CORPORATE

SHARE TRANSFER RESTRICTIONS

Unanswered questions

The Swiss Federal Supreme Court is yet to address the questions surrounding restrictions on the transferability of shares in a company

It was only recently, on May 11 2018 and after several years of costly litigation and publicly displayed animosities between the different parties involved, that the long running conflict regarding the control over the specialty chemical company for building and motor vehicle supplies SIKA based in Switzerland was settled in an overall agreement.

SIKA was controlled by the descendants of the company's founder (the family shareholders). Formally, their shares were bundled together in a special purpose vehicle (SPV) which had no other assets and whose shares, in turn, were being held by the family shareholders. Together, the shares of the family shareholders held by the SPV represented roughly 16% of SIKA's capital but conferred to them 52.4% of all voting rights and, generally speaking, the control over the company. Furthermore, the family shareholders were represented in the board of directors of SIKA.

On December 5 2014, it was brought to the attention of SIKA's management that the family shareholders had agreed to sell all their shares in the SPV to France's Saint-Gobain, indirectly providing this company, a competitor of SIKA, with the majority of all voting rights in SIKA. As consideration Saint-Gobain would pay to the family shareholders an amount per share which greatly exceeded the inner value per share.

SIKA's management and the majority of its board of directors quickly determined that this change in control would not be in SIKA's best interest and decided to oppose it. To that end, they resolved to limit the voting rights of the family shareholders in the general meeting of shareholders with respect to all agenda items which – directly or indirectly – concerned the sale to Saint-Gobain. For this they relied on article 4 of SIKA's articles of association which is dealing with

1 MINUTE READ

Last May, the long running conflict over control of SIKA was settled. The dispute started when the controlling shareholders who held their shares via an SPV decided to sell it to Saint-Gobain. Relying on restrictions on the transferability of shares in its articles of association, SIKA opposed the sale by limiting the SPV's voting rights with respect to all agenda items in the general meeting concerned with the sale. This raised several questions regarding the possibilities of restricting the transferability of shares under Swiss law which still lack an authoritative decision because the parties ultimately settled out of court.

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restrictions on the transferability of shares. This clause provides among other, for the following:

'*The 5% Threshold*
The Board of Directors reserves the right to refuse an acquirer of registered shares as shareholder, if the number of registered shares held by him exceeds 5% of the total number of registered shares entered in the commercial register.
[…]
Legal entities and partnerships with legal capacity, which are affiliated through common ownership or votes, through common control or in any similar manner, as well as natural persons or legal entities or partnerships with legal capacity, which act in concert in view of a circumvention of registration limitations, are regarded under these provisions as a single buyer.
[…]
Fiduciary Acquisition
Furthermore, the Company may deny registration in the shareholder's register if, upon the Company's request, the acquirer does not explicitly declare that the shares have been acquired in his own name and for his own account.'

Unsurprisingly, the family shareholders did not share SIKA's point of view and challenged the decision to restrict the voting rights of their shares in court. This raised several interesting questions regarding the possibilities of restricting the transferability of shares under Swiss law. Although this high profile dispute resulted in several court decisions the case never reached the Swiss Federal Supreme Court and, consequently, these questions still lack an ultimate decision.

This article discusses some of these open questions.

Restrictions to the transferability are only possible with respect to registered shares but not with respect to bearer shares

The Swiss regime on transfer restrictions of shares in companies limited by shares

Since the Second World War the restrictions on transferability had mainly been used to ward off foreign shareholders. This changed towards the end of the 1970s when the restrictions on transferability primarily developed into an instrument to ward off hostile takeover attempts.

Nowadays, restrictions on the transferability of shares aim to prevent the emergence of new influential participations and, therefore, maintain independence of the internal corporate will. In other words, they serve to secure the economic independence and autonomy of a company. A change of the existing powers, ie of the majority shareholders, may be prevented and a diversification of the shareholdings achieved.

Overview of the rules governing restrictions on the transferability of shares in Switzerland

The Swiss legislator spelled out in some detail to what extent and in what way restrictions on the transferability of shares are permissible for Swiss companies limited by shares in articles 685 et seq. of the Swiss Code of Obligations (CO).

As a general principle and since Swiss law still recognises both registered as well as bearer shares, it should be noted that restrictions to the transferability are only possible with respect to registered shares but not with respect to bearer shares.

The Swiss legal regime on restrictions of the transferability of shares makes two important distinctions:

First, the Swiss solution distinguishes between statutory restrictions and restrictions pursuant to the articles of association of the entity which has issued the shares in question.

- Statutory restrictions point to the relatively straightforward restriction of the transferability of registered shares which have not yet been fully paid up. With respect to such shares the issuing company may withhold its consent to them being transferred if the solvency of the acquirer is in doubt and the security requested by the company is not furnished.
- With respect to restrictions pursuant to the articles of association, generally speaking, the company's articles of association may stipulate that the shares may be transferred

only with the consent of the company. Such consent requirement also applies to the establishment of a usufruct but falls away as soon as the company concerned goes into liquidation.

However, in the case of restrictions based on the articles of association, a second distinction has to be made with respect to the question of whether or not the shares in question are listed.

Unlisted registered shares

If unlisted shares are concerned the company enjoys greater freedom to restrict their transferability. In this case, the company may refuse to give its consent to the transfer of the shares if it states good cause cited in the articles of association. Furthermore, the company may also refuse to give its consent if the acquirer fails to declare expressly that they have acquired the shares in question in their own name and for their own account.

A cause is deemed sufficient (ie good cause) if it is based on provisions governing the composition of the entirety of shareholders which are designed to safeguard the pursuit of the company's objectives or its economic independence. Depending on the circumstances of the specific case at hand, the purpose clause in the articles of association may justify the company's refusal of new shareholders if their person or their business were irreconcilable with the company's purpose. However, this would require that the company's purpose clause specifically enumerates to whose benefit the company's business is conducted, be it a family, a political organisation, or members of a professional or geographical group. In addition, the preservation of the company's independence may also qualify as good cause. On this basis, a purchaser of shares could be refused if he was a competitor of the company. However, in all the aforementioned instances an explicit provision in the articles of association is required.

In order to maintain independence, the articles of association may also provide for a percentage limit on the registered shares. In that case the board of directors can refuse to inscribe in the share register any shareholder or shareholder group acting in concert to the extent that they acquire more shares in the company than the percentage limit allows.

Alternatively, ie if the company lacks good cause on which the refusal can be based, it can still offer to acquire the shares from the seller for its own account, for the account of other shareholders or for the account of third parties at their real value at the time the request for consent was made (this being the so-called escape clause). If the parties cannot agree on the real value of the shares in question, they may petition the court to make that determination in their stead. Otherwise, it is worth noting, that the offer shall be deemed to be accepted if the acquirer fails to decline the company's offer within one month of the notification of their real value.

The company has to decide whether or not to refuse the entry of a purchaser of shares in the share register upon his or her request. As long as the consent is not given for the transfer of the shares, ownership and all rights connected thereto remain with the seller. However, to prevent the company from just delaying a decision to the detriment of the acquirer (and the seller) the CO provides that if the company fails to refuse the request for consent within three months of receipt of the petition such consent is deemed to have been given.

In any case, the company's articles may not impose transfer restrictions which go beyond the above.

In order to maintain independence, the articles of association may also provide for a percentage limit on the registered shares

Listed registered shares

If, on the other hand, the shares in question are listed on a stock exchange, then the company's freedom to limit their transferability is substantially smaller. It may refuse to accept the acquirer of the shares as a shareholder only where either the articles of association envisage a percentage limit (percentage clause) on the registered shares for which an acquirer must be recognised as shareholder and such limit is exceeded or, alternatively and similarly to where

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unlisted shares are concerned, where at the company's request the acquirer fails to declare expressly that he has acquired the shares in his own name and for his own account (known as fiduciary clause). With respect to the percentage clause, legal literature opines that a limit of three to 10% may be justified, depending on the circumstances of the particular case.

As to the effects of the purchase of shares with the company's consent still pending there are differences whether or not the shares were acquired on a stock exchange. If they were, the attendant rights pass to the purchaser on transfer, whereas if the purchase was made off-exchange, the attendant rights pass to the acquirer as soon as he has submitted a request for recognition as shareholder to the company. In both cases, the purchaser may not exercise voting rights prior to having obtained the company's consent. If the company does not give its consent the purchaser will be entered in the share register as a shareholder without voting rights. Again, to prevent the company from unduly delaying its decision a purchaser is deemed to be recognised as a shareholder if the company fails to refuse his request for recognition within 20 days.

In practice, the competence to give or to withhold the consent to the transfer of shares is attributed to the board of directors in most of the cases. While, theoretically, this power could also be given to the general meeting of shareholders this is normally not the case for reasons of practicability.

Effects of restrictions on transferability

Whether transfer restrictions in the above described sense are perceived as positive or as negative largely depends on who is asked.

It is evident that transfer restrictions complicate takeovers against the will of the company for the purchaser and allow the board of directors to choose who shall become a company's shareholder. In that sense, they serve as effective defense measures against hostile takeovers.

Furthermore, as the pre-mentioned SIKA case goes to show, transfer restrictions may also serve to perpetuate the existing shareholder structure. On the one hand, this may be to an existing major shareholder's benefit as they may require less capital to maintain control over their company, especially if the transfer restrictions are combined with voting shares. On the other hand, and this became evident in the SIKA case as well, transfer restrictions may also prove to be detrimental to an existing major shareholder as the company may prevent them to some extent from selling their stake in the company in case they want to divest. It seems fair to assume that this would have a negative impact on the value of the share package if the shareholder tried to sell it. In that sense, transfer restrictions tend to perpetuate the status quo for better or for worse.

The court concluded that maintaining economic independence was the main purpose of the transfer restriction provision

Furthermore, if there is no major shareholder, strong transfer restrictions including percentage limits may also have a negative impact from the point of view of the company's other shareholders. They prevent such a major shareholder from arising and becoming able to act as a counterweight to the board and the management. This may result in an increase of the agency problem and, accordingly, agency costs. Also, this may be aggravated in publicly listed companies which tend to already have dispersed shareholders. The same principle holds true in case there is a majority shareholder who guards himself with such transfer restrictions against other major shareholders arising with the agency conflicts existing between the majority and the minority shareholders.

To sum up, transfer restrictions usually are in the interest of the board of directors. At the same time, it really depends on the specific circumstances of whether a current majority shareholder (if any) could also benefit from transfer restrictions. In any case, they tend to perpetuate the status quo and are, therefore, detrimental for anyone intending to build up a substantial stake in the company against the board's wishes.

Remaining uncertainties under the Swiss regime

One remarkable aspect of the SIKA case was that the family shareholders intended to sell their shares in the SPV and not directly the shares in SIKA. It was intensely debated whether such an indirect transfer can trigger the board of directors' right to refuse the transfer of shares.

Another reason why the SIKA case attracted so much attention was the fact that the board of directors applied the share transfer restriction provision before a request for an approval of the share transfer was made. The board of directors limited the family shareholders' voting rights as soon as it had learned of their intention to sell the shares in their SPV to Saint-Gobain.

The court of first instance (Cantonal Court) ruled that a transfer restriction provision can also be applied if someone attempts to circumvent it by employing means which are formally permissible. Accordingly, in the matter at hand, the court concluded that, in view of the purpose of the transfer restriction clause, it was to be applied although the shares in SIKA were not acquired directly but were only to be acquired indirectly through the acquisition of the shares in the SPV. The court considered in particular the anticipated replacement of the board of directors under the share purchase agreement to create conditions under which the new shareholder will be approved, as an undue circumvention of the restrictions.The court namely held that the non-re-election or an election of certain members of the board of directors is a workaround of the transfer restriction provision if:

a) the election is solely intended to elect directors that do not apply the share transfer restriction provision; and

b) there is a legal obligation to exercise voting rights in the election of the board of directors in the interest of the acquirer as for example in a share purchase agreement.

Another argument to uphold the share transfer restriction that was mentioned by the court was that the shares in SIKA were the only material assets in the SPV and that the actual purchase object were not the shares in the SPV but the shares in SIKA.

The court concluded that in the case at hand maintaining economic independence was the main purpose of the transfer restriction provision and therefore encompassed the indirect acquisition of shares.

It has to be noted that when it comes to the introduction of a provision regarding the restriction on share transfers according to a percentage clause a shareholder already exceeding the relevant percentage enjoys protection which means that the board of directors cannot refuse the voting rights relating to these shares (so-called grandfathering exception). There is unanimous doctrine that the grandfathering exception is justified and should apply. However, it remains unclear whether such privilege can be passed on in an indirect sale of shares.

Even though the Cantonal Court of Appeal confirmed the first instance court's decision that the board of directors had the right to apply the share transfer restriction, uncertainties with regard to the scope of the transfer restriction provision remain due to the lack of a final Swiss Federal Supreme Court decision.

Conclusion

The SIKA case shows that restrictions on the transferability of shares can be a strong defence against a takeover of a company. The board of directors is given great power to decide on the transfer of shares. Majority shareholders especially may face difficulties when it comes to the sale of their stake because the transfer of shares depends on the approval of the board of directors.

It's worth remembering that resolutions of the board of directors are not subject to direct judicial control. It will be hard to raise a claim for annulment of the board's decision because there will hardly be reasons for nullity in connection with the share transfer. In cases where the board of directors refuses the transfer of shares the acquirer's only hope remains an action for recognition as shareholder.

When it comes to drawing up provisions regarding the restrictions on transferability of shares, the following must be considered. The shareholders should carefully weigh all pros and cons for the implementation of restrictions on transferability of shares. In other words, they should answer the following question: does the preservation of independence and autonomy of the company outweigh the possibility that the board of directors might apply the provision regarding the restriction on transferability and, therefore, prevent a future sale of shares?

If a restriction on transferability is considered a benefit, a diligent drafting of the provision is necessary. On the one hand, all aspects in which a transfer of shares should be restricted have to be considered and stipulated. On the other, it has to be ensured that the provision is not too broad and excessively hinders a later sale of the shares.

From a bidder's point of view, a precise analysis of the transfer restrictions is necessary before the start of a takeover attempt. It may be, in addition, advisable to involve the board of directors of the target company as early as possible if restricted shares are to be transferred and to seek professional advice in advance so that risks can be correctly assessed and costs reduced. One does not want to find oneself in a hopeless situation or in long, nerve-stretching and costly legal disputes.