MODERN GERMAN CORPORATION LAW

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CHAPTER IX

CAPITALIZATION OF THE CORPORATE ENTERPRISE

A. The Aktiengesellschaft ("AG")

Introduction

Under any system of corporation law, the capital of the corporate entity is designed to furnish this creature of legal fiction with a separate pool of assets which will be answerable to the claims of creditors of the entity. Each system also strives, to a greater or lesser extent, to assure that the amount of capital available to a given corporate entity be ascertainable in some way by interested parties.

As a matter of policy, most jurisdictions at the same time require a specified minimum amount of capital before a corporate entity may be organized. While the amount of this minimum varies from state to state and country to country, the threshold for purposes of incorporation in Germany has always been significantly higher than in the United States. In order to organize a corporate entity in the form of an AG under present law, a minimum capital of DM 100,000 (more than $50,000 at this writing) must have been subscribed to by the incorporators, while organization of a corporate entity in the form of a GmbH requires a minimum subscribed capital of DM 20,000 (now more than $10,000). By way of contrast, the Delaware corporation statute now requires no minimum amount of capital to be subscribed to or paid in as a condition to incorporation thereunder. Even prior to the adoption of the amendments abolishing the minimum capital requirement in Delaware, the capital required at inception amounted to no more

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than $1,000.

While the capitalization of a corporate entity may sometimes be understood as referring to the number and par value of the shares of capital stock authorized and/or issued and outstanding, it more broadly refers to the size of the pool of assets which has been transferred to the entity against the entirety of its shares of capital stock outstanding, either at inception or subsequently, in order to fund its business operations. Since this pool of assets is subject to the fortunes and vicissitudes of the market place from the moment of inception, it may, of course, either increase or decrease in amount during the life of the corporation. Although an increase in the assets of a corporate entity poses no threat to creditors, a decrease thereof will jeopardize the satisfaction of their claims. Accordingly, most corporate systems seek to protect the pool of assets constituting the capital of the corporation by prohibiting distributions to stockholders when capital has been impaired.

While the purpose and meaning of the capital of a corporate entity is thus much the same under both the stock corporation law and the Delaware statute, certain differences between these two laws do exist. The principal difference is to be found in the fact that, while under the Delaware law the capital of a corporation in the broad sense does not necessarily equal the capital authorized in its certificate of incorporation, the capital of an AG will, except under the limited circumstances hereinafter referred to, generally equal the aggregate of the stated capital authorized in its Articles.

This circumstance exists for the simple reason that the Delaware law does not require all of the authorized capital of a corporation to be subscribed to and that, accordingly, only a small portion of this authorized capital may actually have been issued. The difference, if any, between the capital actually issued and the capital provided for in the certificate of incorporation would constitute authorized but unissued capital. Under the stock corporation law, on the other hand, the entire amount of all authorized capital must be fully subscribed to upon its creation. Since authorized but unissued shares thus do not generally exist under the stock corporation law except under limited circumstances, neither the Board of Overseers nor the management board have the power to issue shares of capital stock of the AG in their discretion to the same extent to which the board of directors of a Delaware corporation may issue such shares in the normal course.

Another contrast between the Delaware and the German practice may be found in the manner in which the amount of capital paid into a corporate entity is ascertainable by third parties such as creditors. Under the stock corporation law, for instance, the stated capital of any AG is readily determinable from its Articles on file with the Commercial Register. Thus, if the Articles indicate that aggregate stated capital amounts to DM 1,000,000, the inference that value amounting to a full DM 1,000,000 has been committed to the AG may fairly be drawn. Under the Delaware practice, on the other hand, the certificate of incorporation alone does not indicate what amount of capital has actually been paid in and, in order to ascertain the number of

shares of capital stock actually issued and outstanding, reference would have to be made to the annual report of the corporation as filed with the Secretary of State. However, though that document discloses the not entirely relevant sum of the gross assets of the corporation as per a recent balance sheet, it does not show the amount of capital paid in against the shares of capital stock issued and outstanding. Thus, unless a corporation is subject to the reporting requirements of the Securities Exchange Act of 1934 and its true capital thus ascertainable by reason of its filing of financial statements with the Securities and Exchange Commission, the determination of the actual amount of capital paid into a corporation simply by virtue of the provisions of the Delaware General Corporation Law is next to impossible.

The amount of the original stated capital of the AG is determined by its original Articles. As has been indicated earlier, this amount must be fully subscribed to and will thus be fully issued and outstanding upon incorporation. Subsequent to such time, however, the original stated capital may have to be altered for various reasons. For instance, the AG may have to increase stated capital in order to accommodate a new issue of shares of stock for various purposes or, on the other hand, it may find it advantageous to decrease stated capital in order to write off accumulated operating losses. Furthermore, an increase in stated capital may also be required to provide additional shares of capital stock in order to effectuate a merger with another entity or to satisfy the holders of convertible debt instruments or rights such as warrants. While none of these circumstances normally pose a problem for the Delaware corporation by

reason of the availability of authorized but unissued capital for such purposes, the lack of this facility for the AG required the development of various special techniques to meet these needs.

This part will thus cover the various ways in which increases or reductions of the stated capital of an AG may be effected. It will also cover the issuance of convertible debt instruments. While the issuance of such instruments does not involve an increase in stated capital initially, any exercise of either the conversion privilege or attached warrants, if any, would result in an increase in stated capital. Those exceptions to the general rule permitting the limited use of authorized but unissued shares will also be described herein.

(1) Original Capitalization

The original capital of an AG consists of the sum provided therefor in its Articles at its inception. Certain prescribed provisions relating to such capital are among the minimum required by law to be included in the Articles as a condition to the valid formation of the AG [1/].

Since the manner in which the original capital is established has been comprehensively discussed in the chapter relating to the formation of the corporate enterprise, this material will not be repeated here and reference to such chapter should thus be made [2/].

It must be emphasized, however, that a relatively substantial amount of capital is required to organize an AG under current conditions. Thus, the Articles must provide for a capital of at least DM 100,000, which amount is to be divided

into shares of capital stock with a minimum per share par value of either DM 50, DM 100 or multiples of 100 [3/]. While all of the original capital may consist of common shares, this need not be the case and a certain portion thereof may be represented by preferred shares with such preferences as may be contained in the Articles.

(2) Subsequent Increases in Capitalization

During the life of an AG, an increase in its stated capital may from time to time become desirable. Depending on the purpose of the proposed increase, there exist a number of ways in which an increase in stated capital may be accomplished.

The primary method of increasing the stated capital of an AG involves the issuance of a newly authorized bloc of shares of capital stock to the subscribers thereto for cash or other consideration in kind [4/]. However, since the procedure surrounding this method of increasing capital always requires action by the stockholders, the flotation of a new equity issue becomes quite cumbersome, particularly with respect to the timing of the proposed issue. As a result, a limited exception to this procedure was devised by the introduction of the concept of "authorized capital" which permits certain issuances without simultaneous stockholder action [5/].

Since stated capital must also be frequently increased in order to accommodate the conversion of debt instruments, the exercise of rights such as warrants or the issuance of shares in connection with mergers, the additional concept of "conditional capital" was devised in order to simplify the procedure sur-

rounding the issuance of shares of capital stock under such circumstances [6/]. Under each of these two exceptions to the general rule requiring stockholder action in connection with an increase in stated capital, the management board has the primary authority to cause an increase in stated capital through the issuance of shares of capital stock. To the extent, therefore, that these exceptions to the general rule provide the management board with an opportunity to cause the issuance of shares of capital stock without simultaneous reference to the stockholders, a limited analogy to the Delaware practice exists.

A further increase of stated capital takes place upon the conversion of certain reserves into additional stated capital. However, this procedure amounts to no more than a bookkeeping entry because the increase arises solely out of the internal resources of the AG.

Each of these methods of increasing the stated capital of the AG will be briefly discussed herein.

(i) Ordinary Increase

When an AG desires to raise funds or increase its assets by means of a new issue of shares of capital stock, it may always resort to this traditional method of increasing its stated capital [7/]. However, since the steps required to consummate an increase of this kind are cumbersome and time consuming, this type of capital increase may not be the most desirable under the particular circumstances and the AG may instead wish to take advantage of the "authorized capital" concept discussed below.

The problems associated with an ordinary in-

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crease of capital arise principally out of the fact that the stockholders must approve an amendment to the Articles contemplating the creation of the issue of capital stock involved and that the entire amount of the capital increase so authorized must be subscribed to before the amendment of the Articles can become effective [8/]. As a result of these circumstances, there is a lead time of at least one month between the notice of the required meeting of stockholders and the action taken thereat and it is entirely possible that market conditions at the time of stockholder action may not be favorable for the proposed issue.

As indicated above, the first step in connection with an ordinary increase of stated capital consists of the submission to the stockholders of a resolution providing for the increase of the stated capital of the AG by a specified amount. In addition to the majority vote of shares represented at the meeting, the affirmative vote of 75% of stated capital represented at the meeting is also required for the adoption of such a resolution, unless the Articles provide for a different majority of such stated capital or impose other requirements [9/]. While such action may be taken at the ordinary meeting of stockholders, an extraordinary meeting of stockholders can also be called for this purpose. Regardless of the type of meeting, the action proposed to be taken must be properly noticed. If different classes of stock exist, these requirements also apply to each class voting seprately [10/].

The increase in stated capital may provide for the issuance of common shares, preference shares as well as non-

voting preference shares. Should the creation and issuance of non-voting preference shares be proposed, however, the affirmative vote of 75% of capital represented at the meeting is a mandatory requirement which the Articles cannot reduce to a lesser majority [11/]. Moreover, the limitations upon the issuance of shares of this type should be borne in mind [12/].

In addition to action by the stockholders to increase capital and to amend the Articles, a number of other formal steps must be undertaken in order to accomplish a valid issuance of newly authorized shares of capital stock. These steps commence with the solicitation of subscriptions for the entire issue and are completed with the submission of notification of the effectuation of the increase for recording with the Commercial Register [13/].

Subscriptions may, of course, be sought from a limited number of individuals or the public at large. However, it is the more usual practice to arrange for an underwriting group of banks or other financial institutions to subscribe to all of the shares to be issued. The form of subscription used for this purpose must contain certain prescribed provisions, the most significant of which constitutes the date after which the subscription ceases to be binding upon the subscriber in the absence of effectuation of the increase in stated capital [14/]. Thus, if it is not possible for some reason to obtain subscriptions for the full amount of the increase by the date specified in the subscription form, prior subscribers will be relieved of their obligations and the proposed issue may very well fail.

A further step in this procedure consists of the submission of the stockholder resolution increasing capital and amending the Articles to the Commercial Register for recording. This step can be taken separately, but it is more usually accomplished in conjunction with the submission to the Commercial Register of notification of effectuation of the increase in stated capital for recording. Since the increase is not effective until such notification has been recorded in the Commercial Register, the shares of capital stock involved may not be issued until this final step has been accomplished [15/].

As in the case of an original incorporation, the recording of an increase in stated capital cannot be accomplished, except in the case of issuance of shares for a consideration in kind, before at least 25% of the par value of the shares to be issued, plus the full amount of any premium over par value, has been properly paid into the AG [16/].

Once the required contributions upon the shares to be issued have been made, the management board and the Chairman of the Board of Overseers proceed with the submission of the notification of the effectuation of the increase in stated capital to the Commercial Register for recording. This notification must contain representations comparable to those accompanying the original Articles upon incorporation and must, in addition, be accompanied by various supporting documents such as duplicates of each subscription to the shares of capital stock proposed to be issued together with a list of subscribers setting forth their identities and the amounts paid in by them [17/]. Furthermore, a

calculation of the expenses incurred by the AG in connection with the issue, any governmental approvals, if required, and the agreements, if any, relating to contributions to capital for other than cash consideration must accompany the notification.

Upon the recording of the notification of effectuation of increase in stated capital, the increase becomes effective and shares of capital stock may then be issued. Subsequently, the Commercial Register publishes the accomplished increase in accordance with the requirements of the Commercial Code [18/].

Contributions to Capital in Kind

The foregoing discussion has treated the ordinary increase in stated capital in terms of the usual issuance of shares for cash. However, an increase in stated capital and a new issue of shares of capital stock can also be accomplished for a consideration in kind.

The steps to be accomplished by an AG in connection with an ordinary increase in capital for a consideration in kind are generally comparable to those effected with respect to the issuance of shares of capital stock upon its original incorporation. However, while an issuance of shares upon incorporation for a consideration in kind will bring about an audit of the incorporation procedure and the terms of the transaction involved, an increase in stated capital for a consideration in kind does not automatically bring about such an audit. The only special requirements to be observed in the case of such an increase in capital are that both the notice of the meeting and the resolution increas-

ing capital must contain certain prescribed details as to the proposed transaction. These details consist of a description of the property to be transferred to the AG. the identity of the persons from whom the property will be acquired as well as the aggregate par value of the shares of capital stock which are to be issued in exchange for such property [19/].

It should be borne in mind, however, that this more liberal treatment applies only where the transaction is being effected after two years have elapsed since the date of incorporation. If the transaction takes place within such period and shares having an aggregate par value equivalent to more than 10% of existing stated capital are proposed to be issued in exchange, the law requires the appointment of auditors to examine the transaction. This procedure is referred to as a "delayed" incorporation and has been discussed in the chapter relating to the incorporation of the corporate enterprise [20/].

Although the mere fact that shares of capital stock are to be issued for a consideration in kind in connection with an ordinary increase in stated capital does not require an audit of the transaction, the Court of Register to which the notification will be submitted for recording in the Commercial Register is required to examine the terms of the proposed transaction. If such examination elicits doubts as to whether the fair value of the property to be transferred to the AG is equivalent to the par value of the shares to be issued therefor, it must appoint auditors to examine the transaction. Where it appears that the value of the property is substantially less than the par value

of the shares proposed to be issued, the Court is obliged to refuse the recording of the proposed increase [21/]. Under such circumstances, of course, the increase in stated capital cannot become effective and the shares involved cannot be issued.

Preemptive Rights

In principle, the existing stockholders of an AG enjoy preemptive rights with respect to any issue of new shares of capital stock pursuant to an ordinary increase of stated capital unless the resolution increasing the stated capital and amending the Articles specifically excludes such rights [22/]. Thus, where it is proposed that the stockholders act upon the exclusion of their preemptive rights in connection with a particular increase in capital, notice of the proposal to that effect must be given in the call of the meeting of stockholders [23/]. For the adoption of the resolution excluding preemptive rights, the affirmative vote of at least 75% of stated capital represented at the meeting of stockholders is mandatory. The Articles cannot provide for such action by any lesser percentage of stated capital [24/].

It might be noted that, where the preemptive rights of stockholders have not been excluded by the resolution increasing stated capital, it is the general practice, for the sake of convenience, to cause an underwriting group consisting of banks or other financial institutions to subscribe to all of the shares to be issued, notwithstanding the preemptive rights of the stockholders, but to bind such group to initially offer the shares to the existing stockholders in order to enable them to exercise

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