Annulment of Subscriptions for Shares

by

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1. Introduction

This article discusses the possibilities for subscribers to shares to declare their subscriptions void if there is a defect in the subscription, and thus receive

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back the money they have paid. The rules on annulment and rescission are central concepts of contract law, as well as in other legal relations. However when it comes to share subscriptions there is also the risk of damage to third parties. This risk is the reason why share subscriptions have had a unique position compared to other contractual agreements, and this has led to the development of separate rules. To obtain annulment is of serious legal matter, especially since it can result in restitution. In the case of bankruptcy, a party to a contract may be able to claim the rights of secured creditor if he can get the contract declared void on the grounds of nullity under the Contracts Act. If a subscriber for shares has been misled, for instance by false information from the company, he can get the subscription declared void, under the Swedish Contracts Act, Ch. 3. The annulment of the share subscription means that the transaction must return to the *status quo ante* (*Zug um Zug*),[1] where both parties must refund what has been received,[2] and be put in the positions they had before the share subscription took place.

However, one of the fundamental rules in Swedish company law is that the annulment rules in the Contracts Act do not apply when the shares have been acquired direct from the issuing company. Share issues made under terms which are illegal or misleading can be declared void prior to the registration of the issue of the shares according to Companies Act, Ch. 2-5 when a company is formed, and according to Ch. 4-8, which refers to Ch. 2-5, with subsequent issues of shares. According to these provisions, the share subscription is void if the subscription is made in terms that are not in accordance with the issue decision, but the possibility of declaring the share subscription void only exists prior to the registration being made at the Registrar's Office. In legal theory this deviation from general contract rules has been justified by the need to protect the company's capital. The purpose of Ch 2-5 is thus to prevent the share capital being decreased by the annulment of a subscription after it has been registered. The registration alters the position, and after the registration the rules in the Contracts Act no longer apply.

The rules on companies are constructed so as to strike a balance between two opposing groups, each with a primary interest to protect. These are the rules for the protection of the interests of third parties, such as the company's creditors. And there are the rules established to protect the interests of shareholders. The limited possibility of declaring a share subscription void is due to the law giving priority to the interests of the company's creditors over the interests of the shareholders. Arguments can be made both for and against this policy. On the one hand legislation on share subscriptions should take proper account of the interests of third parties. If the general rules allowed annulment on the grounds of some defect in the share issue, there would be

1 BGH 05.07.1993(II ZR 194/92).

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

much more uncertainty than is usual today. On the other hand, in the light of the increased focus on investor protection, it can be questioned whether creditors should be prioritised, at least to the extent that they are today, where they are protected at the expense of share subscribers who have been misled. This article discusses whether the arguments presented hitherto against allowing a share subscription to be declared void are in accordance with the legislators' intentions as reflected in the laws of the securities market, which are intended to protect public confidence in the securities market and to protect investors.

2. Governing rules

The argument for restricting the application of the general nullification rules of civil law after the registration of a share issue is thus that it protects the company's creditors. When the issue is registered and the capital increase is made public, the contract is no longer solely of interest to the subscriber and issuer, but it can also become of interest to third parties. To make a refund for subscribed shares would require a reduction of the share capital, and in the worst case this could lead to the winding up of the company. This applies both to the formation of a new company and to an increase of the share capital of an existing company. Swedish practice and legal theory consequently maintain that a shareholder may not take action against a company to recover his share subscription, out of consideration for the protection of the company's capital. The Company Law Committee has stated that this principle was established 1935 in a case before the Supreme Court, NJA 1935 p. 270, together with an article in which Hjalmar Karlgren discusses this principle.[3] The Committee establishes that the Companies Act does not include rules on rescission, but once the registration of the company has been completed, the company can only be dissolved by winding up, merger or in some cases insolvency.[4]

Thus, according to legal theory, share subscribers have no possibility of getting their subscriptions declared void after the point of registration. In their commentary to the old Companies Act, Stenbeck, Wijnbladh and Nial state that, after the point of registration, share subscribers cannot plead misleading information as a ground for annulment.[5] It is argued that grounds which would apply against contracting parties acting in bad faith could probably be applied after the point of registration, so that a subscription could be declared

[3] SOU 1997:22 p. 227. For Karlgrens position see Section 2.2.

[4] SOU 1992:83 p. 230.

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

void in cases where there are serious grounds for annulment.[6] This view is shared by Kedner-Roos and Rodhe, and is also stated in the preparatory work to the legislation.[7]

2.1. Legal practice as ground for the rules

In the case NJA 1918 p. 398, the Supreme Court established the principle that share subscriptions can neither be declared void on the basis of fraud nor on the basis of misleading information. The case concerned a share subscription where one of the founders of the issuing company had attached a statement to the subscription documentation regarding the finances of the company, and this contained incorrect information. In the statement it was wrongly stated that the company owned patents in 13 countries. At the time of the share subscription the patents had expired in a number of countries, and the company in fact only had five valid patents. A subscriber claimed that the share subscription should be declared void, and the company should be required to refund the money paid. In spite of this claim being unopposed, the subscriber was held to be bound by his share subscription. The Supreme Court established that a subscriber could not, even under the influence of fraud, "escape from his obligation, through the share subscription, towards the subsequently founded company."[8]

The case from 1935, NJA 1935 p. 270, did not concern the annulment of a share subscription, but the right to be reimbursed for shares that had become worthless in the Kreuger bankruptcy. The grounds for the claim were that, in its financial reporting on the company, the board had given false and misleading information. The Supreme Court found the board members guilty, but stated that the company, Kreuger & Toll, should not pay damages to shareholders who had been misled by fraud.[9]

2.2. The Position in legal theory

In legal theory there has been a debate about the respective rights of share subscribers and creditors according to the Kreuger & Toll ruling in the Supreme Court. In the above-mentioned article, Karlgren discusses the rights of both interest groups and raises the question whether the invalidity rules of

6 For example, in the case of incapacity or duress, whereas fraud is a weaker ground for annulment, 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.

8 NJA 1918 s. 398 at p. 401.

9 *Catarina af Sandeberg*: Prospektansvaret – Caveat Emptor eller Caveat Venditor, 2001 p. 270.

contract law could be applicable to share subscriptions.[10] Karlgren agrees that annulment of share subscriptions would lead to the erosion of capital and possible harm to creditors, so that the capital maintenance rules would not have their intended effect. He concludes that, instead of applying the general rules on nullity to share subscriptions, criminal sanctions and tortious liability could be considered.[11] Karlgren does, however, take the view that subscribers should be able to plead the general principles of law on nullification and reimbursement as long as the claim does not implicate the company's undistributable reserves. Karlgren also states that strong grounds for annulment should be applicable independently of subscriptions for shares.[12] Fredenberg criticised the ruling in the 1935 case, claiming that the ruling is a "sensational exception to the general nullification and liability rules in civil law."[13] Fredenberg's position is that the company's assets should be used to reimburse subscribers who have been misled, as long as the share capital remains intact. Fredenberg argued that this inviolable capital should not include the reserve fund, since the capital in the reserve fund is not included in the share capital, and therefore not created for the purpose of creditor protection.[14] In reply Karlgren argued that Swedish practice does not support the argument that it is only the share capital which is inviolable.[15]

Danielsson discusses the applicability of contract law to the cases.[16] According to Danielsson, in the 1935 case, the court certainly weighed up the general rules on protection against fraud etc. against company law protection of creditors, and gave priority to the protection of the creditors.

2.3. Annulment of share subscriptions in the legal systems of different countries

In Denmark, in theory as well as in practice, share subscriptions can be annulled. Gomard emphasises that share subscription is a voluntary act, and that, like other voluntary acts, it can be annulled under the Danish Contracts Act, Ch. 3 and other similar rules and general principles.[17] Nullification rules can apply even after that the shares have been registered, but this

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

[11] *Karlgren*, supra note 10, at pp. 198-199

[12] *Karlgren*, supra note 10, and in Om stiftelseurkund och aktieteckning vid bildande av aktiebolag enligt svensk rätt, 1930 p. 87.

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

[14] *Fredenberg,* supra note 13 at p. 715.

[15] *Fredenberg,* supra note 13.

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

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

should be done "as soon as possible" out of consideration for the company's creditors.[18] Also, Schaumburg Müller and Bruun Hansen refer to the possibility of getting a share subscription nullified in the event of misleading prospectus information.[19]

According to the Norwegian Companies Act, Sec. 2-10, a share subscription cannot be nullified after its registration in cases where the share subscription would be void according to general civil law principles. However it its stated in the rule that registration does not make a subscription binding if it has been forged, has been made under duress or is in breach of the articles of association. In contrast to the Swedish Companies Act, it follows that a subscription can be declared null even after registration, but only when there are strong grounds for annulment. In Sec. 2-10, it is also stated that in the case of nullification of a subscription, the board of directors can reduce the share capital by the equivalent amount, as long as the share capital does not fall below the legal minimum.[20]

In Norway, as in Sweden, there has been a restriction on the scope for declaring share subscriptions void. In the cases Rt. 1926.512 and Rt. 1932.145 it was established that incorrect and misleading information in connection with an issue cannot be grounds for declaring a share subscription void.[21] However, in a case from 1988[22] concerning a subscription for shares in a limited partnership, the Supreme Court ruled differently. In this case the court accepted the plaintiff's plea to have the share subscription declared void, in spite of the registration of the issue. The court's argument was that it is immaterial to the creditors if the nullifying event occurred before or after the registration, since the creditors' interests can only be harmed in the case of insolvency. In a more recent decision, however, the previous principle has been confirmed. The case Rt. 1996.1463 concerned the invalidity of shares in a limited partnership, but the Supreme Court made it clear that the ruling also applies to limited companies.[23]

In Norwegian practice it has been established that a share subscription is binding even if it has been carried out with faulty documents.[24] This has been interpreted as meaning that a subscriber cannot have his subscription declared

[18] See UfR 1921.988 H and 1921.1005 H.

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

[20] One million NKr.

[21] Whereas the board of directors was liable. 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.

void, even if he has been given misleading information.[25] On the other hand, the right to nullify has been granted if the application to annul has been made before the registration of the shares.[26] Also, in the Norwegian legal literature it has been argued that subscriptions for shares cannot be declared void after they have been registered.[27]

According to the German Börsengesetz, there is a statutory possibility for misled share subscribers to get the subscriptions annulled. In BörsG Sec. 45, it is stated that a company can be liable to repurchase shares from misled investors.[28] This possibility is directly contrary to the previously prevailing legal practice and theory accordingly to which, as in Sweden and Norway, consideration for the interests of creditors was a bar to subscribers being able to claim annulment. Under the influence of, among other things, the emerging legal system of the EC during the 1990s, opinions on the annulment of share subscriptions have changed. For example, in BGH 05.07.1993[29] the company was required to repurchase the shares from a misled investor. The court ruled that the transactions should be returned to the *status quo ante*, so that the shares should be returned to the company, and the investor should be reimbursed.[30]

In the English and American legal systems annulment of share subscriptions is possible in theory, but is rarely used in practice.[31]

3. Criticism of the current law

It is thus clear that in Sweden share subscriptions cannot be annulled after registration of their issue. However, the question is whether this situation should be upheld under broader legal principles (*de lege ferenda*). The following are some of the arguments that have been made for and against the annulment of share subscriptions.

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

26 Rt.1915.265, Rt. 1926.471.

27 See *Magnus Aarbakke*, "Aksjetegning: ugyldighet, mislighold og ansvar", TfR 1989 p. 333 at p. 344, *Kristin Normann Aarum*: Styremedlemmers erstatningsansvar i aksjeselskaper, 1994.

28 It is also notable that, according to BörsG Sec. 48, it is not possible to exempt from liability.

29 BGH 05.07.1993 (II ZR 194/92).

30 This has led to a discussion about 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 249.

3.1. Registration as an obstacle to annulment

After registration, a share subscriber is bound by his subscription, but the justification for using registration as an obstacle to the subscriber's right to claim annulment of his subscription can be questioned. Prior to the registration of the capital increase, the creditors have no knowledge of the increase, so they cannot have any expectations of a higher capital, and the civil rules on nullity are applicable. When the capital increase has been registered, the share subscription is made public, at which point consideration for the protection of creditors is used as an argument for not allowing the share subscription to be annulled.

With many share issues the registration occurs directly after the subscription has been paid for, even though the period for payment is only a few days after the subscription period ends. Often a subscription is effected through payment, since the payment shall be available on the subscriber's account within a certain period. This means that the subscriber does not have much time to reconsider. Defects in the share subscription are usually only discovered some time after the allotment of shares. When the company's directors intentionally mislead subscribers, they most likely to try to conceal the existence of misleading information. The scope for annulment is thus rather restricted.

The practical significance of registration of a capital increase is not as important as one might think, if one were to be guided by the emphasis on registration in the Companies Act. In practice, third parties pay as much attention to the information in a company's financial report as to its registered capital.[32]

3.2. Making a distinction between strong and weak grounds for annulment

As mentioned above, there have also been discussions in legal theory about what grounds for annulment should be accepted. Karlgren argued that strong grounds for annulment should be accepted even after registration.[33] In principle, there is a general view that a share subscription should be declared void, if there are strong grounds for doing so.[34]

If the argument is accepted that the protection of a company's capital constitutes a legal basis for not declaring the subscription void, there is no cause to distinguish strong and weak grounds for annulment.

[32] Also *Karlgren*, supra note 10, at p. 202, and *Håkan Nial*: Om aktiebrev, 1929 p. 95.
[33] *Nial*, supra note 33, 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 should not be used for reimbursement or the payment of damages is upheld to the benefit of the company's creditors. The company is in a unique position because its owners are not being personally liable for the company's liabilities over and above the amount registered as share capital. According to the Swedish Companies Act, Ch. 12-4, a company shall also reserve a certain amount of the profits in a reserve fund. Premiums paid for the shares above their nominal value must be paid into a share premium account. The share capital, the reserve fund and the premium fund together form the undistributable reserves. The undistributable reserves cannot be paid as dividends to the shareholders. The undistributable reserves are intended to create a capital base that will satisfy the demands for the protection of the company's creditors. The company's remaining profits constitute its distributable reserves. The distributable reserves can be used to pay dividends to the shareholders. The distributable reserves ought thus also to be available to reimburse misled subscribers.

The problem arises out of the conflict between creditor protection and investor protection. However, it is relevant to ask how far the capital maintenance rules really meet the demands for the protection of creditors.[35] The company's creditors have traditionally been given priority, and the reasons for investor protection being neglected are many. Initially the capital risk market was relatively restricted and investors were few. Company law has not been adapted to the market as much as the more economically influenced financial market law has been. Thus it has not been usual to take into consideration the allocation function of the financial market. Scandinavian company law has historically been influenced by the German views on creditor and investor protection, with the view that investments in the financial market are associated with risk.[36] However, the Anglo-American perspective is gradually influencing German as well as Scandinavian company law, where the interests of the investors are given priority. In American law the minimum capital requirement is gradually being abandoned. The legal demands for share capital and nominal share value are considered misleading to creditors, and disadvantageous to business development.[37] Therefore, many of the states in the United States do not demand any minimum capital when forming a company, and it is argued that creditor protection is satisfied by giving security or controls over the company's financing policy. The creditor thus does not pay attention to the value of company's share capital, but to the com-

[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 p. 32.

[36] Warneyers Rechtsprechung 1908, nr 164.

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

pany's liquidity, cash flow and comparable key figures. One example of this is that for a long time a company's acquisition of its own shares has been regarded as a natural part of managing a company. The amount that is available for paying dividends to shareholders may also be used by a company to buy its own shares, since from a creditor's point of view it is immaterial *why* the company's capital is reduced. This perspective is influenced by the realisation that the allocation function of the financial market is as necessary as legal rules.

3.4. Differing needs for protection when a company is formed and when new shares are issued?

According to Swedish law, annulment of share subscriptions is neither possible if the subscription is made when a company is formed nor when it subsequently issues new shares. However it can be debated whether these two situations should be regarded as equal. Share subscriptions when forming a company differ in many ways from subsequent issues of shares. The main difference is that if subscriptions made when forming a company were to be declared void, the formation of the company would be threatened. This effect on the share capital could be an argument in favour of upholding the governing principle, that the annulment of a share subscription is not allowed. But declaring a share subscription void when issuing new shares does not necessarily affect the company's existence. If the intention of the new issue is to bring more capital for investments, expansion of the business through acquisitions or other reasons, the annulment can be made without affecting the company's original capital reserves. If the issuing of new shares is made to consolidate an activity that previously was not adequately financed, the creditors' position was already affected before the issue.

When interpreting company law and tort law, the interest which is to be protected must be established when deciding on the applicable rules. Should we allow annulment of the subscription when forming a new company? What effect does it have if the subscription was made under duress, or if the subscriber lacked capacity? What is the effect if the subscriber has been misled by fraudulent information given by the company? What would be better, to save the company and allow it and its fraudulent officers to pursue their activities, or to reimburse the investors and end the company's activity?

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

3.5. A weighing of deserving interests

In the cases referred to above, the Swedish Supreme Court has upheld the protection of the company's creditors. If the rules on annulment in the Contracts Act were applied, the position of the creditors would be undermined,

and the protection given to creditors by the rules in the Companies Act would be ineffective.

In legislation, the interests of third parties must be taken into consideration. But with an emerging focus on investor protection it must be questioned whether this strict rule should be upheld. Creditor protection in the area of company law is the result of the law giving priority to the interests of creditors over investors. A number of arguments can be made for and against this. By contrast with traditional creditor protection, the protection of investors has had a difficult time justifying itself as a legal principle,[38] and the practice is based upon historical precedents with roots in the legal practice and judicial theory of the interwar years, where consideration for a company's creditors weighed more heavily than consideration for shareholders. The question is whether a rule favouring the protection of creditors is desirable in principle (*de lege ferenda*) and whether it should be the determining factor for a subscriber's right to claim annulment under the rules of contract law. Is it fair that dishonest transactions are given their intended effect and are valid? Investors need protection against fraud in connection with share subscriptions, and this ought to be taken into account when considering the possibility of declaring a share subscription void.[39] It can also be argued that a company's representatives who have deceitfully misled investors should not be allowed to use the money obtained to favour the company's creditors.

It is also true that consideration for the interests of other shareholders can be an argument for not declaring a share subscription void, since it can lead to different shareholders being given different economic rights in the company. Reimbursement to subscribers reduces the underlying value of the company per share, meaning reduced value of each shareholder's investment. But the capital that should be protected for the benefit of the creditors and the shareholders should only include capital increases that have been made properly, and not money that has been wrongfully obtained. It is true that new creditors might rely on the size of the share capital, but to prioritise these over a subscriber who has based his actions on misleading information violates general legal principles.[40]

It is even less justifiable to deprive subscribers of the possibility of annulment when no current creditor's interests are affected. Creditors are not harmed by payment from funds that are not part of the undistributable reserves. When issuing new shares, previous shareholders will only be affected if the amount paid back exceeds what was paid for the share; otherwise, they

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

[39] It also deserves to be mentioned that the concerns of the shareholder creditors ought to be taken into consideration – the acquisition is often financed through a loan on security.

[40] "Creditors shall not line their pockets on the debtors void contract", e.g. *Gertrud Lennander*: Festskrift till Hellner, 1984 p. 323.

are put in the same situation as before the issue of the new shares. Not even where, after the issue of new shares, it appears that the company was insolvent at the time of the issue, will the previous creditors be in a worse position because of the cancellation of the purchase. In these cases it is not easy to defend the view that a share subscriber should not be reimbursed.

This should lead to the argument that creditors' interests should be outweighed in the cases where the reimbursement of subscribers does not result in insolvency.

3.5.1. Comparison with a company's acquisition of its own shares

One alternative to the annulment of a share subscription is to require the company to repurchase the shares from wronged investors. The company would thus have the possibility of reoffering the shares for sale, at 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 which the misled investors paid and the price of the subsequent re-sale. If it is not possible to re-sell the shares they should be declared void, and the company should reduce its share capital accordingly.

A company is allowed to purchase its own shares by using its distributable reserves, up to ten per cent of the company's shares.[41] In the Swedish Companies Act, Ch. 7-10, it is stated that shares that have been acquired in breach of the regulations should be sold within six months of their acquisition, and that shares which are not sold within the time limit shall be declared void.[42] The company should then reduce its share capital by the amount of the nominal value of the void shares. Should that reduction breach the rules on the minimum share capital, the company must be wound up.[43]

4. Concluding remarks

In conclusion, the following can be established: annulment of subscriptions when forming a new company can have the effect that the company will not be registered. Is it legally and politically justifiable that a company's representatives should be allowed to carry on the business of the company if the share subscription is made under conditions which would justify a claim for nullity according to contract law? Is it not better in these circumstances for the company's activities to be terminated? Who is more worthy of protection, the company's creditors or subscribers who have been misled into contributing capital by fraud?

41 The Companies Act Ch. 7.
42 See 77/91/EEC Art 20 (3).
43 Prop 1999/2000:34 p. 66.

However, to allow for the possibility of annulment of a share subscription when forming a company would probably create uncertainty for all the involved parties. An effective way to minimise this uncertainty would be to have strict rules of limitation. One possibility would be to allow annulment only up to a certain percentage 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 subsequent issues of new shares. Annulment of the share subscription would not affect the company's existence even if this would mean that the entire amount were to be paid back. Annulment should then be permitted. The company has the opportunity to renew its offer of subscription for the shares, and this time on proper grounds.

The rules and regulations of the financial market deal with the allocation function and the protection of investors.[44] The rules of the financial market should comply with this intention. It is time to abandon the principles created when a joint stock company was a rarity, to prioritise investor protection and allow companies that are led by crooks and culpable officers be dissolved.

[44] See e.g. Prop 1990/91:142 p. 78.