Nullification of Subscription of Shares

By

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1. Introduction

This article discusses the possibilities for share subscribers to declare their share subscription void in the case of fault or defect in the subscription, and thus receive the paid amount back. The rules concerning nullification and rescission are central mechanisms governing and sanctioning contracts, as well as in other legal relations. However when it comes to share subscription there is also the damage risk for a third part. This risk is the reason why share subscription has held a unique position compared to other contractual situations in a way that allows separate rules. To obtain nullification is of great juridical matter, especially since it can result in vindication. In the case of bankruptcy a party could claim separation of his property if he can get the purchase declared void by pleading to grounds of nullification in the Contracts Act. Has the purchaser been mislead by for instance false information from the company, he can get the purchase declared void, supported by the Contracts Act Ch 3. The nullification of the share subscription means that the transaction must return *Zug um Zug,*[1] both parties

[1] BGH 05.07.199(II ZR 194/92), infra note 30.

shall refund what has been received,[2] and be adjudged as before the share subscription took place.

One of the fundamental appreciations in Swedish company law is however that the nullification rules in the Contracts Act are not applicable when the shares are acquired directly from the issuing company. Share subscription pursued in conflict with the law or under misleading conditions can be declared void prior to the registration of the raise of capital, according to Companies Act Ch 2 sec. 5 when a company is formed, and according to Ch 4 sec. 8, which refers to Ch 2 sec. 5, in later issues of shares. According to these sections the share subscription is void if the subscription is effectuated in terms that are not in accordance with the issue decision, but the possibility of declaring the share subscription void is only valid until the registration at the Registrars Office is executed. In the legal theory this deviation from general contract rules has been motivated by the protection of the company's capital. The purpose of Ch 2 sec. 5 is thus to prevent that the share capital, after the company has been registered, is decreased through the nullification. The company's registration shall have a repairing effect, and the rules in the Contracts Act will, after the point of the company's capital increasing registration, no longer be applicable.

The rules regarding companies are constructed as a balance between two principles, each with a primary protection group, namely norms established with a third part's interests in concern, such as the company's creditors, and norms established with the share holders in concern. The inadequate possibility to declare the share subscription void is a result of the legislator's priority of the company creditor's interests prior to the shareholder's interests. Arguments can be presented as well in favour of as against this preference. On one hand legislation regarding subscription of shares deep consideration to third parties must be taken. Would general rules of invalidity on grounds of inadequate prerequisite be applicable, uncertainty would prevail far more from what is usual in for instance an ordinary purchase. On the other hand, in the light of an increasing focus on investor protection, it can be discussed whether creditors should be prioritised, at least to such great extent that is governing, rather than a mislead share subscriber. Discussed in the article is whether hitherto presented arguments against the possibility of getting the subscription of shares declared void agrees with the legislators intention with the legislation on the security market, namely to protect the public confidence in the security market and the protection of that markets investors.

[2] *Kurt Grönfors,* Kommentarer till avtalslagen, 1995, p. 182.

2. Governing rules

The reason for the hindrance of applying general nullification rules in civil law after the time of registration of the capital increase is consequently the protection of the company's creditors. When the registration is effectuated and the capital increase is made public the contract is no longer solely of interest to the subscriber and issuer, but also in the highest possible degree of third part's interest. A reimbursement of the payment for shares requires a reduction of the share capital, and in worst case to the dissolving of the company. This is applicable when forming a new company as well as when increasing the share capital in an already existing company. Swedish practise and legal theory consequently uphold that a shareholder is prevented from the possibility of carrying a plea against a company to get his share subscription declared void, motivated by the protection of the company capital. The Company Law Committee has stated that this principle was established 1935 in a case from Supreme Court, NJA 1935 s. 270, together with an article where Hjalmar Karlgren discusses this principle.[3] The Committee establishes that the Companies Act does not include rules regarding rescission, but when the registration of the company is completed the company can be dissolved only through liquidation, amalgamation or in some cases bankruptcy.[4]

In the legal theory accordingly it is the standpoint that share subscribers do not have the possibility to get their share subscriptions declared void after the point of registration. In the commentary to the old Companies Act Stenbeck, Wijnbladh and Nial thus state that share subscribers after the point of registration cannot adduce misleading information as ground for nullification.[5] It is held that invalidity grounds that apply against the contracting party independent of good faith probably could be applied after the point of registration, thus the subscription could be declared void in cases where a strong ground of invalidity is at hand.[6] This view is shared by Kedner-Roos and Rodhe, and is also stated in the preparatory work.[7]

3 SOU 1997:22 p. 227. For Karlgrens position see sektion 2.2.

4 SOU 1992:83 p. 230.

5 *Einar Stenbeck, Mauritz Wijnbladh, Håkan Nial*, Aktiebolagslagen jämte dithörande författningar med förklaringar, 1966, p. 53.

6 As if in case of incapacitation or coarse duress, whereas fraud is a weak ground of invalidity, see e.g. *Henry Ussing*, Aftaler, 1945, p. 123.

7 *Gösta Kedner, Carl Martin Roos, Rolf Skog,* Aktiebolagslagen med kommentarer, p. 52; *Knut Rodhe*, Aktiebolagsrätt, p. 45, prop 1975:103 p. 298; SOU 1997:22, p. 227.

2.1. Legal practice as ground for governing rules

The Supreme Court in the case NJA 1918 s 398 established the principle that share subscription neither can be declared void on the basis of fraud nor on the basis of misleading information. The case concerned share subscription where one of the founders of the company to the subscription list had attached a statement regarding the economy of the company, which contained incorrect information. In the attachment it was wrongly stated that the company owned patents in 13 countries. At the time of the share subscription the patents in a number of countries had expired, and the company in fact only had five valid patents. The share subscriber claimed that the share subscription should be declared void, at which the company should be imposed to rescind the paid amount. In spite the case being unopposed to the claim, the share subscriber was bound to the share subscription. The Supreme Court established that a share subscriber not even under enticing fraud could "elude oneself from the obligation, through the share subscription, towards the later founded company."[8]

The case from 1935, NJA 1935 s. 270, did not concern nullification of share subscription, but the right to be reimbursed for shares that had become worthless in the Kreuger bankruptcy. The ground for the claim was that the board members in the economic reporting regarding the company had given false and misleading information. The Supreme Court found the board members guilty, but stated that the company Kreuger & Toll should not award damages to the by fraud misled shareholder.[9]

2.2. Positioning in the legal theory

In the legal theory a discussion was carried about the share subscribers respectively the creditors' interests according to the Kreuger & Toll ruling in the Supreme Court. In the above-mentioned article Karlgren discusses both cases and raises the question whether invalidity rules in contracts law could be applicable on share subscription.[10] Karlgren agrees that nullification of share subscription leads to capital excavation and possibly damage to the creditors, at which the capital maintenance rules would fail to produce the desired effect. He concludes that instead of applying general nullification rules on share subscriptions, penal and tort liability can be considered.[11]

8 NJA 1918 s. 398 on p. 401.

9 *af Sandeberg*, Prospekt ansvaret – Caveat Emptor eller Caveat Venditor, 2001, p. 270.

10 *Hjalmar Karlgren*, "Några aktierättsliga anteckningar i anledning av ett par rättsfall", SvJT 1938 p. 187.

11 Id, pp. 198-199

Karlgren does however take the standpoint that share subscribers should be able to plead general principles of law concerning nullification and reimbursement as long as the claim does not intricate the company's restricted capital. Karlgren also states that strong grounds of invalidity should be applicable independently of subscription for shares.[12] Fredenberg criticised the ruling in the 1935 case, claiming that the ruling is a "sensational exception from general nullification and liability rules in the civil law."[13] Fredenberg's position is that the company's assets should be used for replacing mislead share subscribers, as long as the share capital is intact. Fredenberg finds that the inviolable capital should at least not include the reserve fund, since the capital in the reserve fund is not included in the share capital, and therefore not created to uphold the creditor's protection.[14] In a retort Karlgren pleads that Swedish practice does not give support to the argument that only the share capital is inviolable.[15]

Also Danielsson discusses the applicability of contracts law associated to the legal cases.[16] According to Danielsson the court has in the 1935 case certainly made a weighing between general rules concerning protection against fraud etc. and company law protection for the creditors, giving the protection of the creditor's precedence.

2.3. Nullification of subscription of shares in various countries legal systems

In Denmark the point of view in practice as well as in the doctrine is that subscription of shares can be nullified. Gomard emphasizes that share subscription is an act of will, and that the share subscription, like other acts of will, can be nullified according to the Danish Contracts Act Ch 3 and other similar rules and general principles regarding invalidity.[17] Nullification rules can be made valid even after that the share registration has been made, but should be done "as soon as possible" out of consideration for the company's creditors.[18] Also Schaumburg Müller and Bruun Hansen points at the possibility of getting a share subscription nullified in the event of misleading prospectus information.[19]

12 Ibid, and in "Om stiftelseurkund", p. 87.

13 *Gösta Fredenberg*, Skyddsbehövande bolagsborgenärer, SvJT 1938 p. 714-715 at p. 714. (Fredenberg was one of the creditors.)

14 Id. p. 715.

15 Ibid.

16 *Erik Danielsson*, Aktiekapitalet, 1952, pp. 73 and 84.

17 *Bernhard Gomard*, Aktieselskaber og anpartsselskaber, 2000, p. 101.

18 See UfR 1921.988 H and 1921.1005 H.

19 *Per Schaumburg Müller & Erik Bruun Hansen*, Dansk Børsret, 1995, p. 145.

According to the Norwegian Companies Act Sec. 2-10 a share subscription cannot be nullified after its registration in cases where the share subscription is void according to general civil law principles. However it its stated in the rule that the registration does not make the subscription binding when it has been forged, is signed under duress or by violation of the articles of association. In contrast to the Swedish Companies Act it follows that nullification can be done even after the registration, but only when a strong ground of nullification is at hand. In sec. 2-10 it is also stated that in the case of nullification of the subscription, the board of directors can reduce the share capital with the equivalent amount, as long as the share capital is not decreased below the legal minimum.[20]

In Norway, as in Sweden, a restrictive legal practice has been ruling regarding the possibility of declaring share subscription void. In the cases Rt. 1926.512 and Rt. 1932.145 it was established that incorrect and misleading information in connection with the issue can not be held as a ground for declaring a share subscription void.[21] In a case from 1988[22] concerning subscription of shares in a limited partnership, the Supreme Court however ruled contradictory. In this case the court approved the plaintiffs plead to declare the share subscription void in spite of the registration of the subscription. The courts argument was that it is immaterial to the creditors if the nullifying event occurred before or after the registration, since the creditors interest only can be harmed in the case of insolvency. In a decision from later years, however, the previously upheld principle has been confirmed. The case Rt. 1996.1463 concerned invalidity of shares in a limited partnership, but the Supreme Court did make it clear that the ruling is also applicable to limited companies held by shares.[23]

In Norwegian practise it has been established that share subscription is binding even if it has been done with faulty documents.[24] In the legal theory this has been interpreted thus that a share subscriber even presented with misleading information cannot get the subscription declared void.[25] The right to nullify has on the other hand been granted if the application has been made

[20] One million NEK.

[21] Whereas the board of directors were imposed responsibility. See also Rt.1926.519 and Rt.1934.946.

[22] Rt.1988.982.

[23] Rt.1996.1463 p. 7.

[24] Rt.1978.786, Rt.1997.1010.

[25] *Per Augdahl*, Aksjeselskapet etter norsk rett, 1959, p. 79, *Mads Andenćs*, Aksjeselskaper og Allmennakskesellskaper, 1998 p. 109, *Hans Fredrik Marthinhussen & Martin Aarbakke* Aksjeloven, 1996, p. 85.

before the point of registration.[26] Also in the Norwegian literature it is stated that subscription of shares cannot be declared void after the point of registration.[27]

According to German Börsengesetz there is even a statutory possibility for mislead share subscribers to get the subscription nullified. In BörsG sec. 45 it is stated that a company can be imposed the responsibility to repurchase the shares from mislead investors.[28] This possibility is directly contrary to prior leading legal practice and theory accordingly to which, as in Sweden and Norway, consideration for the creditors interests was an obstacle against that the company's shareholders could claim nullification. Under the influence of, among other things, the emerging legal system of the EC during the 1990´s the standpoint regarding nullification of share subscription has changed. In e.g. BGH 05.07.1993[29] the company was sentenced to repurchase the shares from the mislead investor. The court ruled that the transactions should return *Zug um Zug*, meaning that the shares should be returned to the company, and the investor should be reimbursed the invested money.[30]

In the English and respectively in the American legal system nullification of shares is in theory possible, but is in practice rarely used.[31]

3. Criticism against applicable law

It is thus clear that in Sweden nullification of share subscription cannot be done after the point of registration and a capital increase. The question is however whether this is a situation that should be upheld de lege ferenda. Following are the different arguments that have been raised for and against nullification of share subscription.

[26] Rt.1915.265, Rt. 1926.471.

[27] See Ing. *Magnus Aarbakke*, "Aksjetegning: ugyldighet, mislighold og ansvar", TfR 1989 p. 333 at p. 344, *Kristin Normann Aarum*, Styremedlemmers erstatningsansvar i aksjeselskaper.

[28] Notable is also that according to BörsG sec. 48 it is not possible to exempt liability.

[29] BGH 05.07.1993 (II ZR 194/92).

[30] This has consequently lead to a discussion concerning the possibility for a company to repurchase its own shares, see e.g. *Eberhard Schwark*, Prospekthaftung und Kapitalerhaltung in der AG, Raisch-collection, Peter Raisch um 70 Geburtstag, 1995 and further *af Sandeberg*, supra note 9 pp. 221-222.

[31] See further *af Sandeberg*, supra note 9, pp. 206 and pp. 249.

3.1. Time of registration as hindrance for nullification

After the point of registration the share subscriber is bound to the share subscription, but the point of registration as a hindrance to the share subscriber's possibility of nullification can be questioned. Prior to the registration of the capital increase the creditors have no knowledge of the increase, thus they cannot have any expectations of a higher capital, and civil nullification rules are applicable. When the capital increase has been registered the share subscription has been made public, at which the creditor's protection is used as the argument for not declaring the share subscription void.

The registration is at many issues effectuated directly after the subscription amount has been paid, even though the payments respite is but a few days after the subscription periods end. Often a subscription is accomplished through payment, since the payment shall be available on the subscriber's account under a certain period. The share subscriber consequently does not have much time to reconsider. Faultiness of the share subscription is usually only revealed some time after the allotment of the shares. At least when the company's directors intentionally have misled the share subscribers, they most likely try to conceal the misleading information. The possibility of nullification is according to this rather restricted.

The practical meaning of the registration of the capital increase is not as important as one might think according to the emphasis of the registration in the Companies Act. In practice the third party takes as great consideration to the information in the company's financial report as to the registered capital.[32]

3.2. Motives to make a distinction between strong and weak grounds of nullification

In the legal theory is also discussed, as mentioned above, which nullification grounds should be accepted. Karlgren states that strong nullification grounds should be allowed to be pleaded even after the point of registration.[33] In principle reigns unanimity in the attitude that a share subscription should be declared void, in the case where a strong nullification ground is at hand.[34]

If the argument that the protection of the company's capital constitutes the legal ground for not declaring the subscription void, there is no motivation to distinguish between the cases where strong and weak nullification grounds are at hand.

[32] Also *Karlgren*, supra note 10, at p. 202, and *Håkan Nial*, Om aktiebrev, 1929 p. 95.
[33] Idem, and *Karlgren*, supra note 12, p. 87.
[34] *Aarbakke*, supra note 27 at p. 349.

3.3. Protection of the company's capital

The argument that the company's capital should be protected and the use of capital as reimbursement in the form of damages prohibited is upheld in favour of the company's creditors. The company holds a unique position through the owners not being personally liable for the company's liabilities exceeding the amount that is registered as share capital. The company shall further, according to the Swedish Companies Act Ch 12 sec. 4, reserve a certain amount of the profits into the reserve fund. Also further set aside is the amount that is paid for the share above its nominal value in a premium rate fund. The share capital, the reserve fund and the premium rate fund together form the restricted equity. The assets being restricted means that they cannot be used as dividend to the shareholders. The restricted equity aim to create the capital base that will satisfy the demands for the protection of the company's creditors. The company's remaining profit that is not restricted constitute the free assets. The free assets can on the other hand be used as dividend to the shareholders. The amount equivalent to the free capital should consequently also be free to reimburse mislead shareholders.

The problem arises in the conflict between creditor protection and investor protection. A relevant question is however to what extent the capital maintenance rules really meet the demands for protection of the creditors.[35] The company's creditors have been given precendece for a long time, and the reasons for investor protection being neglected are many. Initially the capital risk market has traditionally been relatively restricted, and the investors were formerly few. The company law further has not been adjusted to the market as much as the economically influenced capital market law. Thus it has not been usual to take consideration to the allocation function of the capital market. Scandinavian company law has historically been influenced by the German view upon creditor and investment protection, with the point of view that investments in the capital market is pursued on personal risk.[36] The Anglo-American perspective however gradually influences the German as well as the Scandinavian company law, where the interests of the investors are given preference. In American law the requirements of a minimum capital is gradually being abandoned. The legal demand of share capital and share nominal value is considered misleading for the creditors, and to the

[35] This question is discussed by *Jan Andersson*, Kapitalskyddet i aktiebolag, 1999, and *Paul Krüger Andersen*, Kapitalregler og ansvar, in Selskabers organisation, Langsted ed., 1999, at p. 32.

[36] Warneyers Rechtsprechung 1908, nr 164.

disadvantage of the economical development.[37] Therefore many of the states in the United States do not demand any minimum capital when forming a company, and it is claimed that the creditor's protection is satisfied through a security or control of the company's financing policy. The creditor thus does not pay attention to the volume of the own capital, but to the company's liquidity, cash flow and comparable key numbers and figures. One example of this is that for a long time a company's acquisitions of own shares has been regarded as a natural part of the managing a company. The amount that is used as dividend to share holders may also be used to buy shares, since from the creditors' point of view it is immaterial *why* the company's capital is reduced. The perspective is influenced by the realisation that the allocation function of the capital market is necessary as legal ruling criteria.

3.4. Alternative need for protection when a company is formed and when new shares are issued?

Nullification of share subscription is according to Swedish law neither possible if the acquisition of shares is made neither when a company is formed nor when it is issuing new shares. However it can be considered whether these two situations should be regarded as equal. Share subscription when forming a company is in many ways different from subscribing in a new issue of shares. The main difference is that if the subscription when forming a company would be declared void the creation of the company would be threatened. The effect on the share capital could be an argument in favour of upholding the governing principle, that declaring a share subscription void is impossible. But declaring the share subscription void when issuing new shares does not necessarily affect the company's existence. If the intent of the new issue is bringing more capital for investments, expansion of the business through acquisitions or other reasons the nullification can be done without affecting the company's original bound capital. If the issuing of new shares was made to consolidate an activity that previously was not solid, the creditors´ position was already affected before the issue.

When interpreting the company law as well as tort law the protective interest must be established when deciding on the rules applicability. Should we then allow invalidity of the subscription in cases of forming a new company? What should our opinion be in a case where the share subscription is done under duress, or by a person that is declared incapacitated? Or when the share subscriber has been mislead by information given by the company,

[37] Revised Model Business Corporation Act. See *Andersson*, supra note 35, at p. 38.

as in the case of fraud? What would be most politically correct – to save the company and let the company and it's deceitful representatives pursue their activities, or to reimburse the investors and by that end the company's activity?

Who is in these respective cases most worthy of protection, the creditors or the investors who due to misleading information have contributed with money?

3.5. A weighing of worthy interests

The Swedish Supreme Court has in the cases mentioned above upheld the protection of the company's creditors. Should the nullification rules in the Contracts Act be applicable the position of the creditors would be undermined, at which the protection given the creditors by the rules in the Companies Act would appear ineffective.

In legislation the interest of the third party must thoughtfully be taken into consideration. But with an emerging focus on investment protection it must be discussed whether this strict rule should be upheld. The creditors' protection in the area of company law is a result of the legislator's priority of the company's creditor's interests prior to the investors. A number of arguments can be presented for and against this. In contrary to the traditional creditor protection the investment protection has had a difficult time to justify itself as a legal principle,[38] and practice is based upon historical priorities with roots in the interwar year's legal practice and judicial theory, where consideration to the company's creditors was graver than to the shareholders. The question is whether a rule favouring the protection of the creditors de lege ferenda should be the determining factor for the subscriber's possibilities to plead contractual nullification rules against the company. Is it fair that dishonest transactions get the intended effect and are valid? Investor's need for protection against fraud in connection with share subscription ought to be taken into consideration introducing the possibility to declare a share subscription void.[39] It can further be argued that a company's representatives who deceitfully have misled investors should be allowed to use this capital to favour company's creditors.

It is also true that the consideration to the other shareholders´ interests can render an argument against declaring the share subscription void, since it can lead to that different shareholders will be given different economic rights in the company. Reimbursements to share subscribers relatively reduce the

[38] Apart from the rules in the Companies Act protecting the minority.

[39] Deserved to be mentioned is also that the concern of the shareholders creditors ought to be taken into consideration – the acquisition is often financed through a loan on security.

underlying value of the company per share, meaning a reduced value of the shareholders' capital. But the capital that should be protected in advantage for the creditors as well as for the shareholders should only include capital increase that has been made in proper order, and not money that has been added on faulty basis. It is true that new creditors might have been relying on the size of the share capital, but to prioritise these instead of a subscriber who has based his action on misleading information violates general legal principles.[40]

Even less justifiable is to intercept the share subscriber from the possibility of nullification when no current creditor's interests are harmed. Creditors are not harmed when it is a question of reimbursing funds that are not included in the restricted capital. When issuing new shares previous shareholders will only be affected if the amount paid back exceeds what was paid for the share; in other cases they are put in the same situation as before the issuing of new shares. Not even in the case where it after the issuing of new shares appears that the company is insolvent at the time of the issue the previous creditors will be in a worse situation because of the cancellation of the purchase. In these cases it is not easy to defend the view that a share subscriber cannot get reimbursed the paid amount.

This should lead to the consideration of the creditor interest getting outweigh in the cases where share subscribers reimbursements demands do not result in insolvency.

3.5.1. A comparison of the company's acquisition of its own shares

One alternative to nullification of share subscription is to impose upon the company the obligation to repurchase the shares from injured investors. The company has thus within a certain time the possibility to reoffer the shares for sale, to a price that is adjusted to what the market is willing to pay. The company could carry a loss consisting of the difference between the price the misled investor paid and the price of the later settlement. If it is not possible to sell the shares again it shall be declared void, and the company must reduce the share capital with the equivalent amount.

A company is allowed to a purchase of its own shares by the use of free assets and with up to ten per cent of the company's shares.[41] In the Swedish Companies Act Ch 7 sec. 10 is stated that shares that have been acquired in conflict with the regulations should be sold within six months of the acquisition, and further that shares that are not sold within the time limit shall

[40] "Creditors shall not line their pockets on the debtors void contract", e.g. *Gertrud Lennander*, Festskrift till Hellner, p. 323.

[41] The Companies Act Ch 7.

be declared void.[42] The company should at this reduce the share capital with the equivalent amount of the shares nominal value. Should that reduction be in conflict to applicable rules concerning the lowest allowed share capital, the company shall go into liquidation.[43]

4. Concluding remarks

In conclusion the following can be established: Nullification when forming a new company can have the effect that the company is not being registered. But is it legally and politically motivated that the company's representatives should carry on the business activity if the share subscription is made through proceedings that would render the possibility of nullification according to contract law? Is it not in these cases more correct that the company's activity is ended? Who is in this case most worthy of protection, the company's creditors or the persons who trough swindle have contributed capital?

To entirely admit the possibility of nullification of share subscription when forming a company would however probably bring a great uncertainty for all involved parties. An effective way to minimize this uncertainty is strict rules of limitation. One possibility is further to admit nullification only to a certain per cent age of the share capital, and as long as the share capital does not fall below the minimum amount stated in the Companies Act.

The situation is different in the case of issuing new shares. A nullification of the share subscription does, even if this would mean that the entire amount would be paid back, not affect the company's existence as when forming a new company. Nullification should then be possible irrespective. The company has the prerogative to renew its offer of subscription of shares, and this time on proper grounds.

The subject of the rules and regulations of the capital market is the allocation function and the protection of investors.[44] The rules governing the capital market shall then comply with this intention. It is time to abandon the principles created when a company held by shares was a rarity, to prioritise investor protection and let companies that are led by crooks and culpable representatives dissolve.

[42] Se 77/91/EEC Art 20 sec. 3.
[43] Prop 1999/2000:34 p. 66.
[44] See e.g. prop 1990/91:142 p. 78.