Articles

Freeze-Out Transactions in Germany and the U.S.: A Comparative Analysis

By Christian A. Krebs[*]

A. Introduction

A freeze-out is a transaction in which a controlling shareholder forces out the minority shareholders and compensates them in cash or stock.[1] A successful freeze-out transaction marks the end of the exchange-traded life of a corporation—it is a "going private" transaction. A freeze-out is therefore the counterpart to an initial public offering. Whereas the latter leads to the public listing of a corporation and thus a multiplication of shareholders, the freeze-out transaction aims at reducing the number of shareholders of a corporation to one.

Freeze-out transactions are subject to a wealth of case law and scholarly discussion, both in the US legal system, and in Germany. This does not come as a surprise. The rules on freeze-outs need to resolve the diametrically opposed interests of the controlling shareholder[2] and minority shareholders. The controlling shareholder, often after a tender offer, seeks to consummate her acquisition of the target corporation and to establish efficiency gains. The minority shareholders are excluded from their share of the future earnings of the company and are concerned that they may not receive full compensation for their shares. After all, if the compensation is ultimately set or at least influenced by the

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[1] *Cf.* Guhan Subramanian, *Fixing Freezeouts*, (Harvard Law Sch. John M. Olin Ctr. for Law, Econ. and Bus., Discussion Paper No. 501, 2004); Marco Ventoruzzo, *Freeze-Outs: Transcontinental Analysis and Reform Proposals* 2 (European Corporate Governance Inst., Working Paper No. 137, 2009). In the U.S. legal system, the term *squeeze-out* is used to refer to measures—whether legal or not—which confer benefits from the corporation on the controlling shareholder to the detriment of the minority shareholder, thereby creating a *de facto* incentive for the minority shareholders to leave the corporation. *See id.*; HOLGER FLEISCHER, GROßKOMMENTAR AKTIENGESETZ Vor §§327a–f mn.4 (4th.ed. 2007). In Europe and in Germany, however, the term *squeeze-out* has been established as the equivalent of the term *freeze-out*. *Cf.* Council Directive 2004/25/EC, art. 15, 2004 O.J. (L 142) (EU); FLEISCHER at §327a. In the following, the term *freeze-out* will be used to describe general principles and in relation to U.S. law. The term *squeeze-out* will be used in relation to European and German law and never in relation to its ambiguous meaning in the U.S. legal system.

[2] The terms *controlling shareholder* and *controller* are used interchangeably in this text.

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controlling shareholder, it is evident that a strong element of self-dealing is involved. So the regulation of freeze-outs is caught in a zone of tension between the legitimate interest of the controlling shareholder to maximize the efficiency of her corporation, and the fears of minority shareholders of self-dealing by the controlling shareholder.

It is striking that the rules on freeze-outs differ significantly between the U.S.[3] and Germany. The regulation of freeze-out transactions in Germany is fairly new and quite restrictive by comparison with U.S. standards. This is remarkable, as the corporate and capital market laws of European and U.S. jurisdictions are generally converging as a result of the ongoing development of European capital markets.[4] In many instances, Delaware law has inspired the formulation of corporate laws in Germany and on the EU-level. The German squeeze-out rules, however, are remarkably different from those developed in Delaware. Although the general framework for squeeze-outs has meanwhile been firmly established in Germany, the courts and legal scholars are still engaging in lively discussions of certain aspects of the procedure. So while some aspects of the squeeze-out procedure are still crystallizing in Germany, the discussion is more mature in Delaware, where the last notable development dates back to 2002.[5] The current vitality of the German discussion invites a comparative analysis of the freeze-out procedures in Germany and the U.S., with a focus on Germany. The rest of the article is structured as follows: Part B of the article briefly discusses the economic rationale of freeze-outs. Part C describes the history and development of the rules on freeze-out transactions in Delaware through case law, up to the current state of the discussion. Part D illustrates the introduction of squeeze-out rules into German law in 2002 and the subsequent legal development in Germany. Part E sets out the general squeeze-out procedure in Germany, discusses the most relevant issues with this procedure, illustrates some empirical data on the use of squeeze-outs in Germany, and draws comparisons with the U.S. where appropriate. Part F explains the takeover squeeze-out procedure in Germany and explains, based on empirical data, why this procedure has not yet become popular in practice. Finally, Part G compares the U.S. and German approaches, analyzes some specific issues, and argues that the different systems are a result of path dependency, and that therefore the potential for further convergence between the German and U.S. freeze-out rules is limited.

[3] As the state corporation law of the U.S. today is dominated by Delaware law, which is widely recognized as the most developed corporate law in the U.S. and which governs over 50% of U.S. corporations, Delaware will serve as a proxy for the U.S. for the purposes of this analysis. A reference to the U.S. in this article can therefore be understood as a reference to Delaware.

[4] *See* Reinier H. Kraakman & Henry Hansmann, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

[5] *See In re* Pure Res., Inc. S'holders Litig., 808 A.2d 421, 436 (Del. Ch. 2002).

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B. Rationales for Freeze-Out Transactions

There are several economic reasons for a controlling shareholder to execute a freeze-out procedure. For listed companies, the freeze-out is a way to delist the company from a stock exchange.[6] A freeze-out, then, is the inverse of going public. Such a "going private" transaction can be desirable if the cost-benefit analysis that motivated the earlier decision to go public is no longer viable.[7]

A common reason for going private is the perception that the market price of the exchange-traded securities does not reflect the real value of the issuing corporation. In that case, going private can be desirable for the controller who thinks she is able to extract a hidden value from the corporation, and the minority shareholders who could expect to be paid a premium over the current market price for their shares.[8] The reduction of the cost of compliance with securities laws and regulations may be another reason for a delisting, which appears, however, to be more prevalent in the U.S. than in Germany.[9]

While the aforementioned considerations are mostly limited to listed corporations, there is also a more general reason that justifies freeze-outs, which is also valid for unlisted companies. The protection rights of minority shareholders are quite costly to the corporation. Shareholders have the right to participate at the general meetings of the corporation and they have certain rights of information and of access to the books of the company. These costs remain essentially the same, even if the proportion of minority shareholders diminishes greatly.[10] Also, the board of directors has a variety of fiduciary duties towards minority shareholders, particularly in cases of self-dealing transactions involving the controlling shareholder. These costs can be avoided by freezing out the minority shareholders.

[6] A delisting is generally also possible without a freeze-out, but freeze-outs are a convenient way to achieve a delisting. The reduction of the number of shareholders to one means that no regular exchange trade is possible anymore, so that the admission to the securities exchange is void or will be revoked, depending on the regulations of the respective stock exchange. In Germany, such a measure which leads to the loss of the stock exchange admission is called "cold" delisting. FLEISCHER, *supra* note 1, at mn. 33.

[7] *See* Ventoruzzo, *supra* note 1, at 6 (giving a more detailed overview and additional reasons like reducing agency costs and reducing the corporation's tax burden by increasing the debt-to-equity ratio because of the tax deductibility of interest payments).

[8] *Id*.

[9] A reason for that may be the onerous obligations introduced with the Sarbanes-Oxley Act of 2002 in the U.S.

[10] KOMMENTAR ZUM AKTIENGESETZ: AKTG §327(a) mn. 2 (Gerald Spindler & Eberhard Stilz eds., 2d ed. 2010); FLEISCHER, *supra* note 1, at mn. 8.

Another concern for the controller that may lead her to consider a freeze-out is the permanent risk of disruptive legal disputes with minority shareholders. These claims often need to be settled, sometimes even regardless of their merits. The risk of illegitimate shareholder suits is very high both in the U.S. and in Germany.[11] However, the "nuisance value" of such claims is even higher in Germany, as pending shareholder lawsuits can effectively block the execution of structural changes of the corporation, such as mergers or capital increases.[12]

Finally, in Germany, the freeze-out rules are seen as the necessary counterpart to the mandatory tender offer under Sec. 35 of the German Securities Acquisition and Takeover Act (Wertpapiererwerbs- und Übernahmegesetz—"WpÜG"), pursuant to which an acquirer must offer to buy all shares that are tendered if she acquires more than 30% of the outstanding share capital and voting rights.[13] As compensation for this potentially onerous duty, the acquirer shall be enabled to effectively become the sole owner of the acquisition target.[14]

This very brief discussion of the reasons for freeze-out transactions shows that the institution as such can increase social welfare, and is therefore an important and legitimate component of the toolkit of corporate structural measures. Every freeze-out, however, occurs in the zone of tension between the controlling shareholder's interest to maximize the efficiency of her investment, and the minority shareholder's interest to receive full compensation for the loss of their shares, which embody the right to a share in all future earnings of the issuer.

The problem is that every freeze-out is by its nature a highly conflicted transaction, as the controller determines the conditions of the freeze-out, and most importantly, the timing of the freeze-out and the price per share. Capital markets are highly volatile. Among other factors, there is hence the risk that the controller may use market timing to cash out the minority at a time when the market irrationally undervalues the target shares. Therefore, the bone of contention is almost invariably the question of whether the controller has offered a fair price for the minority shares.

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[11] While in U.S. law *derivative* lawsuits are prone to be abused to extract exorbitant legal fees, in Germany *direct* shareholder claims tend to be used illegitimately.

[12] *See infra* Part E.V.1.

[13] The mandatory bid rule is required by Art. 5(1) of the European Takeover Directive and therefore exists in all EU jurisdictions. However, the applicable threshold was left to be determined by the Member States.

[14] DEUTSCHER BUNDESTAG: DRUCKSACHEN UND PROTOKOLLE [BT] Begr RegE WpÜG, 14/7034, S. 32 (Ger.).

C. History and Development of Freeze-Outs in Delaware

I. Early Developments

Until the first half of the 20th century, the minority shareholder's property interest allowed them to thwart the efforts of controlling shareholders to freeze the minority out; they had the right to continue as shareholders of the acquiring entity.[15] In the 1950s, Delaware adopted a cash-out merger statute[16] after Florida had pioneered this type of statute in the mid-1920s. In a statutory merger freeze-out, the controller establishes a wholly-owned subsidiary of the controlled corporation. The target board, usually dominated by the controller, approves the merger and the shareholders of the target— *i.e.* the board of the controlling entity—approve the transaction. The target shareholders receive either cash or the controller's stock in exchange for their shares in the target.

As of *Singer v. Magnavox*,[17] Delaware courts established that self-dealing transactions of a controlling shareholder, such as cash-out mergers, would be subject to a judicial "entire fairness" review. During the stock market depression of the early 1970s, the level of freeze-out activity increased, which sparked concerns that the controlling shareholders were taking advantage of the low market prices to the detriment of the minority shareholders.[18] The SEC responded to these concerns with the enactment of Rule 13e-3 in 1979, which requires the controller to make various disclosures in relation to the freeze-out transaction to enable minority shareholders to make an informed decision about how to respond to the freeze-out.[19]

II. The Introduction of Procedural Safeguards in Statutory Freeze-Outs

Beginning in the 1980s with *Weinberger v. UOP*,[20] the Delaware courts started to shape procedural safeguards for the decision-making process regarding the freeze-out consideration, which, if observed, would relieve the transaction from entire fairness review. In *Weinberger*, the minority shareholders of UOP were frozen out by its 50.5% shareholder Signal Companies. The decisive fact in the case was that two directors served on the boards of both UOP and Signal and withheld an important feasibility study on the merger

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[15] This paragraph draws heavily on Subramanian, *supra* note 1, at 3.

[16] DEL. CODE ANN. tit. 8 , § 251 (2012).

[17] Singer v. Magnavox, 380 A.2d 969 (Del. 1977).

[18] Subramanian, *supra* note 1, at 3.

[19] *Id.* at 4.

[20] Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

from their fellow directors and the shareholders of UOP. Furthermore, "the entire transaction was presented to and approved by UOP's board within four business days."[21] The Delaware Supreme Court concluded that the freeze-out process was deficient in many ways which amounted to a breach of fiduciary duty by the defendant directors, and subjected the case to the court's entire fairness review.

The *Weinberger* court clarified that entire fairness consists of both fair dealing and a fair price and, in a now famous footnote, introduced the idea that the entire fair dealing element could be met by showing that the contending parties had bargained the terms of the freeze-out at arm's length.[22] This led legal practitioners to set up a Special Committee comprised of independent directors in freeze-out transactions, which would negotiate the terms of the freeze-out on behalf of the minority shareholders. These Special Committees get independent advice from investment bankers and outside legal counsel to enable them to negotiate with the acquirer at eye level. This new practice was viewed skeptically by many academics,[23] as it is questionable whether independent directors can ever be truly independent of a controlling shareholder. Even where no legal ties between director and controlling shareholder exist, there is always the possibility of informal influence by the controller[24] or social pressure by the inside directors.[25] These concerns culminated in the question of what deference courts should afford a freeze-out that was approved by a Special Committee of independent directors, or, put differently, how strict should the standard of judicial review of such a transaction be? The two competing views in the judiciary were either a restriction to business judgment review,[26] or a shifting of the burden of proof that the transaction was not entirely fair from the defendant to the plaintiff.[27]

In *Kahn v. Lynch*,[28] the minority shareholders of Lynch Communications were frozen out by Alcatel. The Lynch board of directors had established a Special Committee of independent directors to negotiate the deal. Alcatel initially offered $14 per share and the Special

[21] *Id*. at 711.

[22] *Id*. at 709 n. 7.

[23] Subramanian, *supra* note 1, at 7.

[24] *In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 436 (Del. Ch. 2002).

[25] *See* Kahn v. Tremont, 694 A.2d 422, 428 (Del. 1997); William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. L.J. 1287, 1308 (2001).

[26] *Cf. In re* Trans World Airlines, Inc. S'holders Litig., CIV. A. No. 9844, 1988 WL 111271 (Del.Ch. 1988) (unpublished decision).

[27] Citron v. E. I. Du Pont de Nemours & Co., 584 A.2d 490 (Del. Ch. 1990); Rabkin v. Olin Corp., 1990 WL 47648 (Del. Ch. 1990) (unpublished decision).

[28] Kahn v. Lynch, 638 A.2d 1110 (Del. 1994).

Committee requested $17 per share. Finally, the Special Committee recommended, and the board endorsed, a price of $15.50 per share after Alcatel had threatened to initiate a hostile tender offer for a lower price. The court held that the Special Committee was not truly independent because it did not have the power to say "no" in the face of Alcatel's threat and remanded the case for entire fairness review with the burden on the defendant. The *Kahn* court also implicitly decided that the establishment of a Special Committee only reverses the burden of proof for the entire fairness review and does not reduce the standard of judicial review to business judgment.[29]

A second way to remedy the conflictedness of the share price negotiation is to get approval by a majority of the minority shareholders (*MOM approval*). The underlying logic of this approach is that the minority shareholders are acting on their own behalf (there is no principal-agent conflict), and therefore the approval of a majority of the affected shareholders should serve as an indication of an arm's length negotiation. After *Weinberger*, it was unclear if Special Committee negotiation and MOM approval would both need to be fulfilled to establish fair dealing, but the *Kahn* court clarified that either requirement would suffice. In *Rosenblatt v. Getty Oil Company*,[30] the deal was approved by a 58% majority of the 89% of minority shares that were voted. As in *Kahn*, the court decided that MOM approval would reverse the burden of showing the (lack of) entire fairness to the plaintiffs, but it did not defer to business judgment review.

As Guhan Subramanian notes, there is no incentive for the controlling shareholders to establish a Special Committee and subject the freeze-out to a MOM approval,[31] as the combination of both measures does not yield any additional benefit to them.[32]

III. The Tender Offer Freeze-Outs

In response to the high standard of review exemplified by *Weinberger*, beginning in the 1990s the statutory merger was complemented by a novel freeze-out technique: The two-

[29] Although the standard of review formally remains the same, it is noted by Rock, Davies, Kanda, and Kraakman that the standard as applied seems to be more lenient. *See* Edward Rock, Paul Davies, Hideki Kanda & Reinier Kraakman, *Fundamental Changes*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 183, 204 (Reinier Kraakman et al. eds., 2d ed. 2009).

[30] Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985).

[31] Subramanian does not mention that there is the benefit of marginally stronger transactional security: in case a court would find either one of the procedural safeguards deficient to reverse the burden of the fairness review, there would still be the other safeguard.

[32] In *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604 (Del Ch. 2005), Chancellor Leo Strine apparently reacted to Subramanian's concern with the proposal (*obiter dictum*) to defer to business judgment review if both an independent Special Committee and MOM approval were established, as was already proposed in Subramanian's paper. *See* Subramanian, *supra* note 1, at 55.

step freeze-out tender offer. Using this route, the controlling shareholder would first make a tender offer for all of the minority shares, usually conditioned on a tender that gets at least 90% of the total amount of voting shares. Next, the controller would effect a short-form merger pursuant to DGCL Sec. 253, which does not require a shareholder vote, in order to eliminate the remaining (non-tendering) shareholders.[33]

This technique became attractive after the Delaware Supreme Court held in *Solomon*[34] that a tender offer by a controlling shareholder to the minority (without freeze-out) was not subject to entire fairness control. This was contrary to the then common understanding that such a tender offer is an interested transaction. This view emphasizes the fact the board of directors of the target company negotiates the terms of the offer with the controlling shareholder.[35] The court, however, saw no conflict of interest, reasoning that the parties to the tender offer are the controller and the minority shareholders.[36] In other words, the minority shareholders cannot be forced to agree to the deal.

In *Siliconix*,[37] the Court rejected the application of the entire fairness review on the front-end tender offer of the two-step freeze-out in the absence of disclosure violations or a coercive offer. Shortly thereafter, the Court rendered judgment on the back-end short-form merger in a freeze-out transaction in *Glassman*,[38] where it also declined to apply an entire fairness review, noting that appraisal is the appropriate remedy for minority shareholders objecting to short-form mergers. The overarching policy argument for this lax standard of review was the *ratio legis* of DGCL Sec. 253: To provide a streamlined process for accomplishing a merger, which would be undermined if too many procedural safeguards were required.[39]

In the final case of interest for this analysis, *In re Pure Resources, Shareholders Litigation*,[40] Unocal, the controlling shareholder of Pure, launched a share-for-share tender offer on the common stock of its subsidiary, conditioned on reaching the 90% threshold necessary for the short-form merger. Unocal stated that it would proceed to the merger as soon as possible after completion of the tender offer, at the same exchange ratio as the front-end

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[33] Subramanian, *supra* note 1, at 11.

[34] Solomon v. Pathe Commc'ns, 672 A.2d 35 (Del. 1996).

[35] Ventoruzzo, *supra* note 1, at 26.

[36] Subramanian, *supra* note 1, at 12.

[37] *In re* Siliconix Inc. S'holders Litig., No. CIV. A. 18700, 2001 WL 716787 (Del. Ch. 2001) (unpublished decision).

[38] Glassman v. Unocal Exploration Corp., 777 A.2d 242 (Del. 2001).

[39] *Id*. at 247.

[40] *In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421 (Del. Ch. 2002).

offer. The Special Committee instituted by Pure briefly considered the implementation of a *poison pill* to increase its bargaining power but ultimately only recommended the minority shareholders not to tender their shares. The plaintiffs filed a class action lawsuit and sought to enjoin the transaction based on entire fairness review.

The court declined to apply the entire fairness review but apparently attempted to close the gap between statutory merger and tender offer freeze-outs with the introduction of an additional requirement for the entire fairness review to be rejected. The tender offer shall not be coercive to the minority shareholders. Specifically, Vice Chancellor Leo Strine established three procedural conditions that must be met in order to defer to business judgment review: (1) the offer must be subject to a non-waivable condition of MOM approval; (2) the bidder must guarantee to promptly consummate a short-form merger at the same conditions as the tender offer regarding exchange ratio and/or share price; (3) and the bidder must make no "retributive threats" in dealing with the Special Committee.[41]

Strine's efforts to introduce additional procedural requirements for tender offer freeze-outs have been aimed to remedy the fact that, in the tender offer situation, the minority shareholders lack a genuine bargaining agent. Whereas in the *Weinberger* line of cases, the Special Committee has the power to say "no," the Special Committee in a tender offer situation only has the duty to make a recommendation to the shareholders. *Pure* therefore aims to increase the Special Committee's bargaining power by setting out the framework for a fair bargaining procedure, and requiring robust engagement of the Special Committee instead of passivity. This leveling of the playing field shall serve to prevent the controller from making low-ball offers to the minority.[42]

IV. Practical Consequences

It was noted, however, that these conditions were already met in most tender offer freeze-outs even before *Pure* was decided, and that they would thus have little practical impact.[43] The unequal treatment of statutory merger freeze-outs and tender offer freeze-outs has been widely debated, and many proposals on how to reconcile these apparently conflicting approaches to freeze-outs have been discussed. According to Subramanian,[44] one line of authors champions an equal treatment of both situations ("convergence up") through

[41] *Id*. at 445.

[42] Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Shareholders*, 152 U. PA. L. REV. 785, 799 n.47 (2003).

[43] Christopher A. Iacono, Comment, *Tender Offers and Short-Form Mergers by Controlling Shareholders Under Delaware Law: The "800-Pound Gorilla" Continues Unimpeded—In re* Pure Resources, Inc., Shareholders Litigation, 28 DEL. J. CORP. L. 645, 668 (2003); Subramanian, *supra* note 1, at 51.

[44] Subramanian, *supra* note 2, at 16–23.

(re)introduction of entire fairness review for tender offer freeze-outs.[45] Another group of commentators defends the status quo,[46] while a third one suggests mixed approaches.[47] This article is not the place to delve into this debate. For the purposes of this analysis it shall be sufficient to note a few points.

The Special Committee has significantly less bargaining power in a tender offer freeze-out than in a merger freeze-out. In the latter, the Special Committee can effectively veto the transaction, whereas in the former, the Special Committee serves only to make a recommendation to the minority shareholders within ten days of the initiation of the tender offer and in accordance with Schedule 14D-9. Subramanian has found in an empirical study that, as a consequence, the share premiums in merger freeze-outs have been higher than in tender offer freeze-outs.[48] The study also found that in the period between 19 June 2001 (announcement of *Siliconix*) and 31 December 2003, there had been 96 freeze-outs of listed Delaware corporations. The percentage of tender offer freeze-outs increased from 6% pre-*Siliconix* to 28% post-*Siliconix*.[49] The answer to the obvious question of why controlling shareholders did not (yet?) prefer the two-step freeze-out after Siliconix remains somewhat unclear, but may be explained by path dependency and lesser experience of legal practitioners with the two-step procedure.[50] There is, however, contrasting empirical evidence offered by Bates et al. which renders Subramanian's findings inconclusive on the hypothesis that minority shareholders get lower payments in tender offer freeze-outs.[51]

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[45] Kimble Charles Cannon, *Augmenting the Duties of Directors to Protect Minority Shareholders in the Context of Going-Private Transactions: The Case for Obligating Directors to Express a Valuation Opinion in Unilateral Tender Offers After Siliconix, Aquila, and Pure Resources*, 2003 COLUM. BUS. L. REV. 191 (2003); Ely R. Levy, *Freeze-Out Transactions the Pure Way: Reconciling Judicial Asymmetry Between Tender Offers and Negotiated Mergers*, 106 W. VA. L. REV. 305 (2004); Brian M. Resnick, Note, *Recent Delaware Decisions May Prove to Be "Entirely Unfair" to Minority Shareholders in Parent Merger with Partially Owned Subsidiary*, 2003 COLUM. BUS. L. REV. 253 (2003).

[46] Jon E. Abramczyk et al., *Going-Private Dilemma? Not in Delaware*, 58 BUS. L.J. 1351 (2003); Thomas M. McElroy, II, Note, In re Pure Resources*: Providing Certainty to Attorney Structuring Going-Private Transactions, or Not?*, 39 WAKE FOREST L. REV. 539 (2004).

[47] Gilson & Gordon, *supra* note 42; Subramanian, *supra* note 1.

[48] Subramanian, *supra* note 1.

[49] Subramanian, *supra* note 1, at 15.

[50] Subramanian, *supra* note 1, at 10.

[51] Thomas W. Bates et al., *Shareholder Wealth Effects and Bid Negotiation in Freeze-Out Deals: Are Minority Shareholders Left Out in the Cold?* 81 J. FIN. ECON. 707 (2006). Bates et al. observe that "on average, minority claimants in freeze-out bids actually receive approximately 11% more than their pro-rata share of deal surplus generated at the bid announcement, an excess distribution of roughly $6.1 million. These results are inconsistent with the notion that controlling shareholders systematically undertake freeze-out transactions at the expense of the minority claimants of the target firm."

V. Brief Summary of Case Law and Conclusion

Freeze-out transactions in Delaware can be achieved by either statutory merger or front-end tender offer with subsequent back-end short-form merger. In contrast to the German system (discussed *infra*), there are no specific shareholding thresholds which the controlling shareholder must meet before a freeze-out can be executed. For a statutory freeze-out, a shareholder needs only as many voting shares to win the requisite shareholder vote by simple majority pursuant to DGCL Sec. 251 (which is the very definition of a controlling shareholder);[52] the controlling shareholding can thus be as little as 35%.[53] In case of a tender offer freeze-out, the controlling shareholder does not need to have any shares before the launch of the tender offer. Here, the relevant threshold is that the controller needs to own 90% of all outstanding shares after consummation of the tender offer in order to meet the threshold for application of the short-form merger statute.

Delaware law does not provide for any specific procedural safeguards to protect the interests of minority shareholders during the freeze-out.[54] The protective framework has been developed by the judiciary on the premise that freeze-outs are self-dealing transactions because the controlling shareholder has the power to influence the board of directors, which negotiates the purchase price of the shares on behalf of the minority shareholders (in case of a statutory merger freeze-out). Shareholders can therefore bring claims against directors based on breach of a fiduciary duty when they think the negotiating process or the negotiated share price was not fair. The Delaware courts will scrutinize the entire fairness of the transaction with the burden on the defendant, unless (1) a Special Committee comprised of truly independent directors with the power to say "no" had been established which negotiated the deal on behalf of the board; or (2) if the deal was sanctioned by a majority of the minority shareholders, in which cases the burden will be on the plaintiffs to show that the transaction was not entirely fair. The rationale for these two exceptions is that they approximate the conflicted transaction to an arm's length transaction, either because an (at least formally) independent actor negotiated the deal, or because the conflicted transaction was put to a market test by way of the minority shareholder approval.

The rendering of the *Siliconix/Glassman* judgments marked the advent of the two-step tender offer freeze-outs. The Delaware courts did away with entire fairness review in

[52] At least in the absence of other control measures like influence on board members, shareholder agreements or special charter rights.

[53] *See, e.g.*, *In re* Cysive, Inc. S'holders Litig., 836 A.2d 531 (Del. Ch. 2003) (finding a 35% stockholder to be a controller).

[54] *See* Subramanian, *supra* note 1, at 48 n.226 (noting that the so-called "freeze-out statute," Del. Code Ann. tit. 8, § 203 (2007), is "generally not applicable to most 'real' freeze-outs").

tender offers, applying the deferential business judgment review and decided that the ratio of the short-form merger—providing a streamlined process for parent-subsidiary mergers—excluded entire fairness review of its terms. *Pure* confirmed this new doctrine and marginally increased the minority protection in two-step freeze-outs by requiring that the transaction may not be coercive.

The Delaware freeze-out regime therefore relies on an *ex post* court review that is regularly initiated by a class action of minority shareholders, based on breach of fiduciary duty by either the board of directors, or the Special Committee which negotiated the deal with the controlling shareholder. These procedural safeguards to protect the minority shareholders in Delaware were entirely evolved in the courtroom. It has been suggested that this fact may facilitate the development of management-friendly rules, because "case-law precedents are relatively free from interest group influence," and management is in a good position to control which litigation will be decided by the courts.[55]

VI. The Appraisal Remedy

In cases where entire fairness review is not available (such as in tender offer freeze-outs) the minority's only remedy is appraisal pursuant to DGCL Sec. 262. *Prima facie*, one might think that the appraisal remedy is actually more beneficial to the plaintiff than a breach of fiduciary duty claim, as the former does not require the showing of such a breach.[56] The appraisal remedy, however, is a less capable remedy for several reasons. First, "appraisal is not available to minority shareholders in the approximately 20% of tender-offer freeze-outs that involve stock consideration"[57] because of the "market-out" exception.[58] Second, unlike an appraisal, a fiduciary duty action can be brought before the effectuation of the merger and may result in a preliminary injunction, which potentially increases the plaintiff's bargaining power in settlement negotiations.[59] Third, fiduciary claims can be and mostly are brought as class actions, in which the legal fees are mostly paid from the settlement or the target company.[60] Lastly and most importantly, whereas the class in a fiduciary claim can consist of all public shareholders of the corporation,[61] the appraisal can only be

[55] Paul Davies and Klaus Hopt, *Control Transactions*, THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 232 (Reiner Kraakman et al. eds., 2d ed. 2009).

[56] WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 496 (3d ed. 2009).

[57] *See* Subramanian, *supra* note 1, at 24 n.133.

[58] DEL. CODE ANN. tit. 8, § 262(b)(2) (2010).

[59] ALLEN, KRAAKMAN & SUBRAMANIAN, *supra* note 56.

[60] *Id.;* Subramanian, *supra* note 1, at 24 n.135.

[61] ALLEN, KRAAKMAN & SUBRAMANIAN, *supra* note 56; SUBRAMANIAN, *supra* note 1, at 24 n.136.

pursued by shareholders who contested the cash-out.[62] The appraisal remedy, therefore, is considered to be "notoriously weak"[63] among scholars and practitioners. Consequently, minority shareholders seldom initiate appraisal proceedings.[64]

From a more doctrinal perspective, it should be noted that appraisal rights were originally introduced by the state legislatures between 1900 and the 1950s in response to the fact that mergers which initially required unanimous consent by all shareholders were now possible with approval of a simple or qualified majority of shareholders.[65] The purpose, therefore, was to give dissenting shareholders in arms-length mergers a possibility to leave the company at a fair price when the capital markets were not yet as well developed as today ("liquidity purpose").[66] The appraisal statute was never designed for self-dealing situations like a cash-out by a controlling shareholder, and as such, it is not a very effective remedy in this respect.

D. History and Development of the Legal Framework for Squeeze-Outs in Germany

The squeeze-out rules in Germany are fairly young. They came into force at the beginning of 2002 through an amendment of Sec. 327a–327f of the German Stock Corporation Act (Aktiengesetz—"AktG").[67] Before that, there was no direct way for controlling shareholders to freeze out the minority. The German Transformation Act (Umwandlungsgesetz) of 1934, however, had introduced a so-called "transferring conversion," through which the controlling shareholder, if she owned at least 90% (later reduced to 75%) of the share capital of the subsidiary, could transfer all assets of the subsidiary company into another entity and thereby freeze out minority shareholders against their will.[68] But this measure had been abolished in 1994[69] because the exclusion of minority shareholders against their will was considered to be contrary to the

[62] DEL. CODE ANN. tit. 8, § 262(d)(1) (2010).

[63] SUBRAMANIAN, *supra* note 1, at 24 n.137.

[64] *Id*.

[65] Ventoruzzo, *supra* note 1, at 11–13 nn.29–30, 34–35.

[66] *See id.* at 13 (noting that this term was coined by Robert B. Thompson).

[67] Gesetz zur Regelung von öffentlichen Angeboten zum Erwerb von Wertpapieren und Unternehmensübernahmen [The amendment was introduced by the Act on the Regulation of Company Acquisitions and Public Offers to Purchase Securities], Dec. 20, 2001, BGBL. I at 3822 (Ger.).

[68] KRISTIAN STANGE, ZWANGSAUSSCHLUSS VON MINDERHEITSAKTIONÄREN (SQUEEZE-OUT) 30 (2010).

[69] Gesetz zur Bereinigung des Umwandlungsrechts [UmwBerG] [Law to Clean up the Transformation Law], Nov. 11, 1994, BGBL. I at 3210, as amended by Gesetz [G], Jan. 1, 1995, BGBL. I at 428 (Ger.).

government's aims of minority protection.[70] Since then, business lobbyists pointed out that a squeeze-out procedure is necessary.[71] Between 1994 and the implementation of the squeeze-out rules in 2002, the controlling shareholder could initiate one of several structural transactions which could indirectly lead to the exclusion of minority shareholders, such as a reverse stock split or a sale of all assets, but these transactions were onerous, might have had unwanted implications, and because of the lack of clear rules, there was generally some uncertainty about the level of minority protection in these transactions.[72]

Until the introduction of the squeeze-out rules, the most relevant of these measures was the "transferring conversion" (übertragende Auflösung),[73] by which a company sells and transfers all of its assets to the controlling shareholder or a subsidiary of the controlling shareholder and is subsequently dissolved and liquidated. This procedure requires shareholder resolutions with a 75% majority of the share capital of the company[74] and has been confirmed as a valid way to exclude minority shareholders, provided that a "full economic compensation" of the excluded minority is ensured and legally enforceable.[75] The transferring conversion, however, entails several disadvantages which render it undesirable in many cases. First, it can lead to the disclosure of hidden reserves with detrimental tax effects. Second, the asset transfer is a complex and laborious exercise and the following liquidation may take up to several years. Finally, the shareholder resolution to sell and transfer all assets of the company can be enjoined on the grounds that the consideration is not adequate (fair market value).[76]

[70] DEUTSCHER BUNDESTAG: DRUCKSACHEN UND PROTOKOLLE [BT] Begründung zum Regierungsentwurf [Legislator's Explanatory Notes], 12/6699, 114 at 144 (Ger.).

[71] Eberhard Vetter, *Squeeze-Out in Deutschland*, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 1817, 1818 (2000).

[72] *Cf.* FLEISCHER, *supra* note 1, § 327(a)–(f) n.34, n. 39 (providing a detailed account of the direct and indirect possibilities to exclude shareholders).

[73] Also known as "sale of assets squeeze-out" or "Moto Meter method."

[74] *See* Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at §§ 179(a), 262(1) no. 2 (Ger.).

[75] Bundesverfassungsgericht [BVerfG - Federal Constitutional Court], Case Nos. 1 BvR 68/95, 1 BvR 147/97, Aug. 23, 2000, 2001 NEUE JURISTISCHE WOCHENSCHRIFT (NJW) 279 (2001) (Ger.).

[76] Bayerisches Oberstes Landesgericht [BayObLGZ - Bavarian Higher Regional Court] Case No. 3Z BR 37/98, Sept. 17, 1998, 1998 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 2002 (1998) (Ger.); Oberlandesgericht Stuttgart [OLG - Higher Regional Court], Case No. 8 W 43/93, Dec. 4, 1996, 1997 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 362 (1997) (Ger.). The arguably more suitable appraisal procedure is not applied by the courts.

Hence, the introduction of the squeeze-out rules in 2002 was welcomed by many practitioners and academics. The enactment of the European Takeover Directive[77] required Germany to allow for a specific squeeze-out procedure following a tender offer.[78] Instead of adjusting the general squeeze-out procedure to the requirements of this directive, the German legislature decided to leave the general squeeze-out rules untouched and to introduce a second squeeze-out regime which applies following a tender offer ("Takeover Squeeze-Out") pursuant to Sec. 39a and 39b WPüG. The Takeover Squeeze-Out aims to allow for a more expedient and cheaper way to exclude the residual shareholders.

E. The General Squeeze-Out Mechanism in Germany

I. General Procedure

In the following, I will set out the particular requirements and steps that need to be fulfilled to achieve a squeeze-out pursuant to Sec. 327a–f AktG.

1. Supermajority of Share Capital

The squeeze out procedure is available to all shareholders holding 95% or more of the share capital and can be initiated by the controlling shareholder through a shareholder resolution at a general meeting (Sec. 327a(1) AktG). The shareholdings of controlled subsidiaries in the target are attributed to the controlling shareholder in calculation of the 95% threshold (Sec. 327a(2), 16(2) and (4) AktG), so the top company of a group of companies does not need to hold all shares itself in order to reach the threshold.

Recently, the German Federal Court in Civil Matters (Bundesgerichtshof—"BGH") has also heard and condoned a case in which the controlling shareholder originally only owned 63% of the outstanding shares and later acquired an additional 33% of shares through a securities loan.[79] According to German law, a securities "loan" entails a transfer of title, but the lessor has the right to the transfer of title in stock of the same kind after termination of the loan agreement. In the case at hand, the loan was not to be terminated before the passage of three years, and the lessor kept her dividend rights. The decision was surprising and contrary to the views of many scholars, which had argued until then

[77] *See* Council Directive, *supra* note 1 and accompanying text; Council Directive 04/25, art. 21, 2004 O.J. (L 142) 12, 23 (EC) (providing that, per Art. 21, the Directive was to be transposed into national law no later than 20 May 2006).

[78] The complementary sell-out right pursuant to Wertpapiererwerbs- und Übernahmegesetz [WpÜG] [Securities Acquisition and Takeover Act], Dec. 20, 2001, BGBL. I at 3832 (Ger.); Council Directive 04/25, art. 16, 2004 O.J. (L 142) 12, 23 (EC) and § 39(c) respectively, are beyond the scope of this analysis.

[79] Bundesgerichtshof [BGH - Federal Court of Justice], Case No. II ZR 302/06, Mar. 16, 2009, 180 BGHZ 154, 2009 (Ger.).

that a squeeze-out was abusive and therefore impermissible if the controller acquired stock above the 95% level only in the short term with a view to the squeeze-out.[80] This judgment has significantly eased the burden of the 95% shareholding threshold and appears to allow a controlling shareholder to combine his shareholdings with other block shareholders in order to meet the threshold.

2. Shareholder Resolution

The controlling shareholder has to ask the management board of the corporation to convene a shareholder meeting and propose the squeeze-out.[81] The requirement of a shareholder resolution can be seen as a peculiarity[82] of the German system. After all, what is the purpose of such a resolution if the controller must own a minimum of 95% of the share capital? Consequently, the requirement of a shareholder resolution was criticized heavily from the beginning.[83] The resolution seems to be an empty formality that gives the minority shareholders one last chance to obstruct the controlling shareholder through an action to enjoin the resolution.[84] Consequently, other European jurisdictions like the U.K., France, Italy, or the Netherlands do not require a shareholder resolution.[85]

The requirement of a shareholder resolution, however, is mainly a means to ensure that the minority shareholders get full disclosure about all relevant details of the squeeze-out and therefore serves the same purpose as SEC Rule 13e3. In preparation of the general meeting, the management board of the corporation must provide the shareholders with various information about the squeeze-out. The convocation to the general meeting must include the agenda to the meeting and must be received by the shareholders no later than

[80] *See, e.g.*, HOLGER FLEISCHER, *Das Neue Recht des Squeeze Out,* ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGR) 757, 758 (2002).

[81] *See* Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at 1089, last amended by Gesetz [G], Aug. 24, 2004, BGBL. I at 2198, § 78 (Ger.) (noting that the management board is generally the competent corporate body to summon a shareholder meeting and set the agenda); *cf.* FLEISCHER, *supra* note 1, at § 327(a) n.57.

[82] Christoph Van der Elst & Lientje Van den Steen, *Balancing the Interests of Minority and Majority Shareholders: A Comparative Analysis of Squeeze-Out and Sell-Out Rights*, 6 EUR. CO. & FIN. L. REV. 391, 398 (2009).

[83] *Cf.* HARALD KALLMEYER, *Ausschluß von Minderheitsaktionären*, DIE AKTIENGESELLSCHAFT 59 (2000); Matthias Habersack, *Der Finanzplatz Deutschland und die Rechte der Aktionäre*, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 1230, 1237 (2001); Vetter, *supra* note 71, at 1819; Eberhard Vetter, *Squeeze-Out nur durch Hauptversammlungsbeschluss?*, DER BETRIEB 743 (2001); Maximilian Schiessel, *Ist das deutsche Aktienrecht kapitalmarkttauglich?*, DIE AKTIENGESELLSCHAFT 442, 452 (1999).

[84] These are the actions used by predatory shareholders as illustrated below. See *infra* text accompanying note 102.

[85] *Cf.* Christoph Van der Elst & Lientje Van den Steen, *supra* note 82; FLEISCHER, *supra* note 1, § 327(a) n.64.

21 days before the meeting (Sec. 120 AktG). The agenda must already include the amount of cash compensation as determined by the controller (Sec. 327c(1) AktG).

The controller must make numerous documents pertaining to the squeeze-out available to the minority shareholders for inspection, among them the annual financial statements for the three previous financial years, a written report by the controller, and an audit report[86] (Sec. 327c(4) AktG). All these requirements aim to ensure that the minority shareholders can make an informed decision and that the squeeze-out can be subject to a comprehensive discussion at the general meeting.[87]

Informing the shareholders, however, could also be achieved without shareholder resolution. It appears that the requirement of a shareholder resolution is in the tradition of the procedure for other structural measures, but in cases involving squeeze-outs, it is just a superfluous formality.

3. Written Report and Auditor's Report

The adequacy of the cash compensation shall be ensured *ex ante* (before the squeeze-out takes legal effect) by two means: A written report of the controlling shareholder and a report of an independent auditor regarding the adequacy of the cash compensation (Sec. 327c(2) AktG), which in practice will often be one of the Big Four auditing firms.

Particularly the auditor's report appears to be another peculiarity of the German system.[88] The auditor is appointed by a court, although the controlling shareholder can make suggestions which will often be heeded by the court in practice.[89] The auditor has the duty to execute an impartial audit of the cash compensation offered by the controlling shareholder and to render a written report.

The rationale of the independent audit is threefold: It aims to (1) protect the interests of the minority shareholders; (2) increase their willingness to accept the cash compensation and thus reduce the number of claims against the valuation; and (3) facilitate subsequent lawsuits.[90] Considering the empirical evidence on the number of lawsuits regarding the valuation it is questionable whether the latter two aims have been achieved, though.[91]

[86] *See infra* Part E.I.3.

[87] *Cf.* FLEISCHER, *supra* note 1, § 327(a) n.65.

[88] Van der Elst & Van den Steen, *supra* note 82, at 430.

[89] The controlling shareholder has a right of appeal if the court does not follow his suggestions pursuant to Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL I at §§ 327(c) ¶ 2, 293(c) ¶ 2 (Ger.).

[90] FLEISCHER, *supra* note 1, § 327(c) n.17.

[91] *See infra* Part E.IV.1–4.

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4. Legal Effect Through Registration in the Commercial Register

The transfer of the minority shares to the controlling shareholder takes legal effect with the registration of the squeeze-out in the commercial register (Sec. 327e(2) AktG). This is not just a mere formality, as the competent register judge has to scrutinize the squeeze-out procedure before registration. This is a formal inspection, so the register judge may not contest the adequacy of the cash compensation.[92]

The registration, however, requires that no lawsuits to enjoin the squeeze-out resolution have been filed (Sec. 327e(2), 319(5) AktG). In principle, the registration is blocked as long as any lawsuits concerning the validity of the squeeze-out procedure are pending. This rule potentially gives minority shareholders the power to block the consummation of the squeeze-out procedure for months or possibly years.[93]

II. Empirical Data on the Practical Application of the General Squeeze-Out

The general squeeze-out procedure has very quickly become popular in Germany. In 2002 alone there already had been more than 100 squeeze outs executed; and this number increased to 289 by May 2007[94] and to 317 by the end of 2007.[95] About 70% of these companies were listed on a stock exchange.[96] The initial surge in squeeze-outs right after its introduction into the German legal system can be attributed mainly to cases in which a shareholder with an overwhelming majority (above 98%) wanted to streamline its holding structure, but did not have the legal means to do so before the enactment of the squeeze-out rules.[97] This process now seems to be mostly completed, shifting the focus of squeeze-outs to those following a control transaction.

However, there are also 27 listed companies which could have been subjected to a squeeze-out for several years—because a controlling shareholder owns more than 95% of their stock—but in which nothing has happened. This may be a sign that controllers have analyzed the costs and benefits of a squeeze-out and concluded that the future efficiency gain does not offset the squeeze-out costs.

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[92] SINGHOF ET AL., *supra* note 10, § 327(e) n.4.

[93] *See infra* Part E.V.1.

[94] SINGHOF ET AL., *supra* note 10, § 327(a) n.4.

[95] STANGE, *supra* note 68, at 279. The following empirical data is taken from Stange unless otherwise indicated.

[96] SINGHOF ET AL., *supra* note 10, § 327(a) n.4.

[97] *Id*.

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141 of 260 (54%) of the general squeeze-out transactions have become legally effective through registration with the commercial register within three months, while the average time for registration was five months. However, a significant number of squeeze-outs (57 of 317 (18%) squeeze-outs in Stange's analysis) have not been registered yet (presumably because of actions to enjoin the squeeze-out).

137 of the 317 (43%) companies were not listed on any stock exchange. This shows that a demand for squeeze-outs also exists for non-listed companies. Out of the 180 listed companies that were subject to a squeeze-out, 62 (34%) had been involved in a tender offer beforehand.[98] The average time between the tender offer and the squeeze-out was 17.3 months.

III. Constitutionality Issue: Property Right Infringement?

The introduction of the squeeze-out regime was accompanied by many comments which voiced concerns about its constitutionality in light of the protection of property pursuant to Art. 14 of the German Basic Law (Grundgesetz—"GG"). Almost all lawsuits to enjoin specific squeeze-outs in the first years claimed the unconstitutionality of the measure.[99] According to the German Constitutional Court (Bundesverfassungsgericht—"BVerfG"), Art. 14 GG protects the economic rights and corporate membership rights of the shareholders.[100] That means that the BVerfG considers share ownership to be real property and not just a capitalized stream of income. Nevertheless, the BVerfG has ruled as early as 1962 that the limitation of the property right of minority shareholders (through the squeeze-out regime, for example) is justified by a legitimate interest to provide entrepreneurial freedom to investors, provided that the minority shareholders are adequately compensated. The court emphasized that the adequate compensation must be effectively protected. The squeeze-out regime provides several safeguards to ensure an adequate compensation of the minority[101]: (1) the cash consideration is scrutinized by a court-appointed auditor; (2) the controlling shareholder has to procure a bank guarantee to secure the claims of the shareholders to be excluded (Sec. 327b(3) AktG); and (3) the minority shareholders can file a claim to enjoin the squeeze-out or initiate an appraisal procedure. Drawing on its reasoning in earlier cases, the BVerfG explicitly declared the

[98] *Id*. This number rises to 50% for the squeeze-outs conducted in the years 2004–2007. This rise can be explained by the fact that 2002 and 2003 a lot of companies with an over 95% shareholder took the opportunity to simplify their shareholder structure.

[99] MARTIN WEBER, *Die Entwicklung des Kapitalmarktrechts im Jahre 2006*, NEUE JURISTISCHE WOCHENSCHRIFT (NJW) 3685, 3693 (2006).

[100] Bundesverfassungsgericht [BverfG - Federal Constitutional Court], Case No. 1 BvL 16/60, Sept. 7, 2011, 14 BVERFGE 263 (Ger.).

[101] STANGE, *supra* note 68, at 84.

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squeeze-out regime to be constitutional in 2007.[102] The court emphasized that the three essential prerequisites for constitutionality were fulfilled, namely an adequate compensation of the minority shareholders, effective legal remedies, and a legitimate interest in the exclusion of the minority shareholders. Regarding this latter point, the court pointed out that controlling shareholders generally can have an interest in a squeeze-out to avoid the administrative costs a minority creates. This is because, in particular, since the 1980s, the number of lawsuits from predatory shareholders[103] with minimal share amounts which try to block structural corporate decisions to create a hold-out situation—which thereby increases their settlement value—has increased. The court finally also argued the required quorum of 95% ensures that only shareholders who have no realistic possibility of influencing the firm management get excluded, or in other words, only shareholders with a purely financial interest and not a strategic interest.

According to this reasoning it is unclear whether the BVerfG would still consider a squeeze-out to be constitutional if the required quorum were reduced to a number below 90%.[104]

IV. The "Adequate Compensation": How to Evaluate the Minority Shares

The squeezed-out shareholders have a right to "adequate compensation" (Sec. 327a(1)(1) AktG). That means that the controlling shareholder has to evaluate the company and explain the evaluation in the required written report to the shareholders. In practice, the evaluation is done through advice similar to a "fairness opinion,"[105] which is rendered by an

[102] Bundesverfassungsgericht [BverfG - Federal Constitutional Court], Case No. 1 BvR 390/04, May. 30, 2007, 11 BVERFGK 253(Ger.).

[103] "Predatory" or "professional" shareholders are those who own only a minimal amount of shares (often as little as one share) and then use lawsuits to enjoin important corporate structural changes to induce the company to "buy out" their claims at a settlement value that reflects their "hold-out" or "nuisance" potential and not any actual damages to the shareholder.

[104] A 90% quorum is sanctioned by the Takeover Directive and therefore unlikely to be held unconstitutional. See *supra* notes 77–78 and accompanying text.

[105] Fairness opinions and audit reports by an independent expert need to be distinguished in Germany. Fairness opinions are neither required nor regulated by law. They have been introduced into German practice through international M&A transactions with the U.S. (where the practice to use fairness opinions for reasons of legal prudence has been established since the seminal judgment in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)). Their aim is to help the management of a company to ascertain and prove the fairness of a determined price in an M&A transaction or other corporate transaction which requires the determination of a company's value. Managers therefore use fairness opinions "voluntarily" to reduce transaction and liability risks. Audit reports by independent experts, in contrast, are an element of many corporate structural measures (like squeeze-outs, mergers, capital increases by contribution in kind and similar measures) which are required by German law to ascertain a certain adequacy of the price or share exchange ratio offered (a "gatekeeper strategy"). The goals of fairness opinion and independent audit report are therefore not completely congruent. Moreover, the independent auditor must be a professional auditor (bound by professional rules) and is appointed by the court for the specific task. In contrast, the drafters of fairness opinions are not necessarily bound by professional rules and are directly chosen by the company. In practice, fairness opinions are done by investment banks, M&A

external advisor (investment banks or audit companies), although in theory the controller could also do the valuation herself. In contrast to a fairness opinion, the written report is issued by the controlling shareholder, signaling that it is she who is ultimately responsible. An independent expert then audits the compensation offered by the controller in the written report.[106]

Four essential questions remain unanswered by academics: (1) Which valuation methodology is required?; (2) How should the reference period for the pre-squeeze-out stock price be calculated?; (3) Should the valuation be based on the company value or on the value of the specific minority shares?; and (4) Should the minority shareholders be benefitting from the synergies of an expected merger? I will address each of these questions in turn.

1. Valuation Methodology

The law does not provide guidance on the question of how a company is to be valued. Such guidelines, however, have been developed by case law in similar situations where minority shareholders are deprived of their "membership rights."[107] The commonly recognized[108] valuation method is the "Discounted Earnings Method" (Ertragswertmethode),[109] but the Discounted Cash Flow Method ("DCF") is getting ever more prevalent in practice.[110]

In pre-*Weinberger* Delaware, the courts used the *Delaware block* (or *weighted average*) method to determine the fair value of a company for appraisal purposes. This technique entailed a mix of factors including earnings, price/earnings multiples in the industry, asset

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advisors or audit companies. On the use of fairness opinions in Germany, see Klaus Cannivé and Andreas Suerbaum, *Die Fairness Opinion bei Sachkapitalerhöhungen von Aktiengesellschaften: Rechtliche Anforderungen und Ausgestaltung nach IDW S 8*, DIE AKTIENGESELLSCHAFT 317 (2011); Holger Fleischer, *Zur Rechtlichen Bedeutung der Fairness Opinion im Aktien- und Übernahmerecht*, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 201 (2011).

[106] *See supra* Part E.IV.1–4.

[107] Such cases are: Controlling entity executes a domination agreement, a profit transfer agreement, or both, with the target company (Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at §§ 291, 305) or so-called "integration" (this rare measure is different from a merger pursuant to German law) of the target company into the controlling entity (Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at § 320(b)).

[108] *Cf.* Oberlandesgericht Düsseldorf [OLG - Higher Regional Court], Case No. I-26 W 7/06, Apr. 10, 2006, 2219 WM 2222 (2006) (Ger.).

[109] This appears to be a typically German valuation method. It is quite old and still commonly used pursuant to the audit standard IDW S1 set by the German Institute of Accountants (Institut der Wirtschaftsprüfer in Deutschland e.V.). "The standard calculates the net present value of the net profits accrued to the shareholders." Christoph Van der Elst & Lientje Van den Steen, *supra* note 82, at 430 n.101.

[110] *Cf.* FLEISCHER, *supra* note 1, § 327(b) n.13.

values and shares' market prices. The DCF method was considered to be too speculative.[111] In *Weinberger*, the court conceded that the "mechanistic procedure" of the block method had been outdated and thus permitted any methods generally accepted in the financial community, so that DCF soon became the standard valuation technique in appraisal cases.

So the German situation appears to arrive at the situation that was already achieved in Delaware in the 1980s: DCF valuation as the prevalent valuation technique. Whether this is the desired result from the perspective of legal certainty remains unclear. As Allen, Kraakman, and Subramanian pointed out, DCF valuations create "exceptionally wide differences in value,"[112] so the Delaware courts have begun to appoint their own expert witnesses—in addition to the parties' expert witnesses—in appraisal proceedings and actions for entire fairness review.

2. Calculation of the Reference Period

The BVerfG has held in *DAT/Altana*[113] that for listed companies, the stock price provides the floor for the calculation of the adequate compensation, so that the compensation may never be lower than the stock price of the target company during a reference period of three months before the squeeze-out, even if the fairness opinion determined a lower value. The court reasoned that the exiting shareholders must be compensated at least as highly as if they had autonomously decided to divest on the stock market.[114]

The BGH, implementing the parameters outlined by the BVerfG in *DAT/Altana*, ruled that the three-month period had to be casted backward from the day of the general meeting of shareholders which would approve the squeeze-out, since Sec. 327b(1)(1) AktG requires that the compensation shall take into account the condition of the company at the time of the shareholder resolution.[115]

This decision, however, quickly became the target of strong criticism. A general meeting must be announced at least 30 days before the meeting (Sec. 123(1)(1) AktG) and from this date the proposed cash compensation amount must be published (Sec. 327c(3) AktG). As a consequence of the efficiency of capital markets, the stock market will quickly incorporate the information about the proposed compensation payment into the share price.

[111] ALLEN, KRAAKMAN & SUBRAMANIAN, *supra* note 56, at 479.

[112] *Id*. (providing an example where one DCF valuation valued stock at $13 a share and the opposing valuation valued it above $60 a share).

[113] Bundesverfassungsgericht [BverfG - Federal Constitutional Court], Case No. 1 BvR 1613/94, Apr. 27, 1999, 100 BVERFGE 289, 307 (Ger.).

[114] ARNE KIEßLING, DER ÜBERNAHMERECHTLICHE SQUEEZE-OUT GEMÄß §§ 39A, 39B WPÜG 144 (2008).

[115] Bundesgerichtshof [BGH - Federal Court of Justice], Case No. II ZB 15/00, Mar. 12, 2001, 147 BGHZ 108 (Ger.).

Therefore from the date of the announcement the share price does not solely reflect the inherent value of the company anymore, but rather the expected discounted value of the compensation payment. In order to avoid this result it is necessary to cast the reference period backward from the date of the announcement of the squeeze-out. After extensive criticism from academics and many OLGs,[116] the BGH recently reversed its old judgment and decided to calculate the reference period from the date of the announcement of the transaction.[117] Most recently the OLG Frankfurt has further specified that the reference period starts at the time the management speaks publicly about the squeeze-out so that a reasonable person would expect it to happen in the near future.[118] That means the reference period can already start before an official announcement to the shareholders (convocation of general meeting). For example, if the CEO of the controlling shareholder speaks publicly about her intention to acquire 95% of the shares of the subsidiary and conduct a squeeze-out, at that time the capital markets will begin to impound the expectations about the squeeze-out into the market price. Such announcements, however, must be reasonably credible and the execution of the announced measure must be palpable, in order to distinguish relevant announcements from mere market rumors. For listed companies, the relevant announcement will often be the ad hoc disclosure pursuant to sec. 15(1) WpHG.[119]

The recent judgment of the BGH certainly was an important clarification for the appraisal of minority shares. This decision, however, introduced an additional rule for cases in which there is a considerable time-gap[120] between the public announcement of a squeeze-out transaction and the date of the shareholder resolution, during which the stock price

[116] Oberlandesgericht Stuttgart [OLG - Higher Regional Court], Case No. 20 W 6/06, Feb. 16, 2007, 2007 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 682 (2007) (Ger.); Oberlandesgericht Düsseldorf [OLG - Higher Regional Court], Case No. I-26 W 13/06, Sept. 09, 2009, 2009 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 1427 (2009) (Ger.); Oberlandesgericht Stuttgart [OLG - Higher Regional Court], Case No. 20 W 2/08, Dec. 18, 2009, 2009 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 274 (2010) (Ger.).

[117] Bundesgerichtshof [BGH - Federal Court of Justice], Case No. II ZB 18/09, July 19, 2010, 186 BGHZ 229 (Ger.); *cf.* Olaf Müller-Michaels, *BGH Schafft ein Neues Feld für Diskussionen und Streitigkeiten*, *in* BETRIEBS-BERATER 1944 (2010).

[118] Oberlandesgericht Frankfurt [OLG - Higher Regional Court], Case No. 5 W 15/10, Dec. 21, 2010, 2011 ZEITSCHRIFT FÜR DAS GESAMTE FAMILIENRECHT (FAMRZ) 832 (2011) (Ger.).

[119] Hartwin Bungert & Carsten Wettich, *Neues zur Ermittlung des Börsenwerts bei Strukturmaßnahmen*, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 449, 450 (2012).

[120] Even though the court did not define the time-gap further, the case law to date suggests that a time frame of up to six months does not qualify as considerable. *See* cases cited *supra* note 116 (7.5 months considerable); Bundesgerichtshof [BGH - Federal Court of Justice], Case No. II ZB 2/10, June 28, 2011, 2011 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 1708 (2011) (Ger.) (3.5 months not considerable); Oberlandesgericht Stuttgart [OLG - Higher Regional Court Case No. 20 W 3/09, Jan. 19, 2011, 2011 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 382 (2011) (Ger.) (up to 6 months not considerable); Oberlandesgericht Frankfurt a.M. [OLG - Higher Regional Court], Case No. 21 W 13/11, Apr. 29, 2011, 2011 AG 832 (Ger.) (4.5 months not considerable).

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develops further. In such cases, the court requires the calculated average stock price to be adjusted in accordance with the current market trends up to the date of the shareholder resolution. So if the market goes up between the end of the reference period and the date of the shareholder resolution, the calculated average price would need to be increased in proportion with the general market trend.[121] Unfortunately, the court did not give more specific guidelines on how to calculate such an adjustment, so this question seems to invite future appraisal claims.

3. Value of the Company or Value of the Minority Shares?

A rather theoretical issue that shall only be briefly discussed is whether the valuation should look at the total company value and give each leaving shareholder a fraction of that value, or if the specific value of the minority shares should be determined. The minority shares can in theory have a value different from the company value because each share is tradable on a stock market. Looking at the value of the minority shares could lead to a situation where the fewer minority shares there are, the more valuable they get, as their holdup value would increase. This would not make sense and would infringe the rule of equal treatment of all shareholders. The value of the whole company, therefore, has to be evaluated, and a respective fractional value has to be attributed to each share.

4. Pre-Squeeze-Out or Post-Squeeze-Out Valuation?

The exit of the minority shareholders leads to efficiency gains in the administration of the company which will positively influence the firm value. It is questionable whether the minority shareholders should benefit from such "squeeze-out gains" which are difficult to determine and quantify.[122] The main argument for factoring in the "squeeze-out gains" is the following: The minority shareholders cannot influence whether they leave the company in case of a squeeze-out. The unilateral determination of the compensation by the controlling shareholder serves as a substitute for an arms-length negotiation between the controller and minority.[123] If the minority had the chance to negotiate the sale of their shares, then they would take the squeeze-out gains into account. Arguably, the minority should not fare worse than in a negotiation which they were deprived of by the legislature by reason of making the squeeze-out procedure more effective.[124] However, the German

[121] It is currently unclear if an adjustment below the calculated average price would also be permissible. *Cf.* Bungert & Wettich, *supra* note 119.

[122] *Cf.* HANS MORITZ, "SQUEEZE-OUT": DER AUSSCHLUSS VON MINDERHEITSAKTIONÄEREN NACH §§ 327 A FF AKTG 125 (2004).

[123] *Id*. at 126.

[124] *Id*.; STANGE, *supra* note 68 at 152.

courts rejected this reasoning in recent convincing judgments.[125] They argued that the squeeze-out gains are not part of the company at the time of the shareholders' resolution (the relevant valuation date) and that the squeeze-out gains are a result of the squeeze-out and therefore could never have been realized by the minority shareholders had they continued to stay in the company. Further, the courts stressed that the recognition of squeeze-out gains would reduce the incentives of the controller to affect a squeeze-out. This could prevent controllers in some cases from initiating squeeze-outs that would be socially efficient. This may be true, for example, because the controller will, *inter alia*, consider the court costs of a subsequent appraisal proceeding (which are in most cases entirely borne by her) in her cost-benefit analysis of an envisaged squeeze-out. Squeeze-out gains are thus to be disregarded in the valuation of the minority shares.[126]

In the U.S. context a similar yet different problem exists. The German squeeze-out procedure can be implemented irrespective of a following merger, so that the question of whether the minority would also participate in the merger synergies does not arise. In Delaware, a cash-out of the shareholders is only possible in the context of a merger. The question therefore arises of whether the minority should participate in the merger synergies.

DGCL Sec. 262(h) clearly states that the valuation of these shares should not include such a premium: "[T]he fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger." In *Weinberger*, the court clarified that the fair value "is to include all elements of future value that were present at the time of the merger, excluding only speculative elements of value,"[127] thereby narrowing down the exception of DGCL Sec. 262(h) significantly.

The *Weinberger* approach seems to be consistent with the German regime. In both jurisdictions, the courts prescribe the valuation of the minority shares including future elements susceptible to determination at the date of the merger, but excluding the gains to be expected from the very measure they are compensated for (the exclusion of the shareholders).

[125] Oberlandesgericht Frankfurt a.M. [OLG - Higher Regional Court], Case No. 5 W 39/09 (June 17, 2010), http://openjur.de/u/305834.html (Ger.); Oberlandesgericht Stuttgart [OLG - Higher Regional Court], Case No. 20 W 9/08, Mar. 17 2010, 2010 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 1498 (2010) (Ger.); Oberlandesgericht Munich [OLG – Higher Regional Court], Case No. 31 Wx 12/06**,** Oct. 26, 2006, 2007 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 375 (2007) (Ger.).

[126] Equally Patrick Hohl, BETRIEBSBERATER 596 (2011), in a commentary on Oberlandesgericht Frankfurt a.M. [OLG - Higher Regional Court], Case No. 5 W 39/09 (June 17, 2010), http://openjur.de/u/305834.html (Ger.).

[127] ALLEN, KRAAKMAN, & SUBRAMANIAN*, supra* note 55, at 479.

V. Shareholder Remedies

Shareholders can bring two different kinds of lawsuits against a squeeze-out procedure: They can try to enjoin the whole transaction by claiming that certain aspects of the procedure were not in accordance with the law; or they can contest the adequacy of the cash compensation, which will be reviewed in a specific appraisal procedure. Both courses of action will be analyzed in turn.

1. Action to Enjoin Squeeze-Out

Every shareholder who contested a shareholder resolution during the general meeting of shareholders has the right to file a lawsuit to enjoin the execution of the resolution. German law distinguishes between the so-called action to void the resolution (Anfechtungsklage) pursuant to Sec. 243 AktG, and the so-called action for nullification (Nichtigkeitsklage) pursuant to Sec. 241, 249 AktG. The former action can be brought for every infringement of stock corporation law with respect to the content of the resolution or the procedure in the run-up to the resolution. This can occur within one month from the date of the resolution and as far as the shareholder has contested this resolution during the general meeting. The latter action is reserved for the most severe breaches of stock corporation law principles and can be brought without time limitation. A squeeze-out cannot be enjoined because of an alleged inadequate compensation of the minority.

The initiation of an action to enjoin creates significant hold-out leverage for minority shareholders, even if their suit would not ultimately succeed on the merits. As long as an action to enjoin is pending, the squeeze-out cannot be registered with the commercial register, and therefore the transaction cannot become legally effective.[128]

Recognizing this flaw and trying to improve the balance between minority and controlling shareholders, the legislature provided a "fast-track" procedure (Freigabeverfahren) to protect the controlling shareholder from (some of) the effects of frivolous claims or claims that the court otherwise considers to be of less relevance than the interest of the controlling shareholder in consummating the squeeze-out. The target company can apply for a court order to rule that the squeeze-out can be registered in spite of such actions to enjoin in certain cases,[129] such as: (1) when it is evident that the action is without merits; (2) the grounds for the action are de minimis compared to the interest of the company (and the controller) to finalize the transaction; or (3) when the plaintiff has owned less than

[128] This problem exists in all structural corporate measures which require a registration with the commercial register to take legal effect.

[129] Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at § 327e(2), 319(6) (Ger.).

EUR1000 in the share capital[130] of the company at the time of the announcement of the squeeze-out.[131] The fast-track procedure is not supposed to take longer than three months.[132]

In practice, however, the fast-track procedure is not always as efficient and quick as intended, and there remains a certain pressure on the controlling shareholder to settle all actions to enjoin. Therefore minority shareholders still have considerable hold-out bargaining power.

2. Appraisal Procedure

The appraisal procedure is governed by the Appraisal Procedure Act (Spruchverfahrensgesetz—"SpruchG") that was introduced in 2003 in order to increase the efficiency of appraisal proceedings.[133] Minority shareholders can initiate an appraisal proceeding against the controlling shareholder within three months from registration of the squeeze-out resolution with the commercial register.[134] In contrast to the action to enjoin and the Delaware appraisal procedure, shareholders do not need to have opposed the merger during the general meeting at which the resolution was passed. The appraisal has a class character insofar as the judicial determination of the adequate compensation is binding on all minority shareholders (*erga omnes* effect), including those who accepted the original compensation offer.[135] The court appoints a shareholder representative in order to duly represent the interests of the class of minority shareholders who are not direct claimants in the proceeding.[136] In practice this will be a representative of an investor protection organization. The presence of the representative shall prevent the controlling shareholder from buying out the plaintiffs with a high settlement to the detriment of the minority shareholders not participating in the appraisal. Should that situation occur, the representative would have the right to continue the appraisal proceeding.

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[130] German stock corporations almost always have shares with a nominal value of EUR 1., so that usually means that the plaintiff or group of plaintiffs needs to have held at least 1000 shares.

[131] This latter case was introduced recently with the Act on the Implementation of the Shareholders' Rights Directive, Gesetz zur Umsetzung der Aktionärsrechterichtlinie [ARUG], May 28, 2009, BGBL I at § 2479 (Ger.), in an attempt to further reduce the impact of predatory shareholders.

[132] Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at §§ 327e(2), 319(6) (Ger.).

[133] STANGE, *supra* note 68, at 256.

[134] Appraisal Procedure Act [SpruchG] [Spruchverfahrensgesetz], June 12, 2003, BGBL I at §§4(1)no.3, 5(1) no.3 (Ger.).

[135] Appraisal Procedure Act [SpruchG] [Spruchverfahrensgesetz], June 12, 2003, BGBL I at § 13 (Ger.).

[136] *Id.* § 6.

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The downside of the appraisal procedure is that the dire prophecies regarding the expected wave of appraisal proceedings[137] came true. 214 of the 317 (68%) squeeze-outs from 2002 until the end of 2007 resulted in the initiation of an appraisal proceeding.[138] Another concern is the length of the proceedings. One of the goals of the SpruchG was to reduce the length of time appraisal proceedings take. Yet there has only been an insignificant improvement in the length of proceedings. Before promulgation of the SpruchG the average proceeding lasted for over five years, but today the average time for proceedings not terminated by settlement is still over three years.[139] A likely important factor regarding the length of the proceedings was that until recently, the cheap interest rate on the possible liability of the controller was only 2% (uncompounded) above the "base rate" (Basiszinssatz)[140] of the German Federal Bank[141]—a price well below the cost of capital of any corporation, which gave the controller an incentive to stall the proceeding for as long as possible. The legislature, meanwhile, has recognized this deficiency and has increased the interest rate to 5% above the base rate of the German Federal Bank.[142]

3. Empirical Data Regarding Shareholder Remedies[143]

Shareholders initiated lawsuits to enjoin the transaction in 107 out of 317 cases (34%). Since 2005, the number of such lawsuits has risen to 60–70% of all squeeze-outs; whereas almost all squeeze-outs of listed companies are being challenged.

In cases in which the squeeze-out was not contested, the registration of the squeeze-out resolution in the commercial register took an average of 68 days (median 54 days). However, the contested squeeze-out resolutions took an average of 286 days (median 240 days) for registration. This clearly shows the hold-out leverage which contesting shareholders can acquire. That the difference is not even more severe is owed to the fact that the overwhelming majority of lawsuits are settled—and thereby the contesting shareholders' compensation is increased. Even after settlement of the suit to enjoin, in many cases the minority shareholders go on to initiate an appraisal proceeding.

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[137] *Cf*. Maximilian Schiessl, *Fairness Opinions im übernahme- und Gesellschaftsrecht Zugleich ein Beitrag zur Organverantwortung in der AG*, ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGR) 814, 837 (2003).

[138] At the time the data was gathered in twenty-four cases, an initiation of the appraisal was not yet possible because of a pending action to enjoin, so the actual percentage of cases may well have been higher.

[139] STANGE, *supra* note 68, at 279.

[140] Currently 0.12%.

[141] *See e.g.*, THOMAS HEIDEL ET AL.,FESTSCHRIFT FÜR WIENAND MEILICKE 2268 (2003); STANGE *supra* note 68, at 259.

[142] Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at § 327b(2) (Ger.).

[143] This section draws on data from STANGE, *supra* note 68, at 279.

Appraisal proceedings were brought against 214 of the 317 squeeze-outs (68%). The appraisal proceedings ended by court decision lasted an average of 37.9 months (median 39 months). Including the cases that were settled, the disputes lasted an average of 31.4 months (median 30 months). 50–75% of the appraisal proceedings were settled.

F. Takeover Squeeze-Out

I. General Remarks

The new Sec. 39a–39c WpÜG regarding the Takeover Squeeze-Out have been in force since July 2006. Germany was required to transpose the EU Takeover Directive into national law, but German scholars were also of the opinion that the legal practice was awaiting a streamlined squeeze-out process for takeover situations.[144] The German legislature decided to introduce a new instrument separate from the general squeeze-out pursuant to Sec. 327a et seq. AktG instead of integrating the takeover situation in the framework of the general squeeze-out. Both forms of squeeze-out are non-exclusive, meaning that in a takeover situation the controller can choose freely between both procedures.

II. Scope of Regulation

The Takeover Squeeze-Out is only available when the relevant shareholding threshold of 95% is reached through a mandatory tender offer or a voluntary offer launched by a non-controlling shareholder to obtain 100%[145] of the target stock.[146] That means that, for example, a controller who owns 51% of the target stock and wants to acquire additional shares (stock-up) cannot take advantage of the Takeover Squeeze-Out.[147] The reason is that the Takeover Squeeze-Out was introduced to compensate the acquirer of a control stake for the cost and effort she incurs through the takeover regulation, and this rationale is not present in stock-ups.[148]

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[144] Philipp Rühland, *Der übernahmerichteliche Squeeze-out im Regierungsentwurf des Übernahmerichtlinie-Umsetzungsgesetzes (Regierungsentwurf)*, NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT (NZG) 401, 402 (2006).

[145] It is a general requirement of German Takeover law that partial tender offers which are limited to an acquisition of less than 100% of the target stock are not allowed. Wertpapiererwerbs- und Übernahmegesetz [WpÜG] [Securities Acquisition and Takeover Act], Dec. 20, 2001, BGBL. I at § 29 (Ger.).

[146] *Cf. id.* §§ 39a, 29.

[147] *Cf.* Ventoruzzi, *supra* note 1, at 50.

[148] Walter Paefgen, Z*um Zwangsausschluss im neuen Übernahmerecht*, WERTPAPIERMITTEILUNGEN (WM) 765 (2007).

III. Determination of Adequate Compensation

As is the case in the General Squeeze-Out, the controller has to adequately compensate the minority shareholders. The compensation shall have the same form as the consideration in the preceding tender offer; in case of a share for share tender offer the acquirer shall also offer cash compensation.[149] The acquirer will regularly ascertain the amount of compensation by way of fairness opinion.[150] In order to facilitate the Takeover Squeeze-Out, Sec. 39a(3)(4) WpÜG presumes that the compensation is adequate if the bidder has acquired more than 90% of the share capital included in the triggering tender offer. That means that the presumption applies if at least 90% of the outstanding shares are tendered. Such a market test indicates that the offer was fair.

It is hotly disputed whether this presumption is rebuttable or unrebuttable by contesting minority shareholders. The legislature initially wanted to create an unrebuttable presumption for the sake of an efficient procedure.[151] However many legal commentators raised concerns that such a rule, which deprives contesting minority shareholders of the possibility of legal recourse, would infringe the protection of property by the German Constitution (Art. 14 GG),[152] the European Convention of Human Rights, and the European Takeover Directive.[153] It was argued that legal redress must be possible at least in exceptional cases, such as insider dealing or securities fraud by publication of misleading information.[154] However the prevailing opinion prioritizes the public interest in an efficient procedure that cannot be stalled after it has passed the market test.[155] Proponents of this view emphasize that market manipulations in these cases are all punishable by law and that empirical evidence from the UK suggests that such cases would be extremely rare, and should not be the reason to prevent an efficient squeeze-out regime.[156] This issue has not yet been decided by the BGH, though.

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[149] Wertpapiererwerbs- und Übernahmegesetz [WpÜG] [Securities Acquisition and Takeover Act], Dec. 20, 2001, BGBL. I at § 39a(1).

[150] Ulrich Noack & Dirk Zetzsche, *Vor §§ 39a bis 39c WpÜG*, *in* KAPITALMARKTRECHTSKOMMENTAR 19 (Eberhard Schwark & Daniel Zimmer eds., 4th ed. 2010).

[151] DEUTSCHER BUNDESTAG: DRUCKSACHEN UND PROTOKOLLE [BT] Begründung zum Regierungsentwurf [Legislator's Explanatory Notes], 16/2003 at 22 (Ger.); STANGE, *supra* note 68, at 271.

[152] Rühland *supra* note 144, at 405; Noack & Zetzsche, *supra* note 150, at Sec. 39a mn. 28.

[153] *See e.g.*, Silja Maul, *Die EU-Übernahmerichtlinie – ausgewählte Fragen*, NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT (NZG) 151 (2005) at 157; Noack & Zetzsche *supra* note 150, Sec. 39a mn. 28.

[154] Noack & Zetzsche, *supra* note 150, Sec.39a mn. 28.

[155] Oberlandesgericht Stuttgart [OLG – Higher Regional Court], Case No. 20 W 13/08, May 5, 2009, 2009 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 1059 (2009) (Ger.); Noack & Zetsche *supra* note 150, Sec. 39a mn. 28.

[156] *Id*.

From a doctrinal perspective it is very remarkable that the public interest in an efficient procedure is given priority here, as German courts and scholars generally attribute superior importance to the human right to an effective judicial review (Art. 19(4) GG), which is construed very broadly. However I support the view that the presumption should be unrebuttable with the arguments set out above—a majority of the minority of 90% is a very high burden. This market test substitutes the procedural protections that otherwise prevail in German law. From a comparative perspective, it must be conceded that this situation is similar to the one decided in *Rosenblatt*,[157] where the Delaware court considered MOM approval to be sufficient to shift the burden of showing the fairness of the transaction, but insufficient to defer to business judgment review. However, the Delaware MOM approval requirement is already fulfilled at the level of a simple majority (>50%), whereas Sec. 39a(3)(4) WpÜG requires at least a 90% majority. This yardstick is sufficiently high to justify a complete deference to the market test.

If less than 90% of minority shareholders tender their shares, then the adequacy of the share price will be determined by the court. Yet the law does not set out specific procedures about how to determine the value. Legal practitioners fear the imponderability of this procedure, which has not yet been applied in practice, and so they avoid the Takeover Squeeze-Out in the vast majority of cases where a 90% MOM approval of the minority is uncertain from an *ex ante* perspective.[158]

IV. Legal Effect by Court Decree

In the interest of an efficient procedure the Takeover Squeeze-Out—in contrast to the general squeeze-out—does not require a shareholder resolution approving the transaction. Instead, if the shareholder owns at least 95% of the voting share capital of the target company, she can file a motion with the court to apply for the transfer of the remaining outstanding voting shares.[159] The substitution of the shareholder resolution with a court procedure is sensible. The shareholder resolution would be a pure formality and almost all squeeze-outs are contested in court anyway.[160] The minority shareholders may file a motion and have the right to be heard, although the court may decide to do so in a written procedure without oral arguments.[161]

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[157] *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985).

[158] *See infra* Part F.IV.

[159] Wertpapiererwerbs- und Übernahmegesetz [WpÜG] [Securities Acquisition and Takeover Act], Dec. 20, 2001, BGBL. I at § 39a(1)(1) (Ger.). The Regional Court (*Landgericht* – "LG") Frankfurt has exclusive jurisdiction for Takeover Squeeze-Out applications. *See id.* § 39a(5).

[160] STANGE, *supra* note 68, at 274.

[161] Noack & Zetsche, *supra* note 150, at Sec.39b mn. 11.

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The squeeze-out becomes legally effective once there is no further legal recourse against the court decree ordering the transfer of the minority shares to the controller. This is the case when the time for appeal has elapsed or when OLG Frankfurt denies the appeal.[162]

V. Empirical Data on the Practical Application of the Takeover Squeeze-Out

Although the Takeover Squeeze-Out option has been available for six years, there are only four known cases in which the procedure has been invoked.[163] One reason could be the uncertainty regarding the procedure which is inherent in untested laws. Most importantly, the law does not specify how the adequacy of the compensation shall be evaluated if the 90% threshold is not reached.[164] Because the legal effect of the Takeover Squeeze-Out is pending until the final determination of the adequacy of the offer price by the court, the legal practice is wary of a possible never-ending procedure, and therefore favors the general squeeze-out procedure, which becomes legally effective at an earlier stage , namely with registration of the transaction in the commercial register.[165]

G. Analysis

I. Convergence or Path Dependence?

US law and German law on freeze-outs have the same goal: To protect the minority shareholder from the risk of an unfair treatment by the controlling shareholder when they are cashed out. Despite this common goal and a global tendency of convergence of corporate laws,[166] I submit that this is not an area of the law where the prophecy of "the end of history for corporate law" will hold completely true. While the general lines and ideas of how to protect minority shareholders will continue to converge—for example, the idea of MOM approval or the idea of a facilitated cash-out for controllers owning at least 90% of a company—many of the formal aspects of the freeze-out procedure will remain different in the two analyzed countries. More specifically: The rules governing freeze-outs in Germany and the U.S. were developed on the basis of different roots and traditions in the respective legal systems and, more specifically, their corporate laws. American law has

[162] *Id*. at Sec.39b mn. 21.

[163] *Cf. Noack & Zetzsche, supra note* 150, at *mn. 3* (accounting for data until May 2010 and found two cases). Two additional cases occurred in 2011: After successful takeovers, Nordfrost GmbH & Co. KG squeezed out the minority shareholders in Kuehlhaus Zentrum AG, and Engine Holding GmbH squeezed out the minority shareholders in Tognum AG.

[164] *See supra* Part F.III.

[165] Kai Hasselbach, *Verfahrensfragen des übernahmerechtlichen Squeeze out,* BETRIEBSBERATER 2842 (2010); Noack & Zetzsche, *supra* note 150, at mn. *3*.

[166] *Cf.* Reinier Kraakman & Henry Hansmann, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

a tradition for preferring to defer the resolution of issues to market forces instead of regulatory intervention. Germany (and Continental Europe, more generally) has the tendency to regulate possible issues between market participants by laws and regulations. This dichotomy is also recognizable in the different approaches of U.S. and German law towards the regulation of freeze-outs. The American system uses a system of *ex post* protection: The controlling shareholder can cash out the minority, but at the risk that they can (and will) bring fiduciary duty claims to force an entire fairness review of the transaction. The specter of class action litigation is supposed to induce the controller and the board of directors of the target company to negotiate a fair cash-out price. The requirement of having a truly independent Special Committee to negotiate the deal with the controller in order to release him from the burden of showing the entire fairness of the transaction shows that US law aims to remedy the conflict of interest with the simulation of an arms-length transaction.

The German system, in contrast, relies on *ex ante* procedural safeguards on the squeeze-out procedure through the introduction of third parties, which impose checks and balances on the controller. The most notable of these checks and balances are the requirements that the cash-out price be audited by an independent expert, and that the transaction must be registered in the commercial register, which checks that all formal requirements of the procedure have been complied with (a *gatekeeper strategy*).[167] The high threshold of 95% shareholding to cash out the minority is also based on the European tradition of seeing share ownership as essentially equivalent to real property, instead of just as a financial security to invest in capital markets. Although German courts have meanwhile recognized that shareholders owning 5% or fewer shares in a corporation are purely financial investors,[168] the German jurisprudence still does not seem to have arrived at quite the liberal capital market definition of share ownership that prevails in the U.S.

The different approaches of US and German law towards freeze-outs therefore seem to be a result of path dependency,[169] which limits the extent to which future convergence of these systems can be expected.

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[167] Rock et al., *supra* note 29, at 202.

[168] *See* Bundesverfassungsgericht [BverfG - Federal Constitutional Court], Case No. 1 BvR 1613/94, Apr. 27, 1999, 100 BVERFGE 289, 302 (Ger.); *see also* Bundesverfassungsgericht [BVerfG - Federal Constitutional Court], Case Nos. 1 BvR 68/95, 1 BvR 147/97, Aug. 23, 2000, 2001 NEUE JURISTISCHE WOCHENSCHRIFT (NJW) 279 (2001) (Ger.).

[169] *Cf.* Mark J. Roe & Lucian A. Bebchuk, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999).

II. The Uselessness of Fairness Opinions and "Independent" Audits, or Why the Fair Cash-Out Price Is Ultimately Determined by the Court

Both approaches to ensure a fair cash-out price work well, but also have deficiencies. What is striking is, for example, that in both jurisdictions, practically every freeze-out gets challenged in court, either by fiduciary duty action in Delaware or by appraisal action in Germany, so that the final arbiter in practice is always the court, which regularly will appoint yet another auditor to evaluate the fair cash-out price. This result seems to be inevitable. There is bound to be at least one shareholder who is willing to take on the risk of losing in court in exchange for the chance that the court determines a higher cash-out price. This situation is reinforced by the fact that the Delaware class action lawsuit automatically spreads legal fees among many investors, while in the German appraisal procedure the court fees are generally borne by the controller; the remaining legal fees are borne by the plaintiffs, but can be imposed on the controller for reasons of equity.[170]

Empirical evidence also suggests that the independent auditor in the German general squeeze-out procedure may not be truly independent after all. That is at least one way to explain Stange's findings that in many[171] cases the court ultimately determined a higher compensation than the independent auditor did. This result is not very surprising considering that the auditor's fees are paid by the controller. Of course, every auditor is bound by professional duties to act objectively, but although the auditor is ultimately appointed by the court, the court generally follows the suggestion of the controller.[172] Hence, the auditor may have an incentive to ingratiate herself with the management of the controller to improve their business relationship. Interestingly, this conclusion seems to be in line with New York's experience with independent court-appointed appraisers that they serve "no useful purpose but add considerably to the expense and time involved."[173]

Consequently, it seems sensible to abolish the requirements of shareholder approval and independent audit report in the general squeeze-out procedure and substitute it with a

[170] Appraisal Procedure Act [SpruchG] [Spruchverfahrensgesetz], June 12, 2003, BGBL I at § 15.

[171] Stange found that in over 40% of cases the ultimate compensation was higher than the one initially offered by the controller. However, this result includes cases where the ultimate compensation was determined by the court or (in the majority of cases) by settlement. The valuation agreed upon in a settlement is not an accurate indicator for the intrinsic value of the shares, however, as the controlling shareholder will also consider the "nuisance value" of the claim and the legal fees she will save (for example, for an additional expert testimony by a court-appointed auditor), considering that she has to bear all legal court fees pursuant to Section 15 of the Appraisal Procedure Act.

[172] See *infra* Part E.I.3.

[173] Michael R. Schwenk, *Valuation Problems in the Appraisal Remedy*, 16 CARDOZO L. REV. 649, 679 (1994) (citing Senator Jess J. Present, in his Memorandum in Support of Chapter 202, reprinted in 1982 New York State Legislative Annual, 96, 97).

court procedure to determine the adequate compensation, as it is in the Takeover Squeeze-Out.

III. The German 95% Threshold

The threshold of 95% of the share capital that a controlling shareholder must meet in order to squeeze-out the minority exemplifies the fundamentally different approach that Germany takes towards cash-outs as opposed to Delaware, where every controlling shareholder can cash out the others. As already set out, I believe that this difference has its roots in the different perceptions of share ownership. The German view seems to be closer to the Delaware view of 1920 than it is to today's prevailing views in Delaware.[174] Whereas in Delaware a share is primarily a financial investment that should be secured, in Germany the share ownership is still viewed as being closer to real ownership.

However, Germany is not alone with its threshold requirement. Indeed, a recent study of EU squeeze-out procedures has shown that many European countries[175]—including the U.K.—have similar thresholds for squeeze-outs, ranging from 90%[176] to 95%.[177] This shows that the 95% threshold is an expression of a European legal tradition. Still, the threshold seems to be overly restrictive. German law provides for other measures that effectively cash out the shareholders and only require a shareholder resolution with a 75% majority. Management can sell all assets of the company and then dissolve the company.[178] However this procedure is rarely used in practice, *inter alia*, because shareholder actions challenging the price for the transfer of assets can delay the transaction significantly.[179] Another way of economically cashing out the minority is a peculiarity of German group law (*Konzernrecht*). The controller can implement a so-called domination and profit and loss transfer agreement (*Beherrschungs-und Gewinnabführungsvertrag*) with the subsidiary. The most salient effects of such an agreement are that (1) shareholders lose their right to dividend payments, which is substituted with a perpetual compensation payment;[180] (2) the subsidiary has to follow all instructions of the controller;[181] and (3) the balance-sheet

[174] *Cf.* Allen, Kraakman & Subramanian, *supra* note 54, at 485.

[175] The study focused on Belgium, France, Germany, the Netherlands and the U.K.

[176] This threshold is predetermined by Article 15 of the European Takeover Directive. However, the scope of this provision is so small that member states could have created or maintained a separate squeeze-out procedure with differing thresholds without infringing on the Directive.

[177] Van der Elst & Van den Steen, *supra* note 82, at 404.

[178] Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at § 179a (Ger.).

[179] Rock, Davies, Kanda, & Kraakman, *supra* note 29, at 207 n. 117.

[180] Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at § 304 (Ger.).

[181] *Id.* § 308.

profit or loss of the subsidiary is automatically attributed to the parent company, which allows for a tax consolidation at the parent level.[182] That means, *inter alia*, for the minority, that they economically cease to participate in the business risks and opportunities of the company, and that they instead receive a perpetual fixed rent payment as compensation. The implementation of a domination and profit and loss transfer agreement also only requires a shareholder resolution with 75% majority.

Consequently the German legislature should consider reducing the threshold for general squeeze-outs to 75%, as well. This demand seems particularly reasonable in light of the recent decision of the BGH, which allows crossing the 95% shareholding threshold by way of securities loans.[183] This judgment has already initiated the retreat from a strict application of the 95% rule. Yet for reasons of legal tradition, path dependency, and because of the question at which threshold the squeeze-out would run the risk of being qualified as unconstitutional by the BVerfG it is unlikely that the threshold will in fact be lowered below a 90% threshold in the near future.[184]

IV. The 90% Threshold in Merger Situations

In mid-July 2011, the German legislature enacted a law to streamline the squeeze-out procedure in connection with upstream mergers in group constellations.[185] If a controller intends to merge a subsidiary into itself, then a squeeze-out in connection with this parent-subsidiary merger shall only require a 90% ownership in the subsidiary (instead of the usual 95%).[186] Additionally, the merger shall not require a shareholder resolution of the target company. The German legislature felt compelled to adjust the applicable threshold in this specific case in order to conform with EU directive 2009/109/EC,[187] but decided against a

[182] KÖRPERSCHAFTSSTEUERGESETZ [KStG] [Corporation Tax Act], Oct. 15, 2002, BGBL. I at 1444, § 14 (Ger.).

[183] See infra Part E.I.1.

[184] Compare, on the one hand, the somewhat reserved comments of several members of Parliament in the *Bundestag* regarding the 90% threshold in Bundestag Plenarprotokoll 17/111, 12754, and on the other hand the judgment of Oberlandesgericht München *infra*, note 186.

[185] DRITTES GESETZ ZUR ÄNDERUNG DES UMWANDLUNGSGESETZES [3. UmwGÄndG], BGBL. I 2011, 1138 [Third Act Amending the Transformation Act], July 11, 2011, BGBL. I at 1138 (Ger.).

[186] As a precursor during the financial crisis a squeeze out procedure for holders of 90% of the share capital of a company was established by Finanzmarktstabilisierungsbeschleunigungsgesetz [FMStBG] [The Financial Market Stabilization Acceleration Act], Oct. 17, 2008, BGBl. I at 1982, §§ 12(3) no.1, 12(4) (Ger.), in order to allow for the measures necessary to rescue or “stabilize” financial institutions. The – apparently – only time this procedure was used to date was in the case of the distressed Hypo Real Estate Holding AG. The squeeze-out was held valid and constitutional by the Oberlandesgericht München [OLG - Higher Regional Court], Sept. 28, 2011, 2011 NZG 1227 (2011) (Ger.).

[187] Directive 2009/109/EC of the European Parliament and of the Council of Sept. 16, 2009, amending Council Directives 77/91/EEC, 78/855/EEC and 82/891/EEC, and Directive 2005/56/EC in regards to reporting and documentation requirements in the case of mergers and divisions.

general lowering of the threshold.[188] It should be expected that the limitation of these new rules to merger situations will not hamper their popularity. In cases where the controller does not want the subsidiary to be merged into herself, she can easily transfer her shares to an intermediary holding company and have the subsidiary merge into this holding company.[189]

The new German legislation bears a striking resemblance to the Delaware short-form merger pursuant to DGCL Sec. 253. Both instruments aim to provide to controlling shareholders who hold at least 90% of the shares of a company, a simplified procedure to merge with their subsidiary without needing to let the minority shareholders of the subsidiary participate in the equity of the controller. In this respect, the German squeeze-out system seems to converge towards the Delaware position.

It is noteworthy that the 90% threshold also emerges in many EU jurisdictions, as well as in Art. 15 of the European Takeover Directive. Across many jurisdictions, therefore, there seems to be a mutual understanding that a 90%-controller has legitimate interests to undertake a business combination, such as a merger, without participation of the minority in the new legal entity.

H. Conclusion

The analysis of German and U.S. freeze-out rules has shown profound differences, but also striking similarities. The similarities concern the 90% short-form merger and the tender offer freeze-out rules. The Delaware jurisprudence in *Pure* has been subjected to substantial critique,[190] as empirical evidence has shown that shareholders in statutory cash-out mergers get higher compensation on average than shareholders in tender offer freeze-outs. The German system also favors tender offer freeze-outs by requiring fewer procedural protections. As Ventoruzzo eloquently notes: "[T]he very fact that very different systems, moving from distinct perspectives and characterized by dissimilar law-making processes have converged toward a common framework is not only an interesting theoretical observation, but offers some support to the soundness of Delaware jurisprudence in *Pure* and its progeny."[191] However, German rules require a 90% MOM

[188] DEUTSCHER BUNDESTAG: DRUCKSACHEN UND PROTOKOLLE [BT] Begründung zum Regierungsentwurf [Legislator's Explanatory Notes], 17/3122 at 12 (Ger.). Reducing the threshold to 90% was necessary because the legislator was reluctant to introduce a sell-out right for minority shareholders, which would have been an alternative way to implement the directive.

[189] This procedure is considered not to be an abuse of a legal position by most German scholars. *Cf*. Stephan R. Göthel, *Der verschmelzungsrechtliche Squeeze Out*, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 1541, 1549 (2011) (Ger.), *available at* http://zip-online.de/b8c99a914d25a8e135632f4037ee771c (last visited 10 Aug. 2012).

[190] *See e.g.*, Subramanian, *supra* note 1.

[191] Ventoruzzo, *supra* note 1, at 61.

approval, whereas *Pure* only requires a simple MOM approval, i.e. over 50%. It makes intuitive sense to believe that the increase of the MOM threshold would increase the value of the cash-out payment the controller will offer in order to get the required approval rate. Delaware should therefore not fall back to entire fairness review in tender offer freeze-outs, but rather increase the MOM approval requirement to a supermajority of e.g. 66%, if the legislature wants to increase payoffs of minority shareholders.[192]

For Germany, in contrast, it would be desirable to reduce the general shareholding threshold from 95% to 75% in order to make the squeeze-out rules more attractive and bring them into line with other corporate measures which achieve a similar economic effect to a squeeze-out. This would improve the consistency of the German legal system in this area and would eliminate the incentive to use other (more complex) measures to circumvent the high 95% threshold. It is submitted, however, that for the reasons set out above in Part G.III, this is unlikely to be realized in the near future.

Germany should also abolish the requirements for shareholder approval and an audit report by an independent expert in the general squeeze-out procedure in favor of a court procedure which will determine the fair cash-out compensation. The court is the place where this question will end up eventually, anyway.

In conclusion, we can see a tendency toward convergence regarding several specific elements of the freeze-out procedures, but also continued differences in the system which are owed to path dependency.

[192] *Id.* at 62.