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Conflicts of interest during rights issues and private placements in Swedish close companies

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Abstract

Our purpose is to provide insight into the displacement of power and conflicts of interest that might appear during rights issues and private placements, primarily in private Swedish close companies. We investigate whether the protection for shareholders is too weak, and analyze whether rights issues and private placements maximize the company value in close companies without contradicting the legal protection every shareholder is entitled to. We make a comparison between listed and unlisted companies and choose a qualitative approach with case studies. Literature and research from studies of listed companies have been applied on unlisted close companies. Both rights issues and private placements open up for new investments. Especially in times of crisis they are important. However, in case of rights issues, a dilution effect with loss of influence power and economic value may occur since there is no efficient market for trading subscription rights of close companies. The effect is even more obvious in case of private placements as not all shareholders are allowed to take part. Therefore, the idea to put the business and profit maximization in focus must be in line with the fact that all the shareholders should be treated equally. In a rights issue, shareholders have the same right in listed as well as unlisted companies to participate in the issue. In the case of non-cash issues, it is important that the capital contributed in kind is economically valuable and useful to the issuing company. We conclude that the primary protection for shareholders, the principle of equality and the general avoidance provisions, is not sufficient. Rights issues or private placement can benefit companies and shareholders, but one cannot guarantee that this is not done at the expense of other shareholders.

Keywords: Rights issue, private placement, close company, dilution, conflicts of interest

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1. Introduction

1.1 Background and problematization

In a ruling from May 2007, the Svea Court of Appeal legitimates a rights issue (rights offering) in a *close company*[1], even though it has a negative impact for one of the parties. In this case, explored more in detail later in this thesis, the Board announced a rights issue at a time when one party could not participate without incurring significant liabilities. However, for this part, there was a trade-off - either to participate by incurring significant liabilities but keep the share of the company, or not to participate and therefore lose share and power of the company. The situation and the Board's choice of time when to announce the rights issue was debated. One could argue whether the rights issue took place to strengthen the company's economy or to decrease the influence of the shareholder.

Most rights issues and private placements[2] are made with peaceful intentions, but rivalry and power struggles can occur in companies - sometimes with destructive results. Some fraction may want to outmaneuver some other fraction and a rights issue or a private placement is clearly a possible way to do this. The focus in this thesis is on possible settings and terms regarding rights issues and private placements. We aim to examine the factors behind the offering decisions and how stakeholders are affected by these decisions. Fictitious and real world cases are shown to illustrate possible scenarios and outcomes. Situations when shareholders are especially vulnerable and target for mistreatment will be considered.

In our opinion, questions of this kind can be evaluated with two perspectives in mind – the *business perspective*, which stresses the importance of maximizing the company's value, and the *legal perspective* which states that every shareholder should be considered equal.

The first perspective states that profit maximization in companies never can be considered as unfair. The purpose of every business decision should be to encourage positive net present value projects, greater profits and to maximize shareholder wealth through e.g. rights issues or private placements if needed.

The latter perspective stands for the protection of the individual shareholder and the foundation is found in the principle of equality[3] and general avoidance provisions[4] in the Swedish Companies Act. However,

[1] Swedish translation "fåmansbolag". Close companies (or closely held companies) are regulated by, but not defined, in the Swedish Companies Act (Swedish translation – "Aktiebolagslagen (2005:551)"). A commonly used definition is however the one found in § 56:2 where a close company is defined as a limited company with four or fewer owners, together owning more than 50 per cent of the outstanding shares or votes. Discussed in later section.
[2] A company targets a specific group of existing or non-existing investors with an offer.
[3] Swedish translation "likhetsprincip". Discussed in later section.
[4] Swedish translation "generalklausul". Discussed in later section.

to some extent these protections can limit the company's possibility to invest in profitable projects, and hence can partly oppose the purpose of profit.

Previous studies made on company value after rights issue announcements and private placement announcements in listed companies point in different directions. Since this thesis deals with close companies, previous studies are however not fully applicable. Nevertheless, there are studies on management behavior and ownership structures in companies more similar to close companies, e.g. family firms, which may give some guidance.

Purpose:

Hence, the purpose of this thesis is to provide more information in a quite undocumented field. The reader will gain knowledge, useful when dealing with stakeholders and conflicts of interest connected to rights issues and private placements, especially in small Swedish close companies. We aim to show and exemplify transfer of wealth and power during rights issues and private placements in Swedish close companies. We investigate whether the protection for stakeholders in unlisted companies during rights issues and private placements is too strong, too weak or reasonably right. Perhaps this is a matter the legislator has to further address. This thesis will analyze if a rights issue or private placement maximizes the company value[5] in a close company without contradicting the legal protection every shareholder is entitled to.

The main questions that help us fulfill the purpose of this thesis are as follows:

Research questions:

How are the shareholders in a close company affected by a rights issue and a private placement, respectively? Are there differences from a listed company?

Is the legal shareholder protection during rights issues and private placements sufficient?

1.2 Contribution

Most companies in Sweden are not listed, but several Swedish studies have been made concerning rights issues and private placements in listed companies from all sorts of different perspectives. Exclusively, all research concerning the influence of ownership, transfer of wealth and power shift in connection with rights issues and/or private placements are based on listed companies. Most of the companies that exist, however, are not listed and surprisingly there is no research in an area that affects a large number of

[5] For unlisted companies there is usually no exact market price valuation, making it hard to study the exact share value before and after e.g. an issue. Discussed in later section.

people and their fortunes in Sweden. A run-through of this specific issue in unlisted Swedish close companies is therefore justified. We want to shed light on situations surrounding rights issues and private placements which seem to be particularly prevalent in practice. As far as we know, no study has been made on this particular topic.

Our aim is that academics, researchers and those interested or involved in rights issues, private placements and/or conflicts of interest in close companies should gain useful insights from our thesis from both an economic and legal point of view.

1.3 Delimitation

We do not intend to go through all the conflicts of interest and situations that conceivably could come to light in connection with rights issues and private placements. As delimitation, we have chosen to study rights issues and private placements where new shares is paid with money, and where it is made with other than cash, so called non-cash issue or issue in kind[6]. We have chosen to ignore offset issues[7] as these are not as common for Swedish companies.

Moreover, we have focused on Swedish unlisted private close companies. A private company may not distribute shares or securities to more than 200 people and the company may not be traded on a regulated market. The availability of e.g. share price data is therefore limited and fewer surveys and studies have been made for unlisted companies. Also, since we are studying unlisted companies, we have no market value for equity, making it hard to value the unlisted company. There are methods to study the company value such as discounted cash flow models and multiple valuations models etc. However, most interesting is to examine whether the company is more or less attractive for investors after e.g. a rights issue or private placement.

Nevertheless, there is much information, research and data to be found on the larger listed companies which also is to some extent applicable on unlisted companies.

1.4 Methodology

For this thesis we have chosen a qualitative approach as it best matches our purpose and research questions. At an early stage we realized that we could not make a quantitative study as there was no sufficient data available of rights issues or private placements in Swedish private unlisted close companies. This may to some extent limit the reliability of the thesis.

[6] Swedish translation ”apportemission”.
[7] Swedish translation ”kvittningsemission”.

Three fictitious case studies and two real world rights issue and private placement cases are presented and discussed. They address both economic and legal aspects. The theoretical foundation is based on academic literature, law doctrine, official and economic reports, news articles and other qualitative material.

1.5 Outline of the thesis

The thesis begins with an introduction of the topic. Our contribution, the purpose of our study and the research questions are initially stated. We present our focus and delimitation. Hereafter the methodology and outline of the thesis is laid out. Three fictitious cases are presented to illustrate the basic concepts of rights issues and private placements. The first case concerns a rights issue in a listed company in an efficient market. The second case concerns a rights issue in an unlisted close company. Finally, the third case concerns a private placement in an unlisted close company. The idea is to illustrate scenarios and provide a more hands-on picture of the different settings where conflicts of interest can occur with our research questions in mind. The idea behind this approach is also to improve the readability. After that, we explain what the legislature has done to address these conflicts of interest. The following section comprises the theoretical and educative framework; earlier research, doctrine and some closely related topics. After the theoretical background we present two real-world cases. In the next section we analyze the cases with respect to what has been previously presented and with a further focus on the conflicts of interest. Finally, conclusions are drawn, final remarks are discussed and the stated research questions are dealt with. We finish off with some thoughts and critical assessment of our thesis as well as suggested topics for further research. Due to the different Swedish legal and economic concepts discussed in the thesis, a dictionary can be found in the appendix for terminology which may not be familiar to all readers.

2. Rights issues and private placements

2.1 Basic concepts and fictitious case studies

If you are not able or willing to finance the company's operation by bank credit, there is a possibility to raise money by issuing shares. The reason for this can be that the company intends to use the capital to expand or pursue a specific investment, or for example to increase the financial strength by paying down debt (especially if unable to borrow money from the bank).

This thesis focuses on two main different ways to raise capital; through a rights issue (with or without trade in subscriptions rights)[8] or through a private placement.

In a regular rights issue, the company grants existing shareholders the right to buy or subscribe for new shares in the company. More specifically, this type of issue gives the current shareholders the right to purchase new shares (often at a discounted price at a specified date). Until this stated date, the shareholder normally has the opportunity to trade these rights in a market and can therefore choose whether to use the rights and make a further investment in the company or sell the rights to another investor. However, if there is no efficient market for trading the rights, which is the case for close companies, the alternatives are fewer.

In a private placement the company seeks new capital by approaching a specific, often outside, group of investors. The share capital is thus increased by issuing e.g. new shares for cash, capital contributed in kind[9], or by making an offset issue.[10]

The best way to further explain rights issues and private placements is to illustrate with three different case studies; a rights issue in a listed company, a rights issue in an unlisted close company, and a private placement in a close company. The cases introduce the basic concepts and focus on the stakeholder conflicts of interest with our research questions in mind.

2.1.1 Case 1: Rights issue in an efficient market in a listed company

When an issue is directed towards existing shareholders, it is an ordinary rights issue with precedence for current shareholders[11]. In a rights issue, new shares are normally offered in proportion to the number of shares previously owned. Every shareholder therefore has the right to subscribe and receive shares in the

[8] There are two different kinds of subscription rights; renounceable rights which can be traded and non-renouncable rights which cannot be traded or assigned to someone else.
[9] Swedish translation "apportegendom".
[10] Skog, R. & Fäger, C. p. 84. (2007).
[11] Swedish translation "företrädesemission".

rights issue in proportion to their current holdings. The rights issue also gives those shareholders the opportunity to receive the benefits of the subscription price if it is particularly advantageous.

Moreover, the preferential right for current shareholders prevents an issue used to upset the balance of power between shareholders (dilution), based on § 13:2 Companies Act and its principle of equality. However, there are exceptions to the main rule which we will look into later. The preferential right contributes to some protection against ownership displacement and economic dilution. However, it does not apply if it is a non-cash issue.[12]

Another aspect in the rights issue process is to set the terms of the issue. An important factor when setting the terms of the issue is to decide the subscription price. This is decided by a General meeting. A common conclusion is that a discount in the issue price is favorable. If you look at the dilution effect that may occur when the issue is being made it is clear that the choice of the subscription price is a sensitive issue. The subscription price is often set so that it is to some advantage for the subscriber.[13] It is argued that as the subscription price is lowered, the increasing value of a right compensates for the decreasing ex-rights value of the stock on a per-share basis. Furthermore, the decreasing value of a stock on a per-share basis is offset by the increase in the number of outstanding shares. From a practical point of view, however, the relationship between the share price and the subscription price may differ. The greater the subscription price discount, the greater the loss suffered by not selling or exercising the subscription rights. One may argue that increasing the size of the discount is an indirect way to encourage non-subscribing, inactive, perhaps uninformed, shareholders to sell their rights so that other investors can subscribe.[14]

Essentially the shareholder has three different options when considering action and response to a rights issue;

1. Use the subscription rights and subscribe to the rights issue in full
2. Take no action and ignore the right to subscribe
3. Sell the subscription rights

During the rights issue process the relationship between management and shareholders, and between different shareholders is of interest to examine further. A possible risk in a rights issue is dilution. A stock

[12] Bergström, C. & Samuelsson, P. p. 232. (2009).
[13] Skog, R. p. 15f. (2007).
[14] Bacon, P W. (1972).

can be seen as diluted if an increased number of shares are not met by a corresponding increase in assets and earning power.[15]

To illustrate this we show an example. Suppose there is a company with three owners which holds 100 shares each, a total of 300 shares. In a rights issue, 100 new shares are issued. Assume that two of the shareholders exercise rights for an additional 50 shares each and the third one leave things as they are. From now on, the first two holds 37.5 per cent (150/400) of the outstanding shares each, whereas the third and last one only holds 25 per cent (100/400). Of course this case is heavily simplified but it clarifies the fundamentals. Normally, the amount of voting power dilution is straight proportional to the number of outstanding shares before and after the rights issue. In case of private placements to non-present shareholders, the degree of dilution in per cent is calculated as the number of new shares issued to the total number of old shares. Dilution of share value can be both positive and "negative" with respect to the mathematical sign. In the hypothetical example above, assume that share value is USD 50 the day the rights are offered. The total share value, up until now, is then USD 15,000. One now sells an additional 100 shares at the price of USD 45 each. Hence, there is a discount of USD 5 per share and the additional capital contribution is equal to USD 4,500 (100*45). The total share value then amounts to USD 19,500 (15,000 + 4,500). From this example, we see that the new share value is USD 48.75 (19,500/400) compared to USD 50 before the rights issue. However, this does not by definition imply that a current shareholder, that chooses not to sign up for new shares, loses the difference. On a well-functioning market, the investor is given the opportunity to sell the right to buy new shares. This right, the subscription right, is added to current shares in connection with the rights issue. Though, if the shareholder sells his subscription rights, he or she will lose some voting power.

Another aspect that must be decided is the subscription period of a rights issue. This is the time period when one can decide what to do with the offering. The period is explicitly given in the rights issue terms and usually varies between two weeks and more. The investor shall during this period consider the information and the terms for the rights issue. Normally, the terms of a rights issue is notified well in advance and decided in connection with a General meeting. To be in line with what is considered good practice on the stock market, the purpose and terms of the rights issue ought to be published already in the first announcement of the rights issue.[16]

However, theoretically, a major shareholder with bad intentions can take advantage of this situation. For instance, a large shareholder with extensive voting power, can set a General meeting in the middle of the summer, post the vocation for the meeting with minimum statutory margin, vote for incongruent biased

[15] Graham, B. & Dodd, D L. (1951).
[16] AMN 2002:2.

rights issue terms and exploit a particular shareholder group. For the larger companies and other relatively trustworthy listed firms this is a no-case. But for close companies it may be more common.

In summary, for the individual shareholder loss occurs if he or she ignores either subscribing or selling the subscription rights. The greater discount in the subscription price, the greater the potential loss. Wealth transfer and hence conflicts of interest may occur. However, if the shareholder sells the subscription right in time, there should be no economic loss in an efficient market.

2.1.2 Case 2: Rights issue in an unlisted close company

Consider another case with a rights issue in an unlisted close company. The circumstances change drastically as there is no market for the share and no efficient market for the subscription rights.

The Swedish private companies that we focus on in this case with few owners are commonly known as "close companies". In the Swedish tax law § 56:2 the term close company refers to a corporation or limited company or a cooperative in which fewer than five people owns shares representing more than 50 per cent of the votes for all shares in the company.[17] It should be emphasized that a close company is not a specific company form, but merely an expression of a company with a small number of shareholders. In these companies there are usually a few owners all of which holds a large share of the company's own shares.

The challenges in rights issues for larger listed shares are not always the same as for close companies. Shares in close companies are not required to be traded in an open market, leading to limitations for the owners to develop and settle their involvement in the company. The single shareholder is dependent on the other owners. In these kinds of companies the legislator must, in avoiding that exploitation occurs, strive to find a balance between the interests of the majority and minority.[18]

An owner may be excluded from all influence over the management and operations if the other shareholders vote against him or her in all matters. This follows from the majority rule[19]. The Swedish Companies Act is based on the majority/principle. This implies that those who have the majority of the votes are granted the authority. In a public company with many shareholders, a minority shareholder with divergent interests is easily voted against by the majority. In close companies, however, the consequences of the majority rule often become more serious than in large companies. This is due to the fact that shareholders many times have invested a large share of their personal fortunes in the company and also often work actively in the company. There are rules in the Companies Act which give the minority the right to appoint a minority auditor as well as rules of increased decision-making criteria for certain

[17] Tjernberg, M. pp. 29-30. (1999).
[18] Skog, R. & Fäger, C. p. 234. (2007).
[19] Kansmark, J. & Roos, C M. p. 22. (1994).

important decisions. Unfortunately, these rules are sometimes found to be insufficient causing a problem for minority shareholders in close companies.[20]

A descriptive example of a situation can be given by a fictional unlisted company which is not traded in an efficient market. If there is not a viable market for the subscriptions rights, certain conditions of the issue are of high relevance. The wealth for a shareholder who does not participate in the new issue goes down and the extent of the owner's loss is mainly due to the issue quota[21]. The issue quota terms decide mainly which dilution effect that may occur.

Two basic examples of rights issues in a close company with no possible trade in subscription rights and where wealth transfers and conflicts of interest can occur:

Example 1:

Issue terms: 2:1 (1 new share per 2 previously owned)
Total value of the issue: 25,000
Number of shares (before): 1,000
Number of newly issued shares: 500
Assumed value per share (before): 70
Subscription price: 50
Value per share (after): 63.33
Value of the subscription rights / loss if not used: 13.33

Example 2:

Issue terms: 1:1 (1 new share per 1 previously owned)
Total value of the issue: 25,000
Number of shares (before): 1,000
Number of newly issued shares: 1,000
Assumed value per share (before): 70
Subscription price: 25
Value per share (after): 47.5
Value of the subscription rights / loss if not used: 22.5

[20] SOU 1978:66, Andelsbolag, p. 124.
[21] Swedish translation ”emissionskvot”.

Hence, one can understand that the issue terms and the issue quota affect the potential loss if one does not participate in the issue or if the subscription rights cannot be sold. Depending on how the issue quota is set the terms for shareholders can change significantly. The shareholders who cannot or do not have the opportunity to participate in the issue risk losing monetarily and in terms of power. The issue quota can ultimately be used in such a way that the majority can benefit unfair advantage at the expense of the minority. The potential loss for those who do not participate in the issue is a typical transfer of wealth example. By extension, an issue quota with unfavorable conditions for the shareholders who do not participate can transfer the wealth and influence from the minority to the majority.

Another important factor is the subscription price. In the example above, the value of the shares decreases equally to the amount the shareholder could sell the subscription rights for. The subscription price and the issue quota are important factors in deciding the transfer of wealth and/or power in a rights issue or private placement.

There are less efficient means for the shareholders to protect themselves against dilution in unlisted shares such as close companies, as the subscription rights are much harder or even impossible to sell. The implication of this is that a major investor can strengthen its influence in the company by biased issue quotas while other shareholders' influence decreases. By extension, such a dilution does mean that a majority shareholder can take over the company and squeeze out the minority.[22]

2.1.3 Case 3: Private placement - divergence from the shareholder's preferential right

Where it is justified on objective grounds, it is possible to deviate from the shareholders' preferential right. When an issue is directed towards a specific group of investors it is commonly known as a private placement[23]. These investors may be either existing shareholders or third party investors.

A private placement can be questioned if the subscription price is not in line with, or at least is very close to, the share price before the issue.[24] The Committee of the Companies Act considers that only in exceptional cases there is room for discounts that deviate from market-based discount.[25] It is likely that the discount is greater if a private placement occurs in a situation where the company is in a financial crisis than if it occurs under normal circumstances.[26]

To deviate from the preferential right is not without controversy, as it can lead to a dilution for the existing shareholders' holdings. A private placement which is targeted at specific shareholders or outside investors may violate the right of shareholders to be treated equally. Nevertheless, it is possible to do a

[22] Krusell, C-J. (2005).
[23] Swedish translation "riktad emission".
[24] Skog, R. p. 58f. (2007).
[25] AMN 2002:2.
[26] Skog, R. p. 23f. (2007).

private placement if good causes exist. However, the Legal Affairs Committee believes that it is extremely rare that it can be relied on reasons that make it possible to deviate from the preferential right without violating the general avoidance provision.[27] There has not been much discussion about the reasons that might be considered acceptable for a private placement and thus one must turn to the doctrine.

Both The Committee of the Companies Act and Skog believe that grounds may exist for a private placement if the company is in crisis and if it is considered to be the only option that can lead the company out of a crisis.[28][29]

Dilution of control can occur when shares are issued to non-present shareholders and when shareholders forget or ignore to sign up for new shares. However, in the latter case, depending on the occasion, shareholders have themselves to blame if not taking action.[30]

The third and final case is a fictive private placement in a close company. The situation is designed in order to demonstrate different issue terms and conditions that may prevail in a situation where an individual shareholder could be severely affected or abused by other shareholders.

A family runs a company in the textile business. The close company is owned by a family with five relatives who took over the company from their ancestor. Their relative ownership of the company varies. Out of five owners it is only two, and especially one, who is knowledgeable in the textile business. The other three are quite passive and uninterested of how business is run, as long as the return is good.

The company is doing well, even though it has a high leverage ratio. The business is however very energy-consuming and in the long run it will probably be expensive to use the present form of energy supply.

Now one of the owners, Xerxes, has found an investment opportunity which he claims will solve the energy issue. It is however a long term investment and will not be profitable until a few years. The investment will be in gigantic wind turbines that will take at least five years until fully functional. Xerxes, who has recently started to become increasingly active in the company, persuades the three not so informed owners of the company that this is the way to meet future requirements of electricity. Together these four have somewhat over 50 per cent of the total votes.

[27] LU 1973:19 p. 45.
[28] AMN 2002:2.
[29] Skog, R. & Fäger, C. p. 24. (2007).
[30] Also known as “rational ignorance”.

Zed is the main owner with over 30 per cent of the votes of the company alone, and has devoted 25 years to build on his ancestor's business. His relatives have not been very involved in the business at all. Now, Zed makes clear away from Xerxes' investment plan and thinks it is too grand and risky. Zed is the one that has by far the most knowledge but is not as charismatic and good at convincing people as Xerxes. Zed had previously looked into other cheaper solutions for future power supply but could not convince the other shareholders to invest.

Concerning the financing of the investment, the company is not allowed to borrow money from the bank since the project is seen as too big in proportion to the company's other assets. Xerxes hereby proposes to bring in an outside investor. He manages to convince all but Zed that this is a good idea and consequently the company makes a private placement to an old friend of Xerxes, Roy. Roy is financially strong, and according to Xerxes also very knowledgeable.

Except for the fact that Zed does not like the investment, he definitely does not like the thought of bringing in an outside investor. However Zed realizes that it is the only way to finance this project. Some months ago Zed bought a villa and he is not able to free up capital now. His nearest relatives are very aware of this.

Finally, the private placement is made and hence,

- The textile company makes a significant and risky investment in wind turbines
- Outside investor Roy becomes a substantial owner of the company
- Present shareholders get heavily diluted
- The family business is to some extent in the hands of an outside investor

In the three previous cases, situations may occur where conflicts of interests can arise.

2.2 Non-cash issue

Another way to raise capital to a company is to do a non-cash issue. Then, other values than money are added, so called capital contributed in kind.[31] The capital contributed in kind can be shares in a company to be acquired, property, or other values that the buying company pays by offering new shares. The added value must be useful to the company's business, have an economic value and have a noticeable impact on operations.[32] Responsibility lies with the Board to make a statement of the facts that may be of importance when judging the value of the non-cash issue.[33] One or more auditors shall then review this statement and comment as to if the capital contributed in kind is supplied to the company and not valued

[31] Skog, R. p. 41. (2011).
[32] Prop. 1975:103 p. 293.
[33] Skog, R. p. 94. (2007).

more than its fair value and whether it is beneficial to the company.[34] In the Companies Act §§ 2:18-19 it is stated that all the conditions must be met before the capital contributed in kind is to be acceptable.

In a non-cash issue, it is of great importance that the subscription price is set to a value equivalent to the former value of the shares, so that the shareholders who do not participate do not suffer from dilution.[35] The principle that overvaluation may not take place and that the capital contributed in kind shall not be valued higher than the actual value for the company can serve as guidance when determining the economic value is the.[36] The economic value of an asset shall be the value of the asset at the date of the transaction, i.e. the valuation date shall be the same as the date of the decision on the issue. The capital contributed in kind has to be, or likely to be, of benefit to the company's operations.[37]

A non-cash issue is depicted in a real world case in section 4.2, “the non-cash issue case”.

[34] Nerep, E. p. 90. (2003).
[35] Skog, R. p. 56. (2011).
[36] Nerep, E. p. 106f. (2003).
[37] Nerep, E. pp. 115-116. (2003).

3. The legislature's measures

There are several laws and regulations that protect and obligate the shareholders, of which many can be found in the Companies Act, as illustrated here.

3.1 The Companies Act

3.1.1 Majority versus minority

The company should follow the ruling with the most votes, and hence the majority has power to decide what is best for the company. However, it is important that the minority has the opportunity to make its voice heard. In the Companies Act there are regulations protecting these shareholders, of which the principle of equality and the general avoidance provisions are the most important. The legislature must strike a balance between the interests of the majority and the minority in order to prevent that abuse occurs. These rules have two sides. They can be used to protect the interests of shareholders against decisions unfavorable to the company, but they can also prevent decisions that benefit the company and thus the shareholders collectively.

Especially in a large public company, ownership and control can be separated, i.e. the management does not always hold shares. Hence, management is not personally affected by their decisions financially and may be more willing to take risks. This fact results in a so called "agency problem". In close companies however, as it is defined here, more than 50 per cent of the votes for all outstanding shares are held by fewer than five people. The presence of control ownership probably mitigates the agency problem and one could instead expect a more stressed conflict of interest between majority and minority[38] or, as is depicted in a case in this thesis, between the majority owners.

3.1.2 The principle of equality

One of the fundamental laws of protection for shareholders is the principle of equality in § 4:1 Companies Act. It states that all shares of a certain type carry the same rights, where the economic proportion property is the most significant one. The principle of equality regulates equality of shares within the company but does not take interests outside the company into account. As a limited company, small or large, is an association containing equity and not physical individuals the principle of equality is also interpreted from that point of view. It does not say anything about the relation between shareholders, except for what concerns the economic value of the shares. Even though the term "likhet" in Swedish is related to equality and equal treatment, the principle of equality is not to be mixed up with some general

[38] Bergström, C. & Samuelsson, P. p. 129f. (2009).

rule of morality. For instance, it is not possible to set up a general duty of loyalty between shareholders based on the principle of equality.[39]

3.1.3 The general avoidance provisions

The principle of equality is however not sufficient as a mean of protection. Further protection for the shareholder is found in general avoidance provisions in § 7:47 and § 8:41 Companies Act. The general avoidance provisions state that the company must not make a decision or carry out a transaction that may give an unjustified advantage to a shareholder or to the detriment of the company or other shareholders. The rule applies in contrast to the principle of equality even when an unfair advantage is given to someone who is not a shareholder in the company. The general avoidance provisions do not deal with the economic proportion property, but are general codes that protect owners' right to be treated equally. The principle of equality is intended to give all shares equal value and rights. The general avoidance provisions, on the other hand, deals with the shareholders' equal rights. Because of this, the general avoidance provisions are not bound to a specific class of shares. Also, they do take interests outside the company into account and can be applicable when these interests are given unfair advantage at the expense of existing shareholders. An important implication of the general avoidance provisions is that they take the consequences of a specific decision, and not the decision as such, into account. A decision can conflict with the general avoidance provisions even though it does not conflict with the principle of equality.[40] Suppose a private placement is about to be carried out and that it does not conflict with the principle of equality. If then a shareholder claims that the issue will cause a shift of power in the company, he or she or them can let the question be brought up in court, with support from the general avoidance provisions. The so called unfairness assessment[41] found in the general avoidance provisions, state that neither the General meeting, nor the Board or the CEO can make decisions that are designed to give unfair advantage to someone, detrimental to the company or shareholders. Notice that the unfair sequel of a decision does not have to be realized for a decision to be seen as unfair. Hence, decisions can be reprehended in advance of its implementation. To get support from the unfairness assessment the specific decision has to give an unfair advantage to:

1. Someone outside the company, detrimental to the company
2. A shareholder, detrimental to the company
3. A shareholder, detrimental to some other shareholder[42]

[39] Bergström, C. & Samuelsson, P. (2009).
[40] Ibid
[41] Swedish translation "otillbörlighetsrekvisit".
[42] Bergström, C. & Samuelsson, P. (2009).

It should be noted that the general avoidance provisions apply only to actions that are detrimental to the company. Probable benefits to third parties or shareholders who are not detrimental to the company are of secondary importance.[43]

3.1.4 Disqualification

An important issue is whether a shareholder who has the opportunity to subscribe for shares in a private placement also is eligible to participate in the General meeting decision making. The provisions of the Companies Act § 7:46 say that disqualification[44] is limited to liability situations and do not prevent shareholders to participate in the economic decisions that affect the shareholder himself, e.g. rights issues. The Committee of the Companies Act has a different view. They argue that these shareholders should not participate in the General meeting's issue decision. This is to avoid the risk of conflict with the requirement of equal treatment.[45]

[43] af Sandeberg, C. p. 134. (2006).
[44] Disqualification occurs when a person might be biased or there is some special circumstance that is likely to undermine confidence in the impartiality.
[45] AMN 2002:2.

4. Theoretical background

4.1 Economics – the shareholder reaction on rights offering announcements

With respect to the every shareholder's rights, private placement is perhaps the most debated scenario of those which may violate the principle of equality and/or the general avoidance provisions. Not much research is made on what makes firms choose to raise capital by a rights issue and not a private placement and vice versa. However, stakeholders likely have different views and preferences regarding in what way new capital should be raised. Stock reactions following a rights issue or a private placement may illustrate some of the conflicts of interests that are likely to develop and the differences between them.

Eckbo and Masulis[46] and Hertzel and Smith[47] present that private placements may reduce the potential underinvestment problems[48] connected to firms making rights issues. Cronqvist and Nilsson[49] have taken this further and studied a sample of 142 rights offerings and 128 private placements made in Sweden between 1986 and 1997, by publicly traded companies. They conclude that firms with a higher degree of asymmetric information about their real value prefer private placements to rights issues. This applies especially when there is uncertainty about the new investment following. Also, Cronqvist and Nilsson find a positive correlation between pursuing a private placement and seeking a strategic alliance and by extension a takeover. Shleifer and Vishny[50] mean that a larger percentage of ownership by a probable future acquirer of the company is a good sign with respect to stock reaction. The purchaser of the private placement has incentives to act in the company's interest since it will benefit him or her in a future takeover and/or an exit situation.

Intuitively, shareholders would have a critical view on this since they may very well be diluted, both economically and ownership wise. However, several studies show that private placement announcements generate positive stock price effects. As an explanation to this Jensen and Meckling[51] and Wruck[52] present what is known as the monitoring hypothesis. It states that private placements are bought by concerned investors who are in position of monitoring management and undertake that corporate funds are taken care of in the best way, i.e. private placements lower agency costs. Hertzel and Smith[53] explain the positive announcement effect with the certification hypothesis. They argue that it is due to the fact that

[46] Eckbo, B E. & Masulis, R W. (1992).
[47] Hertzel, M. & Smith, R H. (1993).
[48] The underinvestment problem is discussed by e.g. Myers, S C & Majluf N S. (1984). It is an agency problem where shareholders prefer to invest in high-risk assets, in order to maximize their wealth at the cost of the debt holders.
[49] Cronqvist H. & Nilsson M. (2005).
[50] Shleifer, A. & Vishny, R W. (1986).
[51] Jensen, M C. & Meckling W H. (1976).
[52] Wruck, K H. (1989).
[53] Hertzel, M. & Smith R H. (1993).

active, well-informed investors defend the market's valuation of the firm by buying a large quantity of stocks.

However, the literature also show examples when stock prices fall in connection with a private placement and/or a regular rights issue. Miller and Rock[54] see external funding as a sign of uncertainty regarding upcoming operating cash flows. Outside funding will therefore be seen of the shareholders as a signal of reduced cash flow expectations, which in turn will have negative effects on stock prices. Ross[55] also argues that a decreasing of financial leverage by pursuing a rights issue or a private placement is negative for stock prices. He reasons that managers want to keep the risk for bankruptcy as low as possible to keep their employment. An increase in the debt to equity ratio increases the risk for bankruptcy only if the intrinsic firm value is low. Therefore, management will decrease leverage only if the firm value is low, why a rights issue or private placement has a negative effect on stock prices. Galai and Masulis[56] identify an equity issue as a redistribution of capital or wealth from shareholders to debt holders. It lowers the leverage and hence the debt holder's risk. However, loan contracts are fixed why the debt holder will not compensate the lower risk in form of a more favorable interest rate. For that reason, the stock market will react negatively to announcements of equity issues, regardless of whether it is a rights issue or a private placement.

As stated before, there is a lack of research on unlisted companies within the field discussed in this thesis. However, as the legislation can be interpreted, and the fact that close companies are most numerous in numbers counted among family businesses, it seems reasonable that ownership structure in close companies and family firms are relatively similar. Therefore, studies made on family businesses to some extent can be applied in our study of close companies. In family businesses ownership and management are usually closely linked. This means that if a partner or family member for some reason loses influence, e.g. connected to a rights offering or a private placement, it is more intrusive in a family business compared to another company.[57] Family businesses are characterized by trust, and loyalty between partners is more important than in other companies. Protection of shareholders' ownership positions is important for family businesses as purchase of shares from outsiders ultimately can destroy the company and limit the possibilities for the next generation to take over.[58] New partners may have conflicting interests or management problems which can jeopardize operations. This prevents development and may result in other partners leaving the company; partners with important connections. To keep the company within the family or within a certain sphere is motivated by the focus and the traditions which then is

[54] Fritzell, M. & Hansveden, J. (2006).
[55] Ross, S A. (1977).
[56] Galai, D. & Masulis, R W. (1976).
[57] Danielsson, H. & Sund, L-G. p. 11. (2005).
[58] Sund, L-G. & Bjuggren, P-O. p. 10. (2007).

easier to uphold than if outsiders are taken in.[59] Translating this to a large business traded on the stock market, a rights offering announcement, and especially a private placement announcement, with outside buyers, would be accompanied by a stock price decrease.

Fritzell and Hansveden[60] have studied the characteristics of Swedish rights offerings and private placements on the Stockholm Stock Exchange from 1986 to 2005 and stock market reactions following their announcements. Firstly, they show that rights offerings to a larger extent are issued by companies with a higher ownership concentration whereas private placements are followed out by companies with a lower ownership concentration. Close companies have a high ownership concentration and according to Fritzell's and Hansveden's study owners of these companies would prefer rights issues to private placements. This is in line with the argument of protecting the firm's traditional values and keeping outside interests away.

Secondly, Fritzell and Hansveden find that rights offering announcements come with an abnormal negative return of which size (~2 per cent) is about equal to the abnormal positive return a private placement announcement comes with. Moreover, they express doubts to Swedish legislation which has a restrictive take on private placements compared to rights offerings. According to their study, shareholders are better off with the former than the latter. Therefore, with respect to shareholder maximization they also conclude that Swedish legislation should have a more permissive attitude towards private placements in relation to rights offerings. This brings us to the next chapter which discusses the legal principles. Note that Fritzell and Hansveden have looked at listed companies in which the relationship between ownership and governance do not necessarily look the same as in unlisted close companies. Regarding the latter, reactions to taking in new owners might not be as welcoming (see the reasoning on family business above.).

4.2 Legal – what justifies a rights issue and a private placement

A problem when applying the principle of equality is to define the degree of equality required in different cases for the principle to be considered satisfied.[61] The fact that a minority does not get a proposal approved at the meeting or that a decision is taken against their will cannot by itself constitute unequal treatment.[62] To assess this, its aim and effect must be studied in detail. The decision must result in unequal treatment of shareholders. According to Åhman it is enough that one or more shareholders have obtained an advantage that no other shareholder had access to, or that one or more shareholders suffer a disadvantage not suffered by all shareholders, for the principle of equality to be infringed. The advantage

[59] Sund, L-G. p. 28 f. (2008).
[60] Fritzell, M. & Hansveden, J. (2006).
[61] Nerep, E. p. 272. (2003).
[62] Ibid

or disadvantage suffered by a shareholder need not always be economical or financially measurable in order for the principle of equality to apply.[63]

The principle of equality applies to all corporate authorities; the General meeting, the Board and any other deputy of the company. A decision or an act could be invalidated if the principle of equality has not been considered.[64] The principle of equality is however not absolute but dispositive. Variations may occur, either by provisions in the articles of association or in the Companies Act. Exceptions may also be made if individual shareholders approve to derogate from the principle. A right must be considered on a case by case basis.[65] As existing shareholders have a preferential right to subscribe for shares, a deviation from this is not entirely uncontroversial, as it may lead to an economic loss in terms of dilution for the shareholders who cannot participate in the private placement. As said, the rule of preferential rights for existing shareholders can be disregarded by a provision in the decision of the issue. Such a provision may contain that the preferential right shall instead appertain to one or more non-members or those who belong to a certain group of people.[66] In a sense, this can be seen as a departure from the principle of equality.

According to Nial and Johansson, the possibilities of deviation may be assessed on a case by case basis through a balancing of interests and should be accepted only when the "majority interest in a deviation is significantly larger than the minority interest in the principle being maintained."[67]

Pehrson says that the principle of equality cannot be "applied so strictly"[68]. Pehrson argues that a measure must be regarded as objectively justified if it is economically sound. Such action shall be deemed permissible under the principle of equality. Pehrson also believes that measures of marginal effects should be given some leeway. Otherwise a situation might arise where the action is deemed permissible under the general avoidance provisions, but not under the principle of equality.[69] Pehrson's statement has faced much criticism in doctrine.[70]

By non-cash issues where the contribution is made by means other than cash, there are no preferential rights for shareholders. It is only those who have the capital contributed in kind, who may have the opportunity to subscribe for shares.[71]

[63] Åhman, O. p. 792f. (2004).
[64] Nerep, E. p. 272f. (2003).
[65] Ibid
[66] AMN 2002:2.
[67] Johansson, S. (2001).
[68] Pehrson, L. p. 500f. (1987).
[69] Ibid
[70] Nerep, E. p. 290. (2003).
[71] Skog, R. p. 59. (2011).

An often debated topic is when a decision ought to have economically positive consequences for the company and how to relate to the unfairness assessment in this situation. For instance, adding capital by pursuing a rights issue can avert an economic crisis in the company or it can make space for new investments with a great forecasted return. Pehrson argues that actions economically motivated for the company cannot be seen as unfair and hence the unfairness assessment is not applicable. He does not consider whether an action may be more beneficial to any of the shareholders than for others. A suggested approach is that the general avoidance provisions only be regarded as applicable in a situation where the disadvantages outweigh the benefits. Determining whether something is in the interests of the company and appears to be good for business should be done on objective grounds afterwards.[72] Bergström, Högfeldt and Samuelsson basically argue in line with Pehrson and refer to a preparatory work[73] in which it is stated that a decision that is in the interest of the business and seems economically sound cannot be seen as unfair, even if it means a deviation from the principle of equality. Bergström et al further clarify, based on the preparatory work, that profit maximization is superior to the principle of equality. Situations where all shareholders are not given the same rights but where the value of all shares altogether increases does not per definition have to be wrong.[74] Also, even though there are disloyal motives behind a capital increase, it can be very hard to get these to decide the matter in an unfairness assessment if the capital increase can be given satisfactory justification.[75]

Rodhe opposes this and the main reason for this is his view that business cannot create standards. The company's interest is equal to the shareholders' common interests. The company's interest cannot therefore be used to resolve a dispute which arose between the owners. Many share Rodhe's view on when the unfairness assessment is applicable; e.g. in the report SOU 1995:44 by the committee of the Companies Act[76] states that it agrees with the criticism regarding to what extent business can create standards.

Åhman agrees with Rodhe as well but states that the principle may have to give way if the company is in a deep crisis. However, he argues that an exception should be used very carefully if it results in benefits to some shareholders at the expense of the company or its other shareholders.[77] Nerep argues that the fact that the company is in a crisis cannot alone be decisive when determining whether a decision is unfair or not. In general, he advocates a more comprehensive assessment of what should be seen as an unfair

[72] Pehrson, L. p. 17. (1987).
[73] Prop. 1973:93 p. 137.
[74] Bergström, C. & Samuelsson, P. p. 141. (2009).
[75] Bergström, C. & Samuelsson, P. p. 18. (2009).
[76] Swedish translation "Aktiebolagsnämnden".
[77] Åhman, O. p. 800f. (2004).

decision and not. A range of factors, among them the minority protection, abuse of power, unfair transactions and to some extent also business reasons, have to be taken into account.[78]

For unlisted companies, the issue quota is interesting. Or more specifically, for companies where there is no market for the subscription rights during a rights issue, the issue quota is interesting. We now refer to the case in chapter 2.1.2 of an unlisted company with lack of trade in the market of the subscription rights. A shareholder could not sell his or hers subscription rights. The loss for this shareholder then increased from 13.33 units to 22.5 units when the issue quota was changed from 2:1 to 1:1. An unlisted close company is an association containing equity. The shareholders' personal economy is not of importance when considering whether a particular decision of the General meeting is in accordance with the principle of equality or not.[79] Hence, the majority can dictate the issue quota without violating the principle of equality. If a shareholder do not want to participate in the rights issue and there is no market for the subscription rights, his or her wealth can partly be transferred to the majority. The majority just has to set an issue quota opening up for this. Though, a shareholder may find support in the general avoidance provisions which state that a decision of the General meeting is not allowed to create an unfair advantage for a shareholder to the detriment for another. It is possible that a certain issue quota violates the general avoidance provisions even though it may be economically justified from the company's point of view.

5. Case studies

In this section we present two real world cases which points to various conflicts of interest that may arise.

5.1 Case 4: The sibling case

The sibling case, "Mål T 1438-05, Svea Hovrätt", reveals a situation where the business-relevance of a rights issue granted by the Board is being questioned.

At an extraordinary General meeting on 15th of February 2002, the Board's proposal to issue shares in Venture Medica AB ("the Company") was granted. The decision meant that three new shares would be subscribed for every old share of the Company and the share capital could be increased by a maximum of SEK 300,000 by issuing a maximum of 3,000 new shares. Furthermore, at the Annual General meeting on 25th of June 2002, it was decided to, until the next Annual General meeting, authorize the Board to issue new shares and convertible debentures and debentures with warrants for shares with the possibility of deviation from the shareholders preferential right.

[78] Nerep, E. p. 302f. (2003).
[79] Bergström, C. & Samuelsson, P. p. 237. (2009).

Paola Bjäringer (“Paola”) took legal action towards the Company where she was a shareholder. She meant that the decision of a rights issue and to authorize the Board to make certain decisions, gave an unfair advantage to some other shareholders to the detriment of Paola as a shareholder. The defendant, the Company, meant that the decisions taken did not give an unfair advantage for other shareholders to the detriment of Paola.

Paola argued that she was withheld information and not invited to the Company meetings. The Company's assets consisted of securities, cash, stamps and art. There was virtually no debt in the Company and no one in the Board stated that the rights issue would be valuable, or even needed, for the Company's ongoing operations. Paola meant that the issue was completely unnecessary from a business perspective. She argued that the purpose of the rights issue was to disparage Paola's right as a shareholder. If she could or did not participate in the rights issue, her share in the Company would be heavily reduced by dilution. The effects of dilution could be catastrophic because the rights issue was decided at an, for Paola, unfavorable issue quota and subscription price. The reason for this was that the Company's equity was substantially higher than the number of shares multiplied by the previous nominal value and the subscription price. If Paola had not participated in the issue, her shares had been diluted and thus she would come under the important 10 per cent ownership required to be covered by the minority protection rules. Furthermore Paola stated that the Board knew of her financially distressed situation and that she would find it difficult to fund the rights issue. The decision of a rights issue was intended to give an unjustified advantage to the other shareholders in the event that Paola could not participate in the issue. If this "unnecessary" rights issue was approved, Paola claimed that there was a risk that the Board would continue to decide on new rights issues until Paola was unable to participate and furthermore not covered by the minority protection rules. Paola stated that the decision gave an unfair advantage for other shareholders, in violation of § 9:37 Companies Act and must therefore be repealed.

The Company opposed Paola’s statement. The Company stated that all shareholders received their shares as gifts and therefore the Board felt that it was desirable that the shareholders also showed their commitment to the Company through their own contributions. Among other things, the Company wanted to increase the capital base to enable a more strategic asset management and increased economic efficiency of the work effort. The claim that the rights issue decision sought to dilute Paola’s holdings, i.e. that the point was that she would not participate in the issue, was erroneous and strange with regard to the selected favorable subscription price. A rights issue was neutral from a shareholder point of view because the existing shareholders would have the same opportunity to retain their shares in terms of economic value and influence power. The Company meant that the extent to which a decision is unfair or not, should be decided according to objective criteria. Objectively speaking, the General meeting decision was

neutral. No such interests, that the general avoidance provision seeks to protect, existed. Martin Bjäringer, member of the Board, stated that business reasons for issuing new capital existed, e.g. to enable participation in a guarantee consortia. Furthermore, he pointed out that the Board was unaware of Paola's financial situation.

The Court district meant that the General meeting could not make a decision that gave unfair advantage or disadvantage to the Company or its shareholders. The question was if all the shareholders were given the same opportunity to the rights issue and if the issue was economically justified. The Court of appeal parted the Court district's assessment that Paola did not demonstrate that the disapproving decision gave an unfair benefit to other shareholders to the detriment of her. Formal and indirectly, the decision implied an equal treatment of shares and shareholders.

5.2 Case 5: The non-cash issue case

The dispute "Mål T 10082-10, Svea Hovrätt" concerns the private placement in Hägerstens Enskilda Fastighetsägare AB ("HEFAB") to Enskilda Fastighetsägare i Bromma AB ("EFIB").

Decision on the private placement took place at the General meeting of HEFAB, 19th of April 2005. It was resolved to authorize the Board to issue new shares. The non-cash issue could be of a maximum of 50,000 shares, PAR SEK 100 and with an exercise price of more than SEK 1,500 per share. The idea of the non-cash issue was to acquire a commercial property or leasehold in Stockholm with capital contributed in kind. In the event of a successful private placement, the new shares are thus assigned a price of at least SEK 1,500 and acquired property should be assigned a value which did not deviate from a fair market valuation. The price should be conditional to an independent valuation and the auditor's authorization. Value of the shares should finally be verified at the acquisition date. Decision on the non-cash issue was later taken at an extraordinary Board meeting on 22th of February 2006 and the private placement was made in March 2006. HEFAB issued 24,064 new shares for SEK 1,683 per share to EFIB in exchange for the capital contributed in kind consisting of leasehold rights (properties). Through the private placement the number of shares in HEFAB increased to 235,065.

The applicant[80] Tino Goetze and his company Brovalvet Förvaltnings AB ("Brovalvet") owned, at the time of the non-cash issue, nearly a 50 per cent stake in HEFAB. After the non-cash issue, Brovalvet's interest in HEFAB dropped to approximately 40 per cent of the shares. Brovalvet was very concerned about this. Brovalvet meant that the subscription price of SEK 1,683 per share did not correspond to the shares' fair value at the time of non-cash issue. The shares' value was not verified at the acquisition date and the Board did not take into account that there recently had been transactions in HEFAB for more than

[80] Swedish translation "kärande".

SEK 1,683. Furthermore, the Board did not consider other independent values of the leasehold rights that indicated values ranging from SEK 1,987 to SEK 2,314. To issue new shares at SEK 1,683 without having verified the correct value at the time of issuance was reckless according to Tino Goetze. The Board's aim was to dilute Brovalvet's ownership interest in HEFAB so that a simple majority could not be reached (> 50 per cent).

To conclude, Brovalvet argued that the private placement decision was made to give an unfair advantage to other shareholders to the detriment of HEFAB and Brovalvet. The Board had thus breached the general avoidance provision. Brovalvet's injury consisted of a declined company value and a lost majority ownership control in HEFAB.

The Board was of a different view. A non-cash issue always implied a strengthening of the company's equity. The issuing company could not be harmed in obtaining certain property or relieved of some debt by issuing new shares. HEFAB's business was to own and manage properties. As part of this activity it could be beneficial to obtain the capital contributed in kind in exchange for newly issued shares. The non-cash issue was also intended to be the first step in collaboration with EFIB. Furthermore, in connection with the acquisition a contact was taken with an independent property assessor. Following this contact, the Board found no reason to change the price and the decision of the non-cash issue was resolved purely by business considerations.

The Court district meant that HEFAB added a capital contributed in kind in the form of a property with a value of SEK 40,500,000. The Court district meant that no damage was inflicted to the company just by a decreasing share price through a non-cash issue. However, the question was whether the shareholder (in this case Brovalvet) suffered by the non-cash issue? The Court district was certain that sufficient action and verification had been made by the Board. There was an underlying business reason for choosing SEK 1,683 per share. Therefore it was not careless by the Board to determine the subscription price lower than the values stated by Brovalvet.

In the next instance, the Court of appeal parted the Court district's view on the case. The Court of appeal discussed the underlying valuation of the capital contributed in kind and concluded that a valuation was difficult to implement and may vary and change over time. The market price was finally determined at the level where buyers and sellers can agree. It was difficult to comprehend that the Board would like to issue shares in HEFAB to such a low price as they themselves would be disadvantaged. Whether the principal purpose of the issuance was to dilute Brovalvet's shares could not be displayed.

6. Case discussion

There are reasons to believe that there are a number of ways that management and certain shareholders can, and do, expropriate the other shareholders. Not surprisingly, most often it is the minority which is taken advantage of. This is sometimes referred to as minority expropriation and can occur in connection with, and by the time of, a rights issue. It can be a way of outmaneuvering parties with interests that stand in conflict with one's own.

It is important to illustrate whether the shareholders are expropriated and how large the economic loss in that case can be. In the three cases (one fictitious and two real world) presented below there are clear examples of how shareholders in a close company may incur harm and economic loss during a rights issue. In some cases the company's best interest has been taken in consideration and in other settings one has sought to protect the individual shareholder.

6.1 Case 3: Private placement - divergence from the shareholder's preferential right

In this case the majority chose to deviate from the principle of equality by conducting a private placement. Zed, who has built the company, is outmaneuvered by Xerxes who step by step has increased his activity in the company. However, there are several aspects concerning the private placement which could be seen as questionable.

An acceptable reason for conducting an immediate private placement is when a company is financially strained or distressed. This company is quite leveraged and unable to get a bank loan. Furthermore the present shareholders cannot afford to put more money into the business which opens up for a private placement. The financial aid is not intended to safeguard the economy, but rather to be used for an investment. It is not perfectly clear that this investment is a matter of course for the company's survival or future opportunities for expansion. To this, it is a notably long term investment and future profits may be hard to see. Zed could propose this to his advantage.

Xerxes points out that Roy has a lot of knowledge in the field. It can be seen as perfectly normal to deviate from the principle of equality in favor of getting needed human capital and knowledge. However, it is not clear whether Roy has a specific knowledge or if it is needed. Zed could propose this to his advantage.

The private placement takes place at a time when Zed has no sufficient liquidity. Hence, Zed is unable to participate in any form of issue. Zed could propose that the time is chosen to his disadvantage, only to make it possible to get a new owner of the company.

6.2 Case 4: The sibling case

The main point in "The sibling case" is whether the rights issue is legitimate or not from a business point of view, or if the issue gives an unfair advantage for certain shareholders and violates the juridical ground rules in a close company. Since there is no trade in subscription rights, the shareholders are forced to either participate using their subscription rights, or not to participate and lose both influential power and economic value.

In this case the rights issue was considered to be beneficial for the Company. That a co-owner did not have the resources required to participate in the issue did not make the issue unjustifiable. The woman in the case points to the dilution effect, noting that the other shareholders are wealthy while she has no income. To maintain her share of the value of the Company she would be forced to extensive personal debt. The question is whether the decision was intended to give other owners an unfair advantage or if the issue was warranted by business reasons.

The General meeting must not take decisions that may give unfair advantage to a shareholder to the detriment of the Company or another shareholder. In this case, the Court district claims that an issue is a common and entirely legitimate measure to provide capital to the Company. The woman has to prove that the decision gives an unfair advantage to other shareholders to the detriment of her. It is claimed that the Company through the issue would receive a larger capital base to enable a more strategic asset management and increase the economic efficiency of labor input. The Company's ability to participate in the guarantee consortia could be positively affected by the rights issue. The decision could thus provide the Company with financial benefits.

The fact that the woman did not have sufficient liquidity is not a reason to claim the decision unfair. The decision shows an equal treatment of the shares. The application of the general avoidance provision in this situation is very limited.[81] One can discuss how important the proposed capital injection is for the survival of the company's business. Nerep argues if it is clear that the company finds it difficult to survive without fresh capital, it would be strange to declare the General meeting decision invalid. This is based on the principle of equality tenet with respect to each individual shareholder's circumstances.[82]

6.3 Case 5: The non-cash issue case

This case underlines the importance of valuation of the capital contributed in kind and the significance of the purpose of the issue.

[81] Kindbom, M. (2007).
[82] Nerep, E. pp. 279-280. (2003).

The question is whether the capital contributed in kind was correctly valued and if the Board had been negligent and thereby caused injury with reference to § 29:1 Companies Act. It is said that the issue was likely to give an undue advantage to EFIB to the detriment of the applicant and that recklessness thereby infringed violation of the general avoidance provision. The Court district dismissed the case and the outcome of the Court of appeal was the same.

In this case it is a major shareholder with an ownership around 50 per cent that may get diluted why the issue severely can change the influence structure in the company. A correct valuation of the capital contributed in kind is therefore very important. It is hard to value something where the actual price is determined depending where buyers and sellers meet. There is a disagreement about the correct value of the property. The owner arguing that he gets exploited thinks the capital contributed in kind is valued too high.

The Court of appeal states that it is difficult to see that Board members would like to issue shares with an economic loss that they themselves would suffer.

The applicant argues that the main purpose of the issue was that the Board of directors wanted to dilute their shareholding and hinder the ability for the applicant to continue to hold a majority position in the company. That this was the case was not shown according to the Court of appeal.[83] There was sufficient ground to complete the issue with the chosen subscription price.

One can conclude that the purpose of the issue was legally legitimate with respect to business reasons. The fact that the largest shareholder lost major influence was not paid attention to and was of peripheral interest.

[83] Byström, R. (2012).

7. Concluding remarks

Our overall purpose is to provide insight into problems and questions, especially the ones related to displacement of power that may come up during rights issues and private placements, primarily in private Swedish close companies. We analyze if and how rights issues and private placements in close companies are performed without contradicting the legal protection every shareholder is entitled to.

First of all, it should be mentioned that the primary goal of a rights issue is hopefully wise, e.g. to fund profitable projects or help a company out of a precarious situation. However, we have noticed that this is not always the case in Swedish close companies. Even in issues with the most peaceful intentions there may subsequently arise situations where minorities or shareholder groups unintentionally are affected. There are situations where the legal guidance and its demarcation are somewhat unclear which opens for valuation and interpretation difficulties. This applies especially as there are very few court decisions to relate to as many disputes are set in the Arbitration board[84]. Moreover, we note that it is difficult to anticipate all kinds of conflicts and situations that can arise in a shareholder agreement.

Answer to research question one:

In contrast to large public companies where many shareholders often have some smaller part of their assets invested in a company, close companies are often owned by a few persons who have a larger part of their assets invested in the company. Hence, the effects of a decision for a single shareholder can be more significant in a close company – especially considering the balance of power. In case of a large public company, the influential power of most of the shareholders is not as important as the total value of the company.

In listed companies, one can get diluted during a rights issue but most often you have the possibility to sell the subscription rights in an efficient market. Hence, the risk for individual economic loss is reduced. In the case of unlisted close companies there is no efficient market for trading in subscription rights which can increase the dilution effect with loss of influence and economic value as a consequence. Also, the issue quota terms are important. An issue quota with unfavorable conditions for the shareholders who do not participate can transfer the wealth and influential power from the minority to the majority. The discount of the subscription price in the issue terms is not a problem per se. However, shareholders may suffer severe losses in private placements. On the one hand, a discount of the subscription price is used to get the issue fully subscribed. On the other hand, the requirement for equal treatment of shareholders must be met in order not to override the legal general avoidance provisions and principle of equality. The

[84] Swedish translation ”Skiljedomsnämnd”.

determined subscription price must be assessed in relation to shareholders' potential capital loss. As it stands right now there is no clear accepted way on how the issue terms should be set to always keep both perspectives fulfilled. Thus, power shifts may occur and the individual shareholder's interest must be balanced against the greater good of the company.

By initiating a private placement a majority shareholder can strengthen his or her position at the expense of other shareholders that get diluted. If a majority votes for a private placement, it will probably be difficult to stop for the minority. This can in the long run lead to a loss of the minority protection. It can often be cumbersome and difficult to rely on the principle of equality and the general avoidance provisions. However, a private placement does not have to be negative with respect to future company value. The study of Fritzell and Hansveden reveals that company value increases after the announcement of private placement in a listed company whereas company value decreases after the announcement of rights issue in a listed company. As for unlisted close companies there is of course also a chance that the company value increases after a private placement announcement and therefore would benefit its shareholders. To that, valuable knowledge and dedication may come with the new investor. Fritzell and Hansveden present a theory which we find very interesting, with respect to our thesis. A private placement should not be considered as something detrimental per se. This should also be reflected in Swedish legislation which today may have a too restrictive take on private placements in relation to its take on rights issues. This is a general conclusion which can be applied both in case of listed and unlisted companies.

In the case of close companies other parameters must often be considered. Even though the value of the company increases as a result of the private placement, the influential power may be of more importance. In a close company the tradition and the management of the company's original idea must be underlined. Previously a comparison with family firms was made. Founders may not want to lose power to someone, e.g. an outside investor, who might not have the same emotional ties as family members generally have. He or she may think short term and be less loyal to the company values.

During a rights issue in an unlisted company every shareholder has the same right as in a listed company to participate in the issue. Even though a rights issue also may result in dilution, it is still in no way as drastic as a private placement to bring in new capital. With the above reasoning, rights issues are concluded to generally be more welcoming than private placements in close companies. Whether the company value will increase or decrease during and after a rights issue or a private placement is hard to predict. Shareholders can choose to see it as a measure for new investments or as Shleifer and Vishny[85]

[85] Shleifer, A. & Vishny, RW. (1986).

explains it; a larger shareholder has a reason to act seriously and increase the company value and thereby maximize his or her own profit. On the other hand shareholders can see it as Miller and Rock[86] explains it; the need for financing is a sign of low future cash flow and thereby the financing is a sign of future unprofitably.

Answer to research question two:

The principle of equality serves as a protection for shareholders from being expropriated during e.g. rights issues and private placements. There are two sides of the principle of equality which somewhat complicates it as a form of protection. On the one hand, it states the requirement of qualified majority for taking certain decisions. On the other hand, it states the equal value of all shares. Hence, one has to make a case by case decision. Though, the principle is probably useful by the time of the fulfillment of the rights issue. Shareholders most often request equal treatment. In this case it is not about blaming a decision taken with qualified majority but rather that the application of this can imply an unequal treatment. Hence, the principle of equality is a support for shareholders, but not a complete one.

Another protection for shareholders during rights issues and private placements is found in the general avoidance provisions. One of the major problems when an issue must be judged on the general avoidance provisions is what is considered to be inappropriate in the rule's meaning. The outspoken purpose of a rights issue or private placement is an important part of the terms. There is a disagreement in the doctrine about how large role the business reasons should be allowed to take. Several of the authors advocate a balanced approach where the different reasons are weighed against each other. The lack of judicial decisions means that the legal position on this point may be regarded as highly uncertain. It is difficult to classify any issue as unfair as one can argue that the rights issue or private placement is economically justifiable. It is hard to see a situation where an increase in the share capital of a company is indefensible. Notice, that pursuing rights issues or private placements can be one of many techniques used to outmaneuver other shareholders. For example, the terms of the issue quota and the subscription price can be set in such a way that the majority can obtain an unfair advantage at the expense of the non-participating minority. In this thesis we have showed several examples where this is the case. Finally, both the general avoidance provisions and the principle of equality are blunt tools for a shareholder to use in order to express his or her rights. If the case of conflicts of interest should arise, shareholders who consider themselves to be exploited can bring the case up in court. However, often this is both costly and time-consuming, and with an uncertain outcome.

[86] Miller, MH. & Rock, K. (1985).

There are many advantages of a private placement, but one must be aware of the consequences it may have on the shareholder economy and influence. The idea to put the business and the company's goal and profit maximization in focus must be in line with the fact that all the shares in a company should have equal rights and that all shareholders in principle should be treated equally. A shift in power is inevitable in a private placement and thus economic shifts may occur. However, most agree that a deviation from a rights issue can be justified when managing a company out of crisis. Even though the shareholder may be both economically and influentially diluted he or she may be better off in the long run as the alternative could be a bankruptcy. This does however per se not imply that all shareholders are equally treated or that the shareholder protection is sufficient. Further guidelines and more real-world cases would be desirable.

In the case of non-cash issues, it is important that the capital contributed in kind is economically valuable and useful to the issuing company and that the property is actually transferred to the company. As long as it is a business-conditioned property that is incorporated, it is a good start and often viable. The correct value of the capital contributed in kind is sensitive to current shareholders as a non-cash issue always has a diluting effect for current shareholders. In our real world case we refer to an example where a shareholder is economically hurt and last but not least loses the majority influence.

Summary:

Whether the protection of the individual shareholder during rights issues is too weak in close companies and if it leads to an unfair prioritization of business over equal treatment must be decided from case to case. The doctrine is two-pronged and no cases seem to be self-evident. One can find some support in traditional views saying that positive net profit investments and total shareholder value should come first. This is also something that our two real-world cases point to, although we have very few cases to rely on. However, the fact that dilution in these cases is considered as acceptable may just be a proof that the law does not perfectly support equality. A rights issue or a private placement clearly affects shareholders. In what way and to what extent it does so depends on e.g. if the issuer is a large, listed company or if it is a small unlisted close company. The non-efficient market of subscription rights of unlisted companies significantly increases the premise for dilution of both economic value and influence. The latter becomes even clearer in the case of private placements. However, we find it impossible to set up a general rule of when to pursue and when to withdraw a rights issue or private placement in close companies. What we can conclude is that the legislation as a measure of protection is not sufficient from a shareholder's point of view. Rights issues or private placement can benefit companies and shareholders, but one cannot guarantee that this is not done at the expense of other shareholders.

8. Suggestions for further research

This paper attempts to provide an insight into close companies and what happens with respect to ownership and asset structure during rights issues and private placements. A special effort has been put on identifying pitfalls stakeholders may face in connection with these. We have highlighted an area that lacks sufficient previous research, and feel that further is required. It would be interesting to look at whether or not shareholders in close companies are taken advantage of, and if potential cases should be studied in more depth. Probably we are discussing a common theme here, but since it is about small companies no attention has been paid. With all certainty there are cases of exploitation, but instead of being brought up in court they have been resolved internally.

As we only have focused on rights issues and private placements, future research could favorably include offset issues.

The next step is to more thoroughly collect data on issues that may reveal further discoveries - perhaps to do a study of a quantitative character. Looking at ownership structures before and after rights issues ought to be one method to see if there has been inappropriate displacement of power. It would be of interest to look further into how different shareholder groups (and their characteristics) react during rights issues and private placements. Taking this further, one should look at the consequences of these circumstances in Sweden and the Nordic countries, but it would also be interesting to examine the topic in other Western countries where the law looks different. It is likely that our question might have been answered differently depending on the underlying legal system.

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10. Appendix

10.1 Dictionary

Swedish	English
Aktiebolag	Limited company (Ltd)
Aktiebolagslagen	Companies Act
Aktiebolagsnämnden	Committee of the Companies Act
Apportegendom	Capital contributed in kind, non-cash consideration
Apportemission	Non-cash issue / issue in kind
Bolagsstämma	General meeting
Emissionskvot	Issue quota
Fondemission	Stock dividend
Fåmansbolag/fåmansföretag	Close company
Företrädesemission	Rights issue
Företrädesrätt	Preferential right
Generalklausul	General avoidance provision
God sed	Good practice
Handelsbolag	Partnership
Hovrätt	Court of appeal
Högsta domstolen	The Supreme court
Jäv	Disqualification, lawful
Kvittningsemission	Offset issue
Kärande	Applicant
Lagutskottet	Legal Affairs Committee
Likhetsprincip	Principle of equality
Otillbörlighetsrekvisit	Unfairness assessment
Riktad emission	Private placement
Skiljedomsnämnd	Arbitration board
Svarande	Defendant
Tingsrätt	Court district