Company/Commercial - Spain

Formal Requirements Should Not Determine Company Interest Test

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Background

The exclusion of pre-emptive rights is allowed under Spanish law in accordance with Article 159 of the Corporations Act (for further details please see the Overview (March 2003)). This provision establishes the capital increase requirements necessary to deprive shareholders of the right to take out an option on new share issues in proportion to their share of stock capital. The necessary condition is the existence of a company interest that justifies the exclusion. In order to establish the existence of a company interest, the law establishes a series of formal requirements which must be present in order to validate the exclusion.

Recent Amendment

Article 159 was recently amended by the Law of Financial System Reform Measures (44/2002). This reform aims to increase objectivity in evaluating pre-emptive rights and the valuation of stock, requiring, above all else, reasonableness in the report presented by the directors to justify the exclusion of the pre-emptive right. To this end, the reform requires the obligatory intervention of independent auditors appointed by the Mercantile Registry to verify that the directors' report reasonably justifies the exclusion of pre-emptive rights. This change is significant, as the directors' report must now pass an independent test, instead of the potentially biased test previously carried out by the company's own auditors.

The exclusion of the pre-emptive right in the interests of the company must follow formal proceedings in order to be considered valid. However, the requirement of company interest should not be reduced to a mere fulfilment of the formal requisites set forth in Article 159 of the Corporations Act. Such a simplification, if the regulation was strictly applied, could give rise to serious problems. A formal interpretation would allow results that could be qualified as abuse of process and carried out by means of an abuse of the law by the majority shareholders.

Case

Company A held 24% of the shares in another company, Company Z. In addition, an agreement existed which regulated the presence of Company A in the shareholding of Company Z. On the one hand, this stipulated that

Company A enjoyed the right to appoint one of the six members of the board of directors of Company Z, as long as it held the cited percentage of stock in the shareholding. On the other hand, the agreement placed limitations on the transfer of shares. As a first step in a strategy to oust Company A, these limitations were removed. Following this, with the aim of excluding Company A from management, Company Z agreed to a capital increase with the exclusion of the pre-emptive right to allow for the entry of a new shareholder, thus not only diluting the shareholding of Company A, but consequently depriving Company A of its power to nominate one of the members of the board of directors.

These corporate resolutions were challenged. The resulting decision considered that the requirements for exclusion of the pre-emptive right had been met, as set out in Article 159.

Comment

On the grounds that the mandatory formal requirements had been met, the decision erroneously equated the interests of the company with the interests of the majority shareholders. In reality, the majority may vote that a company interest exists, but this does not necessarily imply that its interest is equivalent to the company interest. The existence of a company interest as a litmus test for the exclusion of pre-emptive rights is to prevent unfair behaviour by the majority shareholders. This is precisely what occurred, as Company A was deprived of both its economic and political position in Company Z.

An excessively strict application of the legal requirements for the exclusion of the pre-emptive right gives rise to results that run contrary to the purpose of the law. For this reason, the reforms should focus not on determining formal requirements for the exclusion of the pre-emptive right, but on protecting the shareholder harmed by the exclusion of the right where the law is abused or there is abuse of process.

The European Commission Winter Report (1) favoured this interpretation, which advocates flexibility in the formal requirements for exclusion of the pre-emptive right, thus following the tendency set by US law, in which liberalization of the pre-emptive right in listed companies is almost complete. The majority of US states include a non-mandatory regulation that grants the pre-emptive right for former partners unless stipulated otherwise in the bylaws. Despite this, the pre-emptive right has become a historic relic, as almost all of the large companies that are quoted on the US stock exchange have gradually eliminated the right from its bylaws through the necessary modification, and almost no company guarantees the right of its shareholders at the time of any particular capital increase.

Therefore, for any particular capital increase operation which involves the exclusion of the pre-emptive right, not only must the formalities stipulated by law be met, but the existence of a company interest to be achieved by means of exclusion of the pre-emptive right - there being no other alternative means of achieving the same goal - must also be established.

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Endnotes

(1) European Commission Report of the High-Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in

Europe.

Comment/Question for the Author

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