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The Squeeze-Out Rule in Georgia and Germany *

Background for the Squeeze-Out Rule in Georgia and Germany

Black's Law Dictionary defines the term *Squeeze-out* as "an action taken in an attempt to eliminate or reduce a minority interest in a corporation." [1] To say it in other words, squeeze-out is a process whereby majority shareholders of Joint Stock Company can force out the minority shareholders by giving them adequate compensation. Although a squeeze-out right for majority shareholders exist in many jurisdictions, the regulations differ.

In Germany "the possibility to squeeze-out remaining minority shareholders of a company (target company) was incorporated into the AktG on January 1, 2002." [2] Silvia Elsland and Martin Weber compare the existing squeeze-out to "a very special case of a merger and going private transaction", due to the fact that the holder of the 95% or more of the share capital can force out the remaining minorities and as a going private transaction, because very often the aim of the squeeze out is replacement of the "publicly owned stock in a company with complete equity ownership by a private group, so that the company is delisted from the stock exchange and can no longer be purchased in the open markets." [3]

In Georgia the rule was first introduced in 2005. The Parliament of Georgia added article 53^3 to the Georgian Law on Entrepreneurs. Under the above mentioned article the shareholders that held more than 95% of a company's shares had the right to squeeze-out the rest of 5% by paying them a fare price for the shares owned. However, later this article was abolished and article 53^4 came into force, with the same content but dissimilar regulation of the squeeze-out procedure. According to new article in Georgian Law on Entrepreneurs the court is authorized to determine the price of the shares in squeeze-out.

In order to analyze the benefits and drawback of the squeeze-outs in Georgia and Germany vital is to find out first what was the economic as well as the social need of introducing the squeeze-outs in both countries.

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[1] Bryan A. Garner (editor in chief), Black's Law Dictionary, 8th ed. 2004.

[2] Silvia Elsland and Martin Weber, *Squeeze-outs in Germany: Determinants of the Announcement Effects,* 2005, p.2.

[3] *Ibid.*

In developed countries like Germany, where the stock exchange market stands at its height the shareholders are more aware of their rights and how to exercise them. On the contrary, in Georgia the process of mass privatization gave birth to many Joint Stock Companies soon after the dissolution of Soviet Union. The employees of the enterprises were given small shares in privatized joint stock companies, where they used to work before. As a consequence, big number of small shareholders appeared. "People became shareholders without realizing the related implications and without clear understanding of their rights." [4] That is why many enterprises were able to buy out the shares of minority shareholders even without the help of squeeze-out article of the Georgian Law on Entrepreneurs.

In Germany the squeeze-outs were also well-liked - 125 listed companies declared squeeze-out between 2002 and 2003 years. [5] The regulation is not less popular nowadays as well. Major stockholders continue to "kick out" the minority stockholders out of joint stock corporations of Germany as well as Georgia, stating several reasons for that: first of all, the existence of hundreds of minor stockholders is not attractive for the investors. Secondly, the high cost for calling general meetings of shareholders with a view to the participation of minority shareholders and also costs related to other rights exercisable by minority shareholders, such as calling of meetings of shareholders, requests for information, rights to file suits, etc. [6] "Costs and risks associated with a small number of minority shareholders are used as justification for the introduction of a squeeze-out right." [7] But there should be other reasons why the majority shareholders are so eager to exercise their right to force the minorities out of the company. Indeed, "a squeeze-out is often desired by the majority shareholder in order to gain full control of the firm," [8] not only avoiding the additional costs that they might face in relation to the rights exercisable by minority shareholders, but it is also another circumvention in order to protect themselves from the minority shareholder control.

But talking about the benefits of the squeeze-out rule for the majority shareholders, we should remember that the other side of the story is the relevant protection that the states should provide for the minority shareholders.

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[4] OECD, *Corporate Governance in Eurasia: A Comparative Overview*, 2004, p.29-30.

[5] Elsland and Weber, *supra* note 2.

[6] Kakha Kutchava, *Squeeze Out - Violation of Rights or a Path to Better Corporate Governance*, Quarterly Bulletin on Corporate Governance, issue #11, October-November-December 2007, (author's translation), http://www.ifc.org/ifcext/gcgp.nsf/AttachmentsByTitle/QB11A1/$FILE/QB11A1.pdf.

[7] Elsland and Weber, *supra* note 2.

[8] Peer Zumbansen, *German Corporate Law in Constitutional Perspective: The Squeeze-Out*, German Law Journal Vol. 2 No. 2 – 1, February 2001.

As Peter Zumbansen said:

> "It might be just another facet of the recent euphoria over shareholder-value, which dominated global capital markets and the corporate world, that we are now hearing cries for adequate regulation of so-called squeeze-outs of minority shareholders. Yet, it is far from evident whether such an explicit regulation would actually provide effective protection of small, i.e. minority groups of shareholders." [9]

Therefore, the question is what should be done by the states to provide effective protection for minority shareholders' interests in squeeze-outs? In order to answer it let me first scrutinize the issue of constitutionality of the rule in Georgia and Germany and then suggest the solution that might be relevant.

Challenging the Constitutionality of Squeeze-Out Rule

While examining the constitutionality of the squeeze-outs in Georgia and Germany let me turn to the court practice in both countries. To start with Georgia, after the new amendment to Georgian Law on Entrepreneurs in 2005 several suits were brought challenging the constitutionality of the squeeze-out article in the Constitutional Court of Georgia. Among the claimants were the minority shareholders of four joint stock corporations incorporated in Georgia: JSC "Telenet", JSC "Davit Sarajishvili and Enisel", JSC "Ekrani" and JSC "Kaspitsementi" and the suit of the Public Defender of Georgia against the Parliament of Georgia. The cases were united. [10]

The main argument against the squeeze-out article presented by the claimants was that it violated the fundamental right of ownership granted by the Constitution of Georgia, in particular Article 21, which states:

1. The property and the right to inherit shall be recognized and guaranteed. The abrogation of the universal right to property, of the right to acquire, alienate and inherit property shall be impermissible.
2. The restriction of the rights referred to in the first paragraph shall be permissible for the purpose of the pressing social need in the cases determined by law and in accordance with a procedure established by law.

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[9] Ibid.

[10] The Constitutional Court of Georgia, Decision #2/1 – 370, 382, 390, 402, 405, 18th of May 2007, Tbilisi, Georgia (author's translation).

3. Deprivation of property for the purpose of the pressing social need shall be permissible in the circumstances as expressly determined by law, under a court decision or in the case of the urgent necessity determined by the Organic Law and only with appropriate compensation. [11]

However, one of the witnesses on the side of respondent, the State Minister on Economic Reform Issues, Kakha Bendukidze argued about the benefits of the rule, justifying the need of the pertinent article and noted that the minority shareholders usually do not have the opportunity to participate in management of the corporation. They simply hinder the major shareholders in developing the corporation. Because of the huge amount of minority shareholders, it is also not easy to determine their identity. These are the reasons for considering them as the financial, not strategic investors of the company. In the opinion of State Minister, if not the existence of squeeze-out rule, the majority would have found other mechanisms to force out the minorities. Furthermore, the liquidation process of the company may have the same outcome for the minorities as the squeeze-out. The settlement for them in this case is that they get cash compensation instead of their shares, while in the event of liquidation they might have lost the shares, or the buyout would have occurred at an unfair price. [12]

Another justification for the debated legal norm is the social necessity. Because of the fact that most of the joint stock companies in Georgia were created after long and complicated privatization process and were less aware of the advantages or drawbacks of the legal form, now they are not able to use the opportunities presented to them, are not able to attract the investments from foreign markets and are at the edge of bankruptcy. Their shares are not traded on the Stock Market either. There is a need to transfer this kind of quasi joint stock corporations into limited liability companies, which can be done only after the majority shareholders have full control of the company. Taking in consideration the arguments presented, the State Minister found the restriction of property rights of minority shareholders as acceptable. [13]

After assessment of the arguments presented by both parties, the Constitutional Court outlined two main points while discussing the issue. First, whether the squeeze-out rule was constitutional regarding the property rights guaranteed by the Constitution of Georgia, while the second point discussed was the fairness of the procedures contained there. The outcome of the case was that the Constitutional Court declared Article 53^3 unconstitu-

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[11] Constitution of Georgia, Art.21.

[12] The Constitutional Court of Georgia, Decision #2/1 – 370, 382, 390, 402, 405, 18th of May 2007, Tbilisi, Georgia (author's translation).

[13] *Id.*

tional, stating that it violated the 1st and 2nd parts of the 21 Article of Constitution and abolished it. The Court emphasized that the need of squeeze-out rule cannot be discussed in the context of "pressing social need" and cannot be regarded as a legitimate aim for the restriction of property rights granted by the Constitution of Georgia. Furthermore, the Court objected to the argument presented by the State Minister on Economic Reform Issues, by saying that the aim of the legal norm was not the possibility of transforming the joint stock corporations into limited liability companies; moreover, Joint Stock Company is the legal form that is considered most attractive for attracting the investments. The reason for malfunction of the joint stock companies in Georgia is not often the legal form, but the lack of effective management mechanisms.

Turning to the second point, the Court said that the main problem with Article 53^3 in practice was that it did not contain the accurate mechanisms for fair price valuation of the shares. Indeed, the main problem seemed to be not the fact of the squeeze-out itself, but the rule of determining the price of shares that was considered unfair by minority shareholders. The article offered two ways of evaluating the shares: to determine the price by Charter of the company or to determine it with the help of the independent expert (auditor) or broker agent. In case the minority shareholders considered the price unfair, they had right to challenge it in the court. One of the appellants was dissatisfied with the unjust valuation of their shares in JSC "Telenet". Each share was valued at 40 Tetri (Georgian currency), which equals to 0.20 EURO. The Court stated that the article does not provide for the relevant protection of minority shareholders and underlined the necessity of guaranteeing the balance between the majority and minority shareholders in the corporation by the state, expelling the opportunity to use the economic power by majority shareholders. In this context the most crucial for legislator is to determine the legal procedure for determining the fair price of the shares in a way that would be clear enough in order not to give any party the opportunity to manipulate. This task is not so easy to enforce. As the Constitutional Court stated in its decision of May 18, 2007, one can hardly find anywhere the perfect mechanism to determine the fare share price. Any evaluation process is the matter of subjective process. [14]

If we look at the example of Germany, the major shareholders are the ones who determine the reasonable amount of compensation for the minority shareholders in the resolution, which has to be passed by simple majority voting rights: [15]

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[14] See *supra* note 12.

[15] German Stock Corporation Act, §327 b.

> The principal shareholder must give the shareholders meeting a written report that presents the basis for the transfer and explains and justifies the adequacy of cash compensation. The adequacy of the cash compensation shall be reviewed by one or more expert auditors. These shall be selected and appointed by the court on application of the principal shareholder. [16]

The rule is included in the Stock Corporation Act and the reference is made to the fact that the squeeze-out should not be considered as the legalization of the expropriation in any way and is not violating the Constitution of Germany. [17] Nonetheless, the issue of share price determination for minority shareholders is widely discussed here as well. "An issue often arising in this context is whether or not and in what way the stock price of the company should be a benchmark for the appropriateness of compensation". [18]

Current decision of the Federal Constitutional Court (FCC) is expected to have considerable effect on the future practice of squeeze-outs in the Germany. [19] "The Court's decision can be seen as falling in line with those voices in the debate that favor the discretion of the firm's majority, limited only by the obligation to adequately compensate for shares purchased." [20] That is why decision of the FCC is interesting to examine in comparison with the decision of the Georgian Constitutional Court. The issues emphasized in these decisions illustrate the similarities as well as divergences two jurisdictions may face in protection of minority shareholder rights in the squeeze-outs.

The constitutional complaint was brought in FCC by 1% minority shareholder of the close corporation "Moto-Meter", attempting to declare the squeeze out action void. [21] "The FCC concluded that the majority's discretion is constitutionally valid under Art. 14 Basic Law as long as certain protections of the minority's interests are guaranteed." [22] The Court emphasized that the minority shareholders' interests should be protected on the stage of evaluation of the fair price for their shares and that the ruling out of the minorities is constitutionally justified as long as they are compensated sufficiently. On the other hand, the FCC said that the forms of evaluating suf-

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[16] *Ibid*. §327 c (2).

[17] Kutchava, *supra* note 6.

[18] Silvia Elsland and Martin Weber, *Squeeze-outs in Germany: Determinants of the Announcement Effects*, 2005, p.2.

[19] Peer Zumbansen, *German Corporate Law in Constitutional Perspective: The Squeeze-Out*, German Law Journal Vol. 2 No. 2 – 1, February 2001.

[20] *Ibid*.

[21] *Ibid*.

[22] *Ibid*.

ficient compensation of the shares applied in practice in squeeze-outs are unconstitutional as long as they do not guarantee relevant protection of private property. The FCC demanded that the share valuation should be conducted by the courts and not an expert which is contracted by the majority shareholders. This is indispensable, as the FCC clarified, in order to protect the minority shareholders' rights. [23]

The decision of the FCC is rather complicated one. After having examined the constitutionality of a squeeze-out procedure, the FCC established that first, that there was no actual loss incurred by minority shareholders, and second, that the case didn't not heave new constitutional matters that had not been yet discussed by the FCC. In its decision the Court gave emphasis to material value of the shares in squeeze-out rule and not the membership interest of the minority shareholders. That is why the Moto-Meter minority shareholder could not succeed in claiming "the loss of membership as the basis of an objection to the squeeze-out." [24] The FCC stated that the crucial aspect of the constitutional protection for minority shareholders is "protection based on the capital market, i.e. material value, of the shares held." [25]

As it can be seen from the perspective of the German law development "the general statement that the markets are not liable in the case of a squeeze-out cannot be supported" [26] German practice of determining the share price according stock exchange price can be seen as more or less good protection for minority shareholders.

But if we apply the same rule to Georgia, it may cause difficulties, because there is no effective Georgian Stock Exchange today, as only some companies are listed on the stock market and trade shares there. Accordingly, there is no mechanism to determine the fair price. Everyone understands how independent can be the "independent expert", which is invited by majority shareholders in evaluating the shares. [27] However, the situation is different in those courtiers, including Germany, where the tradition of using the independent experts and brokerage companies has been practiced for many years and none has doubt in their objectiveness. In case of Georgia it can't be said.

Soon after the abolishment of the squeeze-out article, another article, number 53^4 was added to the Georgian Law on Entrepreneurs with the similar plot but another heading. In this case the legislator changed the proce-

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[23] *Ibid*.

[24] *Ibid*.

[25] *Ibid*.

[26] Silvia Elsland and Martin Weber, *Squeeze-outs in Germany: Determinants of the Announcement Effects*, 2005, p.26.

[27] Kutchava, *supra* note 6.

dure of share price evaluation and gave the right to determine the price to the court. In particular, only the court has right to make decision regarding the squeeze out procedure as well as to determine the price of the shares according to the Civil Procedure Code of Georgia. [28] The court does not determine the price itself but appoints the independent expert or brokerage company to evaluate the shares. [29]

But even the new solution to the existing problem seems rather weak safeguard for the minority shareholders, as far as the majority shareholders can still influence the independent expert or Brokerage Company nominated by the court.

Challenging the constitutionality of the squeeze-outs in Germany and Georgia led us to the new problem in Georgian jurisdiction, which is a need for implementation of fare price evaluation methods. The only rational solution suggested is limiting the scope of the squeeze-out article only to the companies that are listed on Georgian Stock Exchange (GSE). In this case the price will be determined according the market value of the shares and not the independent evaluation of the expert nominated by the courts. On one hand that will guarantee more fair system of evaluation and on the other hand give company opportunity to attract investments offering its shares on stock exchange. The later will help the development of stock exchange in Georgia. [30] According to the Georgian Capital Market Overview there are only 278 companies admitted to trading at GSE. [31] The number is not so high, but the recent developments on the GSE ensures relevant gain of the companies that will be trading on the stock exchange in the future.

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[28] Georgian Law on Entrepreneurs, Art. 53^4 .

[29] Civil Procedure Code of Georgia, Chapter $XXXIV^2$

[30] Kutchava, *supra* note 6.

[31] http://www.gse.ge/QuickTour/GSEPresentation_files/v3_document.htm, slide #16.