be incorporated formally and verbatim in express, specific legislation; a general legal context may, depending on the context of the directive, be adequate for the purpose".[64]

V. Why Spain?

It seems non-trivial why the action was brought exclusively against Spain. Clearly, other countries provide for flexible, standard-based norms that allow for an issue of new shares below market value when pre-emption rights are excluded.[65] Consider Germany, the country from where the legal capital

61 See, e.g., the decisions by the Audencia Provincial de Cantabria of January 14, 2004 and July 5, 2004.

62 Article 1968 of the Código Civil (Civil Code) refers to article 1902 only. However, it has never been disputed that the reference includes the articles 1903, 1905, 1906 etc as well; see, e.g., the decisions of the Spanish Supreme Court: June 26, 1909; February 23, 1956; February 11, 1977. Further examples include the reference of article 972 Código Civil to article 823 Código Civil; article 1568 Código Civil with its reference to the articles 1101 and 1124 Código Civil.

63 See, e.g., the decisions of the European Court of Justice C-131/88 [1991] ECR I-825; C-59/89 [1991] ECR I-02607; C-225/97 [1999] ECR I-03011.

64 C-59/89, paragraph 18. See also C-131/88 [1991] ECR I-825.

65 See Bagel, *Der Ausschluss des Bezugsrechts in Europa* (1999) with an extensive comparison of jurisdictions, including Germany, Italy, Spain, Portugal, England, France, Belgium, Netherlands, and Switzerland.

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system was transplanted into EU law and that most prominently defends the Second Directive.[66] According to article 255 of the German Act for Public Corporations, the price may not be "inappropriately low". However, it may be below the market value if there is a reasonable justification.[67] A discount of 3% is regarded as normal, 5% is said to be the maximum,[68] even though as a matter of fact, larger discounts are being reported.[69] Austria, another Member State with a long legal capital tradition, establishes that the price has to be "appropriate", which may be above or below market value.[70] In the United Kingdom, the ABI Guidelines consider share issues at a 5% discount as routine.[71] Swedish law does not provide for an explicit minimum limit in any official documents; it is generally accepted that the issue price may not be inappropriately low.[72] Several other Member States do not provide for an explicit minimum threshold but work exclusively with implicit or explicit general clauses.[73] Clearly, if one takes the Commission's allegations literally, infringement proceedings would likely have to include a variety of countries.

Several reasons may have made Spain the primary target for the Commission. One may be that interest groups that have invested their money in Spain pressured for legal action. Spanish law in the books may be easy to attack because it provides for a minimum threshold that may be far below the market value and uses little defined general clauses to protect investors. As explained

66 Lutter (ed.), Legal Capital in Europe (2006).

67 Hirte, *Kapitalgesellschaftsrecht*, n. 6.30; Hüffer, Aktiengesetz § 255 note 5; K. Schmidt in *Großkommentar Aktiengesetz* § 255 n. 12.

68 See the legislatory annotations Bundestags Drucksache 12/7848, p. 9, 17; Wiedemann in *Großkommentar Aktiengesetz* § 186 n. 152; Pfeifer in *Münchener Kommentar zum Aktiengesetz* (2003) 354 § 186 note 87; Hirte, *Kapitalgesellschaftsrecht*, n. 6.34; Servatius in Spindler & Stilz, *Kommentar zum Aktiengesetz* (2007) § 186 n. 59. Other authors (Hüffer, *AktG* § 255 n. 5; Martens in *Festschrift Bezzenberger* 275 et seq.) seem not to consider this a strict minimum limit.

69 Schlitt & Seiler, WM 2003, 2179 (mentioning that there are "close to market" issues and such where the discounts range from 10 % to 25 %).

70 Winner in Doralt/Nowotny/Kalss, *Kommentar zum Aktiengesetz* (2003) § 149 note 31 et seq. Kalss & Zollner, "Gesellschaftsrechtliche Fragen bei der Kapitalerhöhung der börsennotierten Gesellschaft", in Brandl et al., *Finanzierung über den Kapitalmarkt* (2006) 128 apply the German 3–5 % discount standard to Austria.

71 Guidelines of the Association of British Insurers, Section 4.11 and 4.18. See Sections 564 et seq. Companies Act 2006, regarding exceptions and disapplications of pre-emption rights. See also Davies, "Shareholder Value, Company Law, and Securities Markets Law: A British View", in Hopt & Wymeersch (eds.), *Capital Markets and Company Law* (2003) 261, 278–79.

72 Skog, *Rodhes aktiebolagsrätt*[21] 59.

73 Bagel, *Bezugsrecht* 306.

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it treats a price as fair which is below the fair value as defined under Spanish law. Perhaps, the most intuitive reason is that the courts construe the law differently than other countries and come to an interpretation that is less favorable to shareholders. An infringement of European law does not need to be a consequence of parliamentary action but can consist in actions of the courts.[74] Indeed, anecdotal evidence suggests that discounts range between 20 % and 40 % of the stock market price.[75] Clearly, this fact could distinguish Spain from other countries and result in an infringement of European law if such discounts were not justified in the companies' interests. Extensive empirical analyses would be necessary to show how large discounts are and whether they are in the overall interests of the companies and/or their shareholders.

VI. A divergence of legal culture?

1. Shareholder value v. stakeholder value and the company's interests

The dispute between the European Commission and Spain can be seen as a struggle of certain interest groups, e.g., holders of convertible bonds versus shareholders, Spanish investors versus foreign investors etc. I want to look at the dispute from a legal culture point of view.

On the face of it, Spanish law is not substantially different from the Second Directive. Neither law sets an explicit minimum threshold for the issue price at the market value but relies on a general clause; in the case of the Second Directive, equal treatment of shareholders. How strictly this standard protects shareholders is not undisputed. In *Siemens AG v. Nold*, the Court held that this question was left to the Member States to decide in the case of an increase by consideration in kind.[76] Moreover, the Court held that the Second Directive seeks to ensure a "minimum equivalent protection for both shareholders and creditors"[77], which seems to include bondholders with conversion rights. Even though bondholders are not the primary group of creditors to be protected under the Second Directive,[78] they are certainly subject to the same problem of moral hazard as other creditors. In the case of an increase in capital by consideration in kind, the Court considered the withdrawal of

74 See Borchardt in Lenz & Borchardt, *EU- und EG-Vertrag. Kommentar* (2003) Article 226 note 7.

75 Iglesias & Paz-Ares, InDret 2007, 23.

76 Siemens AG v Henry Nold, C-42/95 [1996] ECR I-06017, note 18. See supra 9.

77 Id, note 13.

78 See supra footnote 54 and accompanying text.

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pre-emption rights, where the withdrawal was in the company's interest, consistent with the Second Directive. Even though the case is different from the current infringement proceeding, it shows that the European Court of Justice is not opposed to justifying a potential discrimination of shareholders on the ground of the company's interests.

It seems that the divergence of opinion between the Commission and Spain derives straight from different views as to what constitutes the interests of the company and different interpretations of the principle of equal treatment of shareholders. According to the Commission, equal treatment prohibits companies from issuing shares below market value. The Commission thereby seems to apply a "strict" shareholder value approach under which some transactions that enhance the total wealth of a company are not permitted if existing shareholders are not treated equally to new shareholders.

Consider the following example. It can be less costly to pay managers and employees in shares (or share options) rather than in cash. In order to achieve this, pre-emption rights are excluded and shares are granted to the beneficiaries below the market price; instead of paying a salary of 100 in cash, shares that are worth 150 on the market are given to the employees for 50. Of course, where the payment is in shares rather than in cash, the old shareholders are not treated equally to the new ones (the employees) in the sense that the employees as the new shareholders receive shares below market value and the old shareholders lose wealth. However, in either case, there is a cash flow of 100 from the old shareholders to the new ones. Clearly, in the second case, total welfare *may* be increased due to the incentive effect for employees. The fact that such share issues should be allowed is also reflected in article 41(1) of the Second Directive, which explicitly allows Member States to derogate from article 29.[79] It shows that the Directive does not adopt the Commission's version of shareholder protection. For the same reason, an increase by consideration in kind may have been exempted from article 29 (1) of the Directive, rendering pre-emption rights non-mandatory on an EU level; otherwise, perhaps, too many efficient transactions could not be carried out.

Without discussing the vast shareholder value/stakeholder value literature in detail,[80] a short remark seems apposite. If the total welfare of the corporation

79 Under Austrian corporate law (section 153 AktG), the acquisition of shares by employees is an explicit justification for excluding pre-emption rights. Under s.566 of the UK Companies Act 2006, pre-emption rights are automatically excluded in the case of an employees' share scheme; see e. g. Davies, *Company Law* 633.

80 For the latest major critique on the shareholder value approach see Blair & Stout,

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is increased, then the shareholders may also benefit. One could say, if employees are incentivized to work more productively, then the corporate profits for the shareholders are larger. In order to incentivize employees to make firm-specific investments (ex ante), e.g. regarding their human capital, a strict (ex post) protection of the rights of employees may be necessary. Likewise, creditors of the company will be better off because they are less likely to lose their investments. Of course, this does not address distributive issues. It is important to note that the Commission has a specific kind of shareholder protection in mind.

The fact that some efficient transactions may not be carried out (or become more costly) does not render a shareholder value approach, as argued by the Commission, necessarily inefficient overall. If a low price may be justified by a vague rule, like the company's interests, then the interests of some third party may illegitimately be accounted for, contrary to the legal conception. Who is to say what is in the interest of the company? Indeed, it is often argued that low prices are used to pay underwriter fees that are unjustifiably high.[81] Strict rules have the advantage of preventing such wealth transfers and identifying violations more easily, and through minimal expenditure, but the disadvantage is that some efficient transactions may not be carried out. This issue is connected to the discussion of general clauses and analogies.[82]

As mentioned above,[83] Spanish company law goes beyond a mere protection of shareholder rights but includes all kinds of stakeholders. This is apparent in the case of challenging decisions of the general meeting where the law explicitly states that the shareholders' interests are not equal to the company's interests.[84] If transactions that maximize the total wealth of the company were prohibited in favor of shareholder wealth, one would have to ask whether such decisions could then be challenged. Even though EU supremacy may solve the issue in the sense that decisions cannot be challenged if they conform with European law, the point is that the two approaches are incompatible. Spanish corporate law, as well as the law of other Member States, would have to change its conception of the company's interests that has

"A Team Production Theory of Corporate Law", 85 Va. L. R. 247 (1999). Useful recent summaries include Charreaux & Desbrières, "Corporate Governance: Stakeholder Value Versus Shareholder Value", Journal of Management and Governance (2001) 107–128; Engert, "Eine juristische Theorie des Unternehmens", in Lorenz et al., in *Festschrift für Andreas Heldrich* (2005) 87–111.

81 E.g. Davies, *Company Law* 637.

82 See infra page 13.

83 See supra page 7.

84 See supra page 8.

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evolved over the decades and it is not clear whether the change is more efficient.

In order to attract capital, the national authorities have an incentive to provide for some investor protection. Even though this mechanism does not work perfectly and, typically, improvements in the law take a long time to evolve, it creates a weak presumption against irregularities, especially where it concerns capital which can easily be moved from one country to another (relatively, compared to the movement of persons and companies). For these reasons, the European Court of Justice would have good reasons to go less far than the European Commission.

2. General clauses and analogies

Spain is a typical civil law country that codifies its laws and uses analogical reasoning to fill gaps, such as the exclusion of pre-emption rights of bondholders. In this tradition an argument for a certain outcome is made by means of applying a statute that regulates a similar set of facts.[85] In order to comprehensively regulate a certain field of law, Spanish law uses general clauses such as the concept of the "company's interests".

In this specific dispute, however, the European Commission appears to treat such an approach as illegitimate and seeks to impose on all Member States a technique often associated with the interpretation of statutes in a common law environment, namely a strictly textual method of interpretation (and, consequently, of legislation) that neglects the usefulness of general clauses. The Commission argues that a clear rule explicitly prohibiting share issues below the market value (where pre-emption rights are excluded) is better than a general clause; and that a clear rule regarding the exclusion of pre-emption rights of bondholders is better than reasoning by analogy. It may be that one or the other approach is better across all countries; however, it is also possible that a certain approach is so deeply embedded in a legal culture that a change would be prohibitively costly (path dependence).

An analysis of this "rules versus standards" related issue is complex and results are likely to differ with national particularities. First of all, the effect on legal certainty is unclear. On one hand, it seems more costly to learn about a general clause due to its lack of specificity; however, on the other hand, it may

85 See Grechenig & Gelter, "The Transatlantic Divergence in Legal Thought: American Law and Economics vs. German Doctrinalism" (St. Gallen Working Paper No. 2007–25).

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be just as costly to learn about a large number of single norms.[86] Secondly, general clauses and wide discretion for analogies delegate the law-making powers from the legislator to the courts (and other influential interpreters, like legal scholars). This effect lies in the very nature of vague norms and can have both positive and negative effects. The question is whether the courts or parliament is better suited to make a specific decision. One may argue that courts are more independent due to the judges' life-tenures, whereas parliament (including the European Parliament) is subject to interest group intervention. Yet, parliament is subject to some checks and control through elections. Moreover, one could say that standards are more receptive to corruptive intervention by parties than rules because biased judgments are more difficult to challenge and involved persons are less likely to be held responsible when the law is less clear cut. Simply put, there is less discretion in deciding whether shares were issued below the market value than in deciding whether a share issue was in the interest of the company. Standards involve other enforcement costs as well. In order for judges to make unbiased decisions, they need more time to learn about the law applied to a specific case. On the other hand, the advantage of standards is that different cases may be solved differently.[87]

The point is that whether a jurisdiction ought to operate with general clauses and standards or specified rules depends on a great number of factors.[88] In the end, it is an empirical question and often a certain culture has developed taking into account these factors – sometimes better, sometimes worse.

VII. Conclusion

The European Commission has brought forth several arguments some of which are less plausible than others. The fact that Spain has not regulated the exclusion of pre-emption rights of bondholders explicitly does not seem to constitute a violation of the Second Directive, nor of general principles of legal certainty. Otherwise, a wide range of norms across many European

86 Cf. Kaplow, "Rules versus Standards: An Economic Analysis", 42 Duke L. J. 557, 597 (1992).

87 Literature on rules versus standards and on the optimal decision-maker includes e.g. Kaplow, 42 Duke L. J. 557 (1992) and Posner, *Economic Analysis of Law* (6th ed. 2003) 529 et seq, 542 et seq.

88 Schäfer, "Rules versus Standards in Rich and Poor Countries: Precise Legal Norms as Substitutes for Human Capital in Low-Income Countries", 14 S. Ct. Econ. Rev. 113 (2006) argues that low-income countries should use specified rules whereas high-income countries should use standards.

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countries (if not all within the civil law tradition) would contradict European law.

Secondly, the fact that Spanish corporate law allocates pre-emption rights to both shareholders and bondholders with conversion rights simply seems to protect the rights of both groups. Without pre-emption rights, bondholders would be subject to a moral hazard problem, requiring contractual provisions in order to protect them from dilution. Whether a legal rule or contractual negotiations are better, is a complex empirical question and likely to have different results in different countries.

The only allegation that would appear to have some merit is the potential wealth transfer from existing shareholders to new shareholders in the case of a low price for newly issued shares when pre-emption rights are excluded. The fact that Spain uses general clauses does not seem to violate European law, most importantly, because the very Directive uses a general clause to prevent a dilution of shareholdings. Moreover, there is a variety of countries that allows share issues below value when pre-emption rights are excluded. According to the Commission's standard, the action would have to be brought against all those countries. Whether discounts that are tolerated in Spain are justified, is once more an empirical question, where one has to know whether the companies' wealth is increased or decreased, on average. This should be true, even if Spain uses larger discounts than the average country. If prices below value were used to increase the company's wealth, there would be no genuine reason for convicting Spain. If, however, discounts were used for other reasons, as implied in the action brought by the European Commission, the European Court of Justice would have good reasons to hold Spain liable for an infringement of European law.