TRACKING STOCK IN GERMANY:
IS GERMAN CORPORATE LAW FLEXIBLE ENOUGH TO
ADOPT AMERICAN FINANCIAL INNOVATIONS?

YORK SCHNORBUS*

Article Contents:

1. Introduction ................................................................. 543
2. Evolution of the Tracking Stock Culture in the United States. 546
3. Reasoning for Establishing a Tracking Stock Culture.......... 552
   3.1. Enhancement of Shareholder Value.......................... 553
       3.1.1. The General Idea........................................... 553
       3.1.2. Some Empirical Statements on Shareholder Value
               and Tracking Stock.......................................... 554
   3.2. Tracking Stock in Mergers & Acquisitions Contexts........ 556
   3.3. Tracking Stock as Employment Consideration............. 558
   3.4. The Tax Issue: Whose Stock is it?......................... 559
   3.5. Hybrid and Hidden Risks of Tracking Stock............... 561
   3.6. Corporate Governance and Decision-Making
       Nightmares.......................................................... 562


I would like to thank Professor Edward B. Rock of the University of Pennsylvania Law School for his valuable and insightful comments on earlier drafts. Again I wish to express thanks to my academic teacher Professor Dr. Meinrad Dreher, LL.M. (University of Pennsylvania), of the University of Mainz Law School and to Prof. Dr. Barbara Grunewald of the University of Cologne Law School for their essential support and encouragement concerning my research in the U.S. I am most grateful to my LL.M. classmate Justin Hee-Loong Jiang for his thorough editing of this article.

German sources have been verified by the Author and not by the University of Pennsylvania Journal of International Economic Law.

Published by Penn Law: Legal Scholarship Repository, 2014
3.7. Preferences Regarding other Methods of Diversification ................................................................. 568
  3.7.1. Spin-off .......................................................................................................................... 568
  3.7.2. Carve-Out ...................................................................................................................... 569
  3.7.3. Prevailing Reasons for Tracking Stock ........................................................................... 569
4. Tracking Stock Basics under American Law ................................................................. 571
  4.1. Salient Corporate Features of Tracking Stock ................................................................. 571
    4.1.1. Voting Rights ........................................................................................................... 571
    4.1.2. Dividend Rights ...................................................................................................... 574
    4.1.3. Liquidation Rights ................................................................................................. 576
    4.1.4. Exit: Conversion and Redemption Rights ................................................................... 577
  4.2. Implementation and Issuance of Tracking Stock .............................................................. 578
    4.2.1. Implementation ........................................................................................................ 578
    4.2.2. Issuance ..................................................................................................................... 579
      4.2.2.1. Recapitalization .................................................................................................. 579
      4.2.2.2. Initial Public Offering ....................................................................................... 580
      4.2.2.3. M&A Currency ................................................................................................ 580
5. Tracking Stock under German Corporate Law ............................................................. 580
  5.1. Basics of the German Stock Corporation ..................................................................... 583
  5.2. Important Changes to the Stock Corporation Act ....................................................... 585
  5.3. Structuring Tracking Stock under the Stock Corporation Act ...................................... 586
    5.3.1. Dividend Rights ........................................................................................................ 587
      5.3.1.1. The Modification of the Distribution of Profits ......................................................... 587
      5.3.1.2. The Influence of the Outcome in the Core Business ................................................. 589
      5.3.1.3. Dividend Preferences .......................................................................................... 591
      5.3.1.4. Issuance of Participation Rights ......................................................................... 593
      5.3.1.5. Preliminary Conclusion ....................................................................................... 596
    5.3.2. Liquidation Rights ..................................................................................................... 597
    5.3.3. Voting Rights .......................................................................................................... 598
      5.3.3.1. Class Voting ....................................................................................................... 598
      5.3.3.2. Floating Voting ................................................................................................... 599
      5.3.3.3. Cumulative Voting .............................................................................................. 600
  5.4. Corporate Governance Issues ....................................................................................... 601
    5.4.1. Determination of the Business Segments and Management Guidelines .................. 602
1. INTRODUCTION

The United States of America and Germany represent two powerful economies and influential legal systems. Their economies are linked in the dynamics of international trade, and their constitutions share in the wide culture of Western constitutional thought. In light of these facts, the direct relationships between these big trade partners in matters of business and law are always of great importance, in both the practical and the scholarly view. Of course, the influence of
American corporate law and its financial innovations on German law and capital markets is much greater than it is vice versa, and American visions serve as models for other jurisdictions more than the visions of other jurisdictions. However, even this observation is an understatement. Delaware, the most important corporate law jurisdiction in the United States,¹ is so flexible, resourceful, and rich in ideas, that it might be both difficult and challenging for European continental lawyers to explore or create similar rules and to institute them in their civil legal systems.

In recent decades, American corporations have embraced many new and unique ways of structuring their capital and undertaking corporate transactions. In this context, among the group of innovations that demonstrate the flexibility of American corporate law, tracking stock plays an outstanding role.² Debt, preferred stock, and common stock represent the typical capital structure of a corporation. Tracking stock is thereby a class or series of common stock of that corporation. Each class is designed to track the operating and financial performance of a distinct business segment, subsidiary or revenue stream of that corporation. The outstanding common stock of such a corporation is typically redesigned as one class of tracking stock linked to the corporation's remaining or better core business; whereas the new class of tracking stock is linked to this "tracked" segment, division or group by means of separate financial reporting. The different classes of tracking stock are then listed or quoted individually and are traded separately. From the market perspective, this means that tracking stock and the company's other stock each have their own trading symbols and often are followed by separate groups of analysts, depending upon the industry.

¹ Because almost all tracking stock corporations in existence today are Delaware corporations, Delaware corporate law will be construed and applied throughout this Article exclusively regarding corporate law issues in the American jurisdiction. For a comprehensive overview on Delaware corporate law and some issues of its developments, see Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 UCLA L. REV. 1009 (1997).

² Tracking stocks are also known as alphabet stocks, lettered stocks or targeted stocks. The reasons therefore are discussed by, for example, Jeffrey J. Hass, Directorial Fiduciary Duties in a Tracking Stock Equity Structure: The Need for a Duty of Fairness, 94 Mich. L. REV. 2089, 2090 n.3 (1996) (explaining the origin of tracking stocks' various names).
Structuring a tracking stock culture, however, does not lead to the formation of separate entities. Tracking stock remains the equity of the parent corporation and holders of tracking stock continue to be, or become, shareholders of the whole corporation and not of the tracked business segment (whereas in carve-outs and spin-offs, conversely, the subsidiary’s assets are transferred to a new company). Accordingly, preferred stockholders as well as general and secured creditors of the parent corporation, are basically unaffected by the implementation of a tracking stock culture because all assets of the corporation remain available to satisfy all liabilities. Regardless of how the firm organizes the structure of issued stock and conducts its accounting and financial reporting system, the subject of private liability always will be the same. In sum, it is not the relationships between the shareholders on the one hand and the corporation and its creditors on the other that are affected, but mainly the relationship between the owners of tracking stock and owners of the residual class of common stock.

In Germany, publicly held corporations still do not issue a financial tool like tracking stock. Of course, the implementation of a tracking stock culture is often discussed among investment banks and law firms. Many companies are now attempting to broaden their shareholder base, and the creation of “shareholder value” has become a goal of some larger German companies. However, until now no German company has faced the challenges and opportunities of tracking stock in praxis. What are the reasons for this? German reluctance regarding American financial innovations? A legal system that is not established and prepared for new ways to finance a company and to enhance shareholder value? Indeed, it is often argued that the inefficiency and inflexibility of German corporate law is responsible for the nonexistence of tracking stock. Only the shares of the nominal capital of a stock corporation (Aktiengesellschaft) may be quoted on stock exchanges, but never, so some might guess, can “virtual” shares linked to the performance of a particular business unit be so quoted. In Germany, the effect of tracking stock could only be reached by equity carve-outs or spin-offs.

Of course, to be more precise, when the preferred stockholders have conversion rights, they can potentially be affected.
Regarding tracking stock, this Article scrutinizes whether German corporate law is indeed unable to adopt this American financial innovation or if it at least allows the creation of something equivalent to tracking stock. This analysis will lead to the conclusion that Germany is basically prepared to implement a tracking stock culture and, however, problems will arise in the details of the structure. Moreover, the comparison between the outcomes under American law on the one hand and German law on the other shows that the main issues and their legal handling in both jurisdictions widely correspond. Following this introduction, Section 2 of the Article briefly describes the development of tracking stock in the United States. Section 3 discusses the reasoning for issuing tracking stock and why Wall Street financial engineers are still busy improving this financial tool. A key point here, among others, is to explain the rationale behind the use of, and how capital markets evaluate, tracking stock. Section 4 deals with tracking stock under American law. Here the reader should get a general understanding of the structure of, and some legal issues relating to, this hybrid form of common stock in order to prepare herself or himself for the approach of the German civil law jurisdiction. Therefore, the goal of this part is only to create an awareness of general legal issues, and not to scrutinize problems under American law and lead them to a satisfying solution. This limitation also means that subjects under the American Securities Act of 1933 or under the Exchange Act of 1934 are not focused upon at all and tax issues will only be dealt with briefly. Section 5, as the main content of the Article, articulates the unique legal challenges to structuring and implementing a tracking stock culture under German corporate law. There are some complex topics to consider, many of which have little or no precedent in German experience. Hence, the focus on corporate law is necessary and indicates here as well that issues of securities regulations, accounting, and taxes are not addressed. Section 6 closes the investigation with a summary and a forecast.

2. EVOLUTION OF THE TRACKING STOCK CULTURE IN THE UNITED STATES

The development of tracking stock is derived from the tendency to diversify business activities of an enterprise. Diversification in this context means to run a business with two or
more unrelated product lines. Even when there are no historical reasons for diversification, corporations almost always strive for diversification to minimize the risks of a downturn with just one product line (in the worst case insolvency) and to maximize the effects of synergies. Even with diversified activities, however, the holders of the outstanding shares collectively own the entire ownership interest in the corporation. To the extent that the corporation as a whole performs well, the price of shares and the payment of dividends reflect this outcome regardless of how any particular segment of that corporation performs. Whereas under this construction usually only one single class of common stock exists, a corporation with a tracking stock culture has shares of at least two separate and distinct classes of common stock outstanding. Yet, each class of common stock of a tracking stock corporation gives the basis to "track" or "target" the financial performance of a distinct business segment or group.4

During the past decade in the United States, tracking stock has converted from an obscure, unknown, and little-understood corporate finance tool into one that is commonly accepted, although still debated. For quite a long time, issues regarding tracking stock solely have been a matter of practical interest for Wall Street law firms and investment banks. Only lately has the legal scholarly interest caught up and started to accompany the exploding development of tracking stock. Whereas initially mainly articles in handbooks were published,5 more and more scholars are

---

4 According to the terminology of Hass, supra note 2, at 2095.
beginning to scrutinize the financial and legal problems of tracking stock in highly recognized journals and books. The reason is obvious; a number of prominent U.S. companies have undertaken to operate their business using an evolutionary corporate equity structure that employs a tracking stock culture—and more and more firms must consider catching up with this development.


The first well-documented use of tracking stock was General Motors Corporation's ("GM") introduction of an independently traded stock for Electronic Data Systems ("EDS"), in conjunction with GM's acquisition of EDS in 1984. Industry Tycoon Ross Perot, the previous owner of EDS, had expressed concern that the performance of EDS managers would have little impact on undivided GM stock. The introduction of a separate tracking stock for EDS helped to convince Ross Perot to sell the firm. The same mechanism to create a special merger currency was used by the firm just one year later when it bought Hughes Aircraft in 1985. Because this first generation of tracking stock was designed to track the operating and financial performance of a subsidiary as a legal entity (e.g., EDS or Hughes Aircraft), these tracked stocks were also named "subsidiary shares." The term "alphabet stock" is derived from GM's creation of "E" and "H" stock to track its subsidiaries, EDS and Hughes Aircraft.

The so named second generation of tracking stock was created for the first time by USX Corporation in May 1991. The issuance of USX tracking stock differed from the stock issued by GM because the latter stock was linked to certain divisions (U.S. Steel and Marathon Oil) instead of to a subsidiary. U.S. Steel and Marathon Oil operated in widely different industries and it appeared that USX's undivided stock was undervalued by the market. As a major stockholder demanded that the company spin off its steel division to enhance shareholder value, the company decided to issue tracking stock for its steel and oil division and thus created the first "divisional shares." Shortly thereafter, in September 1992, USX created a third tracking stock when it sold shares of USX Delhi Group Stock in an IPO.

The process of issuing tracking stock does not stop there. Rather, on April 26, 2000, AT&T raised roughly $10.6 billion in a public offering of a new class of tracking stock designed to track AT&T's wireless group services business. At that time, the AT&T

---

8 See General Motors Corp., Proxy Statement/Prospectus (Sept. 21, 1984) [hereinafter GM-EDS Proxy Statement].
9 See General Motors Corp., Solicitation Statement (Nov. 13, 1985).
offering ranked as the largest U.S. initial offering in history. In sum, there are currently in excess of twenty different tracking stocks outstanding in the United States. Even outside the United States, more and more firms contemplate implementing a tracking stock culture. Fletcher Challenge Ltd. of New Zealand introduced a tracking stock for its forest division in 1992. The firm issued three more tracking stocks for its paper, building, and energy divisions in 1996. The French company Alcatel was the first European company to sell tracking shares, following U.S. companies such as Sprint. Alcatel raised $1.2 billion in October 2000 from selling shares in its optical parts unit, which it priced at the low end of the range because of declines in technology stocks. The high-tech company sold 16.5 million new shares that track the performance of Optronics, Europe’s top maker of lasers, filters, and parts that boost a fiber-optic network’s capacity. The shares are trading in Paris on the Premier Marché under the symbol CGO and as American Depository Receipts (ADRs) on the NASDAQ under the ticker ALAO.

---

12 Dahlberg & Perry, Tracking Stock: Virtual Equity, Virtual Entities, and Virtual Mergers and Acquisitions, supra note 5, at 245.

13 See FLETCHER CHALLENGE LTD., SOLICITATION STATEMENT AND PROSPECTUS (Oct. 21, 1993) [hereinafter FLETCHER SOLICITATION STATEMENT].

14 American depository receipts are designed to further facilitate the bringing of foreign stock closer to investors. They represent a certain number of foreign shares on deposit with a U.S. bank or a custodian bank in the foreign country. The U.S. bank acts as a transfer agent for investors and receives dividends, pays taxes, converts all amounts into dollars, and distributes the money to shareholders. ADRs established—especially for German companies—the major way to American capital markets. For more information on ADRs and international securities transactions, see Michael Gruson, Global Shares of German Corporations and Their Dual Listings on the Frankfurt and New York Stock Exchanges, 22 U. PA. J. INT’L ECON. L. 185 (2001) (discussing ADRs and international securities transactions); Amir N. Licht, Genie in a Bottle? Assessing Managerial Opportunism in International Securities Transactions, 2000 COLUM. BUS. L. REV. 51 (2000) (arguing that regulatory concern should address potential opportunistic behavior of corporate managers in international securities transactions).
Table 1: Samples of Highly Recognized Tracking Stock Issuance

<table>
<thead>
<tr>
<th>Company</th>
<th>Stock</th>
<th>Trading Symbol</th>
<th>Main Exchange</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Motors</td>
<td>Hughes</td>
<td>GMH</td>
<td>NYSE</td>
<td>1985</td>
</tr>
<tr>
<td>USX</td>
<td>Steel Group</td>
<td>X</td>
<td>NYSE</td>
<td>1991</td>
</tr>
<tr>
<td></td>
<td>Marathon Group</td>
<td>MRO</td>
<td></td>
<td>1991</td>
</tr>
<tr>
<td>Pittston</td>
<td>Minerals</td>
<td>PZM</td>
<td>NYSE</td>
<td>1993</td>
</tr>
<tr>
<td></td>
<td>Brinks</td>
<td>PZB</td>
<td></td>
<td>1996</td>
</tr>
<tr>
<td></td>
<td>Bax</td>
<td>PZX</td>
<td></td>
<td>1996</td>
</tr>
<tr>
<td>Fletcher Challenge</td>
<td>Forests Division</td>
<td>FFS</td>
<td>NZSE</td>
<td>1993</td>
</tr>
<tr>
<td></td>
<td>Paper Division</td>
<td>FLP</td>
<td></td>
<td>1996</td>
</tr>
<tr>
<td></td>
<td>Building Division</td>
<td>FLB</td>
<td></td>
<td>1996</td>
</tr>
<tr>
<td></td>
<td>Energy Division</td>
<td>FEG</td>
<td></td>
<td>1996</td>
</tr>
<tr>
<td>Genzyme</td>
<td>General Division</td>
<td>GENZ</td>
<td>NASDAQ</td>
<td>1994</td>
</tr>
<tr>
<td></td>
<td>Tissue Repair</td>
<td>CZTR</td>
<td>N-Mkt</td>
<td>1994</td>
</tr>
<tr>
<td></td>
<td>Molecular Oncology</td>
<td>GZMO</td>
<td></td>
<td>1998</td>
</tr>
<tr>
<td></td>
<td>Surgical Products</td>
<td>GZSP</td>
<td></td>
<td>1999</td>
</tr>
<tr>
<td>CMS Energy</td>
<td>CMS Energy</td>
<td>CMS</td>
<td>NYSE</td>
<td>1995</td>
</tr>
<tr>
<td></td>
<td>Consumers Gas</td>
<td>CPG</td>
<td></td>
<td>1994</td>
</tr>
<tr>
<td>INCO</td>
<td>INCO Ltd. Common Shares</td>
<td>N</td>
<td>TSE</td>
<td>1996</td>
</tr>
<tr>
<td></td>
<td>INCO Ltd. Class Shares</td>
<td>N/V</td>
<td></td>
<td>1996</td>
</tr>
<tr>
<td>Georgia Pacific</td>
<td>Georgia Pacific Group</td>
<td>GP</td>
<td>NYSE</td>
<td>1997</td>
</tr>
<tr>
<td></td>
<td>Timber Group</td>
<td>TGP</td>
<td></td>
<td>1997</td>
</tr>
<tr>
<td>Sprint</td>
<td>Sprint FON Group</td>
<td>FON</td>
<td>NYSE</td>
<td>1998</td>
</tr>
<tr>
<td></td>
<td>Sprint PCS Group</td>
<td>PCS</td>
<td></td>
<td>1998</td>
</tr>
<tr>
<td>Conectiv</td>
<td>Conectiv Common Stock</td>
<td>CIV</td>
<td>NYSE</td>
<td>1998</td>
</tr>
<tr>
<td></td>
<td>Conectiv Class A Common Stock</td>
<td>CIV/A</td>
<td></td>
<td>1998</td>
</tr>
<tr>
<td>AT&amp;T</td>
<td>Liberty Media</td>
<td>LBTYA/B</td>
<td>NYSE</td>
<td>1998</td>
</tr>
<tr>
<td>Perkin</td>
<td>Celera Genomics</td>
<td>CRA</td>
<td>NYSE</td>
<td>1998</td>
</tr>
</tbody>
</table>

15 Aktien für Geschäftsbereiche sollen mehr Schwung in den Handel bringen, HANDELSBLATT FINANZZEITUNG, Apr. 4, 1999, No. 69, at 45.
### Table

<table>
<thead>
<tr>
<th>Company</th>
<th>Stock</th>
<th>Trading Symbol</th>
<th>Main Exchange</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elmer</td>
<td>PE Biosystems</td>
<td>PEB</td>
<td></td>
<td>1998</td>
</tr>
<tr>
<td>Ziff-Davis</td>
<td>ZD Stock</td>
<td>ZD</td>
<td>NYSE</td>
<td>1999</td>
</tr>
<tr>
<td></td>
<td>ZD-Net Stock</td>
<td>ZDZ</td>
<td></td>
<td>1999</td>
</tr>
<tr>
<td>DLJ-Direct</td>
<td>DLJ Common Stock</td>
<td>DLJ</td>
<td>NYSE</td>
<td>1999</td>
</tr>
<tr>
<td></td>
<td>DLJ-Direct Common Stock</td>
<td></td>
<td></td>
<td>1999</td>
</tr>
<tr>
<td>Quantum</td>
<td>Hard Disk Drive Group</td>
<td>HDD</td>
<td>NYSE</td>
<td>1999</td>
</tr>
<tr>
<td></td>
<td>DLT &amp; Storage Systems Group</td>
<td>DSS</td>
<td></td>
<td>1999</td>
</tr>
<tr>
<td>Walt Disney</td>
<td>Walt Disney Common Stock</td>
<td>DIS</td>
<td>NYSE</td>
<td>1999</td>
</tr>
<tr>
<td></td>
<td>Go.com Common Stock</td>
<td>GO</td>
<td></td>
<td>1999</td>
</tr>
<tr>
<td>Snyder</td>
<td>SNC Common Stock</td>
<td>SNC</td>
<td>NASDAQ</td>
<td>1999</td>
</tr>
<tr>
<td>Communications</td>
<td>Circle.com Common Stock</td>
<td>CIRC</td>
<td>N-Mkt</td>
<td>1999</td>
</tr>
</tbody>
</table>


3. **Reasoning For Establishing A Tracking Stock Culture**

Corporations have implemented the tracking stock culture for a number of reasons. To enhance the shareholder value and to provide a unique type of consideration in the context of Mergers & Acquisitions ("M&A") are deemed to be the primary reasons.16 Although these aspects are very crucial, other points and serious disadvantages have to be taken into account. As a matter of basic principle, issuance of tracking stock is, speaking in corporate finance terms, a capital structure decision.17 As a lawyer, understanding how capital structure can increase or decrease value

---

16 Hass, supra note 2, at 2099-2107.

is important in estimating how to structure transactions to take maximum advantage of those opportunities without violating the law.\textsuperscript{18}

3.1. Enhancement of Shareholder Value

3.1.1. The General Idea

Tracking stocks are chiefly launched to unlock hidden shareholder value.\textsuperscript{19} They are employed to enable the market to value more accurately the respective businesses of the issuer without complete economic separation. The financial engineering idea behind tracking stock is that the company’s currently outstanding common stock is undervalued because such stock has been linked too closely to the performance of the entire business rather than to the performance of a particular, probably more attractive, division of the whole corporation (conglomerate discount).

A similar situation exists if a firm has different investment projects available, but some are hard to value for investors. In all cases

\footnotesize{\textsuperscript{18} Regarding capital structure like tracking stock, see id. at 187-88, 191-92. See generally Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 YALE L.J. 239 (1984) (explaining how business lawyers can increase transaction value).

\textsuperscript{19} See, e.g., Kenneth N. Gilpin, Shares That Track Assets Add Value at a Cost, N.Y. TIMES, July 18, 1999, § 3 at 7 (arguing that companies have issued tracking stock to increase shareholder value); Adam Lashinsky, Will The Boom in Tracking Stocks Derail Investors?, FORTUNE, Jan. 10, 2000, at 210-12 (arguing that companies use tracking stocks to boost their share price); Arthur M. Louis, Tracking Stock Can Unleash a Unit’s Value, S.F. CHRON., May 11, 1999, at C1 (explaining that tracking stocks are designed to unleash the market potential of promising subsidiaries); Making Tracks, ECONOMIST, Nov. 13, 1999, at 79 (explaining that many tracking stocks aim at unlocking value trapped in profitable subsidiaries); Steven Syre & Charles Stein, Genzyme Tracking Stocks Are Off Track on Returns, BOSTON GLOBE, June 24, 1999, at D1 (arguing that large companies create tracking stocks to unlock market value of a small unit); Marcia Vickers, Are Two Stocks Better Than One?, BUs. WK., June 28, 1999, at 98-99 (explaining that companies issue tracking stock believing that tracking stock and the parent company’s stock will be worth more than a single company stock); Chemmanur & Paeglis, supra note 6, at 7-9 (describing various potential motivating factors for issuing tracking stocks). For the statements of the issuers, see also RALSTON PURINA CO., PROXY STATEMENT AND PROSPECTUS, at 28, 29 (June 9, 1993) [hereinafter RALSTON PROXY STATEMENT]; TELECOMMUNICATIONS, INC., PROXY STATEMENT AND PROSPECTUS, at 49 (June 28, 1995) [hereinafter TCI PROXY STATEMENT]; US WEST, INC., PROXY STATEMENT AND PROSPECTUS, at 40 (Sept. 5, 1995) [hereinafter US WEST PROXY STATEMENT]; Fletcher Solicitation Statement, supra note 13, at 23.}
investors are likely to discount the hard-to-value projects significantly because of the problems caused by asymmetric information. In other words, capital markets are not efficient enough in valuing these stocks. USX Corporation, for instance, has implemented its tracking stock structure in order to unlock hidden shareholder value.

This assumption might more or less meet the market situation; however, in any case, tracking stocks separately offer shareholders the opportunity to evaluate and either retain or sell the securities depending on their personal investment objectives. The goal in implementing a tracking stock culture is to provide more transparency and to create a fiction in the investment community. Tracking stock corporations and their advisors hope that shares of each class will trade in the financial marketplace based directly on how the tracked business segment performs and only indirectly, if at all, on the performance of the corporation as a whole (quasi pure equity play). The possibility of evaluating a company under different investment objectives has some positive side effects. First, there is an increase in coverage by analysts. Additionally, the restructured company attracts new investors.

3.1.2. Some Empirical Statements on Shareholder Value and Tracking Stock

The prevailing financial press and academics are pessimistic regarding the issuance of tracking stock. Some commentators

---

20 Huang & Knoll, supra note 17, at 188; Chemmanur & Paeglis, supra note 6, at 7-8.
21 USX-DELHI PROXY STATEMENT, supra note 11, at 11.
22 Steinberger & Hass, supra note 5, at 527.
23 See Hass, supra note 2, at 2096, 2107 (explaining that corporations implementing tracking stock cultures will assess shares of each class as shares of a stand-alone corporation).
24 See, e.g., Anslinger et al., supra note 6, at 18-23 (providing a broader description of side effects); Chemmanur & Paeglis, supra note 6, at 8 (listing reasons for the possible increase in coverage by analysts).
25 See, e.g., Susan Pulliam & Steven Lipin, Target Stock is Under Fire from Investors, WALL ST. J., April 11, 1995, at C1 (noting that some studies have concluded that tracking stocks do not perform as well as complete spinoffs); Jennifer Reingold, Targeted Stock is the Flavor of the Month in Corporate America. It Won't Taste Good to Everyone, FIN. WORLD, Sept. 26, 1995, at 32-33 (explaining the numerous downsides of tracking stock); Stephanie Strom, It's Called Target Stock; Shun it, Some Experts Say, N.Y. TIMES, July 12, 1994, at D1 (arguing that tracking
speculate that tracking stocks trade at a discount of as much as five to ten percent when compared to their peers. Prominent scholars even say that it "is absolutely the purest form of financial engineering, and it yields no benefit at all." 26 However, some tracking stocks, such as Sprint PCS, have performed quite well, and proponents argue that issuing tracking stock has very real advantages over having a single stock for a conglomerate or spinning off of divisions. 27

Recent comprehensive investigations support this estimation. Souza and Jacob have attempted to present empirical evidence to shed some light on the debate regarding whether the issuance of tracking stock is accompanied by an increase in equity value. They find a statistically significant positive market reaction through an abnormal return of 3.61% within a three-day window around the announcement of proposed tracking stock issuances (announcement effect). They conclude that the market appears to regard the issuance of tracking stock as good news. This increase in value could stem from the availability of more detailed information on each tracking stock segment, as well as from the monitoring and motivational advantages of having a stock directly linked with the industry segment. However, they limit their results insofar as tracking stocks of the same firm do not trade independently of each other. They figure that stock returns on tracking stock and cash flows from operations of tracked segments seem to target their firm more than their industry. 28

These optimistic, but still unclear, results correspond mostly with other comprehensive investigations. McKinsey & Company


26 Strom, supra note 25, at D1 (quoting Professor Bruce Greenwald of Columbia University).

27 Anslinger et al., supra note 6, at 18-23; Logue et al., supra note 6, at 43-61; D'Souza & Jacob, supra note 6, at 7-9. But cf. Chemmanur & Paeglis, supra note 6, at 28-29 (finding that tracking stocks underperform in the long run). See also the first German investigation in INGO NATUSCH, TRACKING STOCK ALS INSTRUMENT DER BETEILIGUNGSFINANZIERUNG DIVERSIFIZIERTER UNTERNEHMEN (2nd ed. 2000) [hereinafter NATUSCH, TRACKING STOCK ALS INSTRUMENT DER BETEILIGUNGSFINANZIERUNG DIVERSIFIZIERTER UNTERNEHMEN].

28 D’Souza & Jacob, supra note 6, at 11, 24-25.
studied the performance of the large ownership restructurings—those in which the parent company had revenues upward of $200 million at the time of divestiture—that took place in the United States from 1988 to 1998.29 Their research shows that the announcement of tracking-stock deals or spin-offs tends to raise the price of the parent company’s stock by two to three percent. Regarding recent announcements of majority-owned equity carve-outs, however, they found no positive effect on the parent company’s stock. In the longer term, equity carve-outs in which the parent company retains majority ownership easily outperformed the Russell 2000 index, with an average annual return of twenty-four percent as compared with eleven percent in the two years after issue. McKinsey chose to concentrate on majority-owned carve-outs, since they are more common than those involving minority stakes. Spin-offs also substantially outperform the market, showing a two-year annualized return of twenty-seven percent, compared with fourteen percent for the Russell 2000 and seventeen percent for the S&P 500. Large-cap spin-offs actually lag the market. It is the spin-offs with lower market capitalization—less than $1 billion—that account for this performance. By contrast, tracking stocks tend to trail the market, with a return of nineteen percent as compared with twenty-one percent for the S&P 500. Yet benchmarked against industry peers, they kept pace.

Although some researchers have found very positive trends and studies have reported increases in stock values—especially when stocks were previously discounted due to cross-industry operations—tracking stock does not exist in adequate numbers to generate a statistically valid sample. Too few tracking stock deals—even outside the United States—have been done in the past fifteen years to support any general conclusions. Among others, it is still particularly unclear whether the performance of tracking stocks is related to their nature as tracking stock or the characteristics of the issuers of these securities.

3.2. Tracking Stock in Mergers & Acquisitions Contexts

Many M&A deals involving tracking stock are financed with the shares of the acquiring company for all or part of the

29 See Anslinger et al., supra note 6, at 19-20.
consideration to the selling stockholder.30 Two major reasons lead to this structure. Raising consideration from own common stock is first of all a formidable way to finance a deal instead of using cash. In order to eliminate conflicts that arise when a minority equity interest in the target remains outstanding, own stock as a deal currency also offers the shareholders of the target company the opportunity to continue their participation in the expected future performance of the acquired corporation and increases the likelihood that the acquiring company will get all shares of the target. However, in practice the negotiating sellers are often faced with a huge conglomerate that is running various business lines and is complexly structured. Yet, the threat is that the performance of the former target will become extinct in the conglomerate and will be unable to trace back. In particular, shareholders of a target corporation with high earning potential may be unwilling to accept regular common stock of an acquirer with only average earning potential. Tracking stocks help to solve such conflicts and they are often designed as a special acquisition currency.31 In order to provide that this consideration in the form of common stock is still linked to the performance of the target company after the deal, the acquiring company creates a separate class of tracking stock. Simultaneously the remaining outstanding common stock of the acquiring company would be modified to track all other business lines except the segment of the target.32 Eventually, the target company may also negotiate for additional class voting rights,

30 See, e.g., Gupta, supra note 7, at 154-155 (arguing that tracking stock capital may facilitate mergers); Allan Sloan, Why AT&T Is Feeding Ducks, NEWSWEEK, Dec. 13, 1999, at 71 (noting that AT&T stock price went up, as a result of issuing tracking stock, before it took over MediaOne).

31 The transaction between TCI and Viacom provides an example. Viacom issued cable subsidiary common stock to its shareholders in a spin-off of this subsidiary. Immediately following the acquisition by TCI of the cable subsidiary, these common shares were converted automatically into preferred stock that is exchangeable for TCI tracking stock five years after issuance. For further examples, see Brown & Handler, Tracking Stock, supra note 5, at 159-60.

32 See GENZYME CORP., PROSPECTUS AND JOINT PROXY STATEMENT (November 10, 1994), at 38 [hereinafter GENZYME PROXY STATEMENT] (describing Genzyme Corporation’s plan to create a new class of stock that will reflect the value and track the performance of a new division to be established within the company); GM-EDS PROXY STATEMENT, supra note 8, at 19-21.
which may be reflected in the charter or contained in the acquisition agreements.\footnote{33} Thus, in comparison to regular stock as a financing consideration for M&A deals, tracking stock allows former shareholders of the target company to continue participation in any equity appreciation associated with that company.\footnote{34} The very first introduction of tracking stock by GM is a vivid example of that reasoning. Moreover, a tracking stock culture is more likely to motivate the management of the target company to stay. This can be reached when bonus and stock option plans are tied to the performance of an equity security, reflecting the operating results of their own management conduct rather than the business of the whole merged business over which such managers naturally have little or no influence. Eventually, tracking stock can be used as a defensive measure.\footnote{35}

3.3. Tracking Stock as Employment Consideration

Not only in the context of M&A deals, but also in general terms, firms enhance the use of tracking stock as a special compensation for employees.\footnote{36} A tracking stock culture improves

\footnote{33} Hawthorne, Tracking Stock Terms, Methods of Issuance, Advantages, and Disadvantages, supra note 5, at 52.

\footnote{34} In addition, if the businesses are to any extent complementary, keeping them together may be beneficial. See Hass, supra note 2, at 2100.


NL Industries provides an example of tracking stock used as a defensive measure. In response to a tender offer from the Simmons Group, NL Industries anticipated undertaking a spin-off of the wholly owned subsidiary, NL Chemical, and issued Series C preferred stock, which tracked Chemicals' assets to NL shareholders. For a closer description of this case, see Thiel, SPARTENAKTIEN, supra note 7, at 22.

\footnote{36} See, e.g., Peter Coy, Tracking Stocks Are Accidents Waiting to Happen, BUS. Wk., Aug. 22, 1999, at 33 (noting that managers can be rewarded with tracking stock options, and that in particular, the Internet industry has spawned this use of tracking stock to hire top talented employees).
employee stock option plans and management incentive programs by more closely aligning stock with the performance of a specific business.\textsuperscript{37} Besides its function as employment consideration, tracking stock provides a further feature. Tracking stock moves managers in the position to act more as owners than as employees. Hence, tracking stocks might create value by reducing agency costs.\textsuperscript{38}

3.4. The Tax Issue: Whose Stock Is It?

Beyond the scope of this Article, but very often discussed under the subject "tracking stock," are tax issues.\textsuperscript{39} Because tax matters are always important and sometimes even crucial for structuring a corporation, they should be mentioned briefly. In this connection, the major question is whether tracking stock will be treated as stock of the parent corporation, stock of the tracked subsidiary (in the case of subsidiary tracking stock), or stock of a virtual entity holding the tracked assets (in the case of divisional tracking stock). Section 1032(a) of the Internal Revenue Code ("I.R.C.") provides that a corporation does not recognize gain or loss on the receipt of property in exchange for its stock.\textsuperscript{40} In contrast, if treated as stock of, let's say, a subsidiary, the issuing corporation would not be protected by that provision and would instead be required to recognize gain or loss at the time of an IPO. Further, section 311(a)(1)\textsuperscript{41} and section 305(a)\textsuperscript{42} of the I.R.C. allow a

\textsuperscript{37} Gupta, supra note 7, at 155; Schick, supra note 7, at 1372-73.

\textsuperscript{38} Huang & Knoll, supra note 17, at 188; Manfred Steiner & Ingo Natusch, Tracking stocks – Innovatives Instrument der Beteiligungsfinanzierung, 1996 DIE BANK 580, 584 (1996).

\textsuperscript{39} See, e.g., Thiel, SPARENAKTIEN, supra note 7, at 93-99; Borek, supra note 7, at 1107, 1108 (discussing the uniqueness of tracking stock in its "vertical division of corporate interests" and deliberating "whether it will be subject to various corporate tax provisions"); Dahlberg & Perry, Tracking Stock: Virtual Equity, Virtual Entities, and Virtual Mergers and Acquisitions, supra note 5, at 255-95 (describing the vertical division of corporate interests provided by tracking stock); Finkelstein et al., Tracking Tracking Stock, supra note 5, at 182-191 (explaining the different consequences of treating tracking stock as parent stock or subsidiary stock); Ingo Natusch, "Tracking Stocks": aus Sicht des US-Steuerrechts, 6 INTERNATIONALES STEUERRECHT [ISStR] 609 (1997) [hereinafter Natusch, "Tracking Stocks": aus Sicht des US-Steuerrechts].

\textsuperscript{40} I.R.C. § 1032(a) (1994).

\textsuperscript{41} Id. § 311(a)(1).

\textsuperscript{42} Id. § 305(a).
corporation to distribute its own stock to its shareholders without incurring tax liability to both the issuer and its shareholders. If tracking stock is stated to be something other than the stock of the parent corporation, however, the distribution would be taxable to the shareholders under section 30143 of the I.R.C., and the issuing corporation would be required to recognize gains pursuant to I.R.C. § 311(b), unless the distribution qualified as a tax-free distribution under I.R.C. § 355. Corresponding problems arise in the context of the use of tracking stock as M&A currency (in a forward triangular merger under I.R.C. § 368(a)(2)(D)), recapitalization of existing common stock (under I.R.C. § 368(a)(1)(E)) or the eligibility to file a consolidated federal income tax return as members of an affiliated group. If a tracking stock construction is regarded as a class of the undivided company's stock, the firm can file a consolidated tax return after the issuance of tracking stock, thereby allowing one division's losses to offset other divisions' profits.

As will be shown below, tracking stock possesses specially tailored attributes that are designed to provide investors with the economic equivalent of an equity stake in a legal entity. This hybrid form of common stock, therefore, consists of some very characteristic features provided for by the corporation's articles of incorporation regarding the rights, powers, and limitations of shareholders. In any case, it is necessary to differentiate how closely or loosely the stocks are structured to track their related business segment. The conclusion for one view or the other leads to a classic tracking stock culture or a stock culture of different approaches and determines the structure of the analysis. A tracking stock culture must be structured carefully to ensure that the IRS considers the tracking stock to be common stock of the

43 Id. § 301.
44 Id. § 311(b).
45 Id. § 355.
46 Id. § 368(a)(2)(D).
47 Id. § 368(a)(2)(E).
48 See Brown & Handler, Tracking Stock, supra note 5, at 133-34; Dahlberg & Perry, Tracking Stock: Virtual Equity, Virtual Entities, and Virtual Mergers and Acquisitions, supra note 5, at 256-57; Finkelstein et al., Tracking Tracking Stock, supra note 5, at 184.
company rather than stock of a subsidiary. 49 The rule of thumb is to structure the tracking stock as loosely to the tracked business segment as possible so that it will be treated like stock of the parent corporation. Due to this advice, it is the prevailing conclusion that, in most cases, tracking stock should be considered stock of the issuer, 50 which provides the firm with tremendous tax advantages. 51 Some issues of tax neutral tracking stock structure briefly will be touched upon again when this Article scrutinizes the salient features of tracking stock under American corporate law. 52

3.5. Hybrid and Hidden Risks of Tracking Stock

Holders of tracking stock remain subject to unique risks involving all of the company's operations. Although the dividends on tracking stock are linked to the performance of a particular segment of the corporation, holders of tracking stock, as already shown, remain stockholders of the whole entity and consequently all of its assets (i.e., the investment of the shareholders and its performance expressed by the stock price) cover the liabilities of all creditors. Further, net losses or special cash payments (especially dividends) only with respect to one tracked segment may reduce the funds of the company legally available for the payment of dividends on the other classes of tracking stock. Thus, tracking stocks are faced with typical risks. Unlike a carve-out situation, the return on investment and the value of the stock price are not exclusively linked to the performance of the tracked segment. In addition, impacts (both positive and negative) arising from operations of the remaining business or other tracked segments can affect the firm's overall financial condition and have to be taken into account for the analyzed tracking stock. Consequently,

49 For example, see the suggestions by Brown & Handler, Tracking Stock, supra note 5, at 133; Finkelstein et al., Tracking Tracking Stock, supra note 5, at 187-88.

50 Dahlberg & Perry, Tracking Stock: Virtual Equity, Virtual Entities, and Virtual Mergers and Acquisitions, supra note 5, at 261; see also Thiel, SPARTENAKTEN, supra note 7, at 96-99 (emphasizing that this outcome is in the interest of all parties of the deal and thus should be attainable); Natusch, "Traxking Stocks": aus Sicht des US-Steuerrechts, supra note 39, at 616.

51 The CFO of U.S. West's Media Group estimated that issuing tracking stock, instead of doing a spin-off, was likely to save the firm $200 million in potential taxes over a few years. See D'Souza & Jacob, supra note 6, at 8 n. 7.

52 See infra Section 4.1.
tracking stocks theoretically should never be deemed to be like stocks of stand-alone corporations. However, although tracking stock corporations engage in disclosure of the fact that financial effects arising from any particular business segment could affect both the entire outcome of the enterprise and the performance of other tracked segments, apparently the majority of investors in tracking stock corporations are not fully aware of the hybrid structure of this financial tool. For some investors, tracking stock fails with its complexity and the evaluation through capital market will take this into account.

3.6. Corporate Governance and Decision-Making Nightmares

The creation of a tracking stock structure basically has no impact on the legal structure of management. The parent corporation retains full operating control of all tracked business groups and only a single board of directors sits for the entire corporation. By contrast, in equity carve-outs and spin-offs, management reports to new and separate boards. The board in a tracking stock culture, however, is still responsible for formulating corporate policies and making major corporate decisions regarding all operative and strategic matters of the entire company. A separate board of directors related to each individual class of stock does not legally exist. As already noted, the issuance of tracking stock potentially creates conflicts between the multiple groups of shareholders because they are usually provided with different legal rights and concerned with different financial interests. And,

53 Hass, supra note 2, at 2117.
54 See Genzyme Proxy Statement, supra note 32, at 31 (warning that shareholders of the tracked divisions remain shareholders of the entire corporation and therefore are subject to all the risks associated with an investment in the corporation); US West Proxy Statement, supra 19, at 29; see also Donaldson et al., Prospectus (May 26, 1999), at 10 ("The board of directors may make decisions that favor DLJ at the expense of DLJdirect. Due to the extensive relationships between DLJ and DLJdirect, there will be inherent conflicts of interest . . . there can be no assurance that DLJ will not expand its operations to compete with DLJdirect.").
56 See, e.g., Donaldson, Lufkin & Jenrette, Prospectus (May 26, 1999), at 10 [hereinafter DLJ-Prospectus] (emphasizing this course).
57 For a deeper analysis of the conflicts that arise between shareholders in a tracking stock culture, see Hass, supra note 2, at 2112-39.
of course, the board of directors has fiduciary duties to the holders of each class of stock.58 Hence, tracking stock presents directors with unique challenges that are not prevalent in conventional corporations. Indeed, satisfying diametrically competing interests can create decision-making nightmares for a board of directors.59

Directorial conflicts principally arising in this context can be broken down into different categories.60 Primarily, conflicts arise each time directors make corporate decisions involving allocations of corporate assets, resources, opportunities, or personnel between or among the tracked segments. These decisions, which come up in the case of initial allocations and on an ongoing basis, may have a significant impact on the prospective reported earnings of the tracked segment and, as a result, the market value of the security. For instance, the allocation of interest expense and goodwill may have a significant influence on the operating result of each group. Further, the board encounters conflicting interests among shareholders when repurchasing stock or paying dividends on one class of stock. Ultimately, transactions and other dealings between or among the business groups of a tracking stock corporation offer fertile ground for claims of unfairness and violated duties. Therefore, viewing the problem from the economic side, tracking stock might impose agency costs by creating conflicts of interests.

58 It is one of the basic principles of American corporate law in general, and of Delaware corporate law in particular, that directors are subject to the fundamental fiduciary duties of loyalty and disinterestedness. Moreover, under American corporate law the fiduciary duties of directors are equal to all shareholders regardless of the class or series. See Sternberg v. O’Neil, 550 A.2d 1105, 1124 (Del. 1988); Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d. 1171, 1174 (Del. 1988); Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985). For a recent analysis, see, for example, R. Franklin Balotti et al., Equity Ownership and the Duty of Care: Convergence, Revolution, or Evolution?, 55 Bus. Law. 661 (2000); Edward Rock & Michael Wachter, Corporate Law as a Facilitator of Self Governance, 34 GA. L. REV. 529, 539-42 (2000).

59 See Schick, supra note 7, at 1365 (“[T]he tracked business groups are not independent of the parent corporation, and the parent’s board of directors still governs the affairs of each business group. This creates unique conflicts for directors who must please multiple groups of stockholders whose interests are not always consistent.”).

60 See id. at 1374-77 (categorizing the conflicts as those arising from the allocation of corporation resources, assets, and opportunities; arising from stock repurchases or dividend payments to one class of stockholders; and arising from transactions between competing business groups within a tracking stock corporation); Hass, supra note 2, at 2120-32 (differentiating six subdivisions).
over cost allocations, liquidation rights, and internal transfer payments.\footnote{61}{Huang \& Knoll, supra note 17, at 188 n.72.}

As with other business decisions and transactions, judicial review of resource allocations is limited by the business judgment rule. Generally, the business judgment rule avoids a court's "second guessing" the decision of a board of directors that acted on an informed basis, in good faith, upon due inquiry, and without self interest in a situation involving disparate impacts on the respective classes.\footnote{62}{Cf. Smith \& Van Gorkom, 488 A.2d at 872 (explaining that liability under the business judgment rule is based upon gross negligence, and therefore there is a high burden of proof set as the standard).}

However, in tracking stock contexts, the board's impartiality is typically in question because directors and executive officers will hold shares or options in both classes of stocks, but the value represented by one class exceeds the value represented by the other.\footnote{63}{See generally Balotti et al., supra note 58, at 666-71 (illustrating numerous Delaware opinions which support the concept that directors who are substantial stockholders will be influenced by their stock ownership).}

This presents further potential conflicts. Nevertheless, for a long time there existed little or no guidance for directors faced with a tracking stock structure. Of course, several cases have settled fiduciary duty issues arising in the background of transactions that affect more than one class of stock.\footnote{64}{See, e.g., Zahn v. Transamerica Corp., 162 F.2d 36, 42 (3d Cir. 1947) (detailing court analysis concerning fiduciary duty issues when there are multiple classes of stock); Gilbert v. El Paso Co., 575 A.2d 1131, 1147 (Del. 1990) (discussing conflicts that arise when dealing with fiduciary duties and trying to resolve competing interests among multiple shareholder groups); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721 (Del. 1971) (discussing fairness of dividends among multiple shareholders); Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 595 (Del. Ch. 1986) (describing applications of the "intrinsic fairness" test and the business judgment rule when dealing with multiple classes of stock).}

In these decisions Delaware courts have stated that a director's duty of care runs to the corporation and its shareholders as a body, rather than to any particular group of stockholders.\footnote{65}{In particular, see Gilbert v. El Paso Co., 575 A.2d 1131, 1147-48 (Del. 1990). Subsequently applying the business judgment rule, the Court upheld the directors' decision because it was (at least) intended to further the interests of the corporation. Because, when any duty owed by directors to the shareholders had to be considered in the narrow light of their duties to the corporation and all its shareholders, the interests of a particular group lose weight. For more information on this case, see Sparks \& O'Neil, Merger Issues at the New...}
The first Delaware court decisions involving tracking stock transactions to substantively address allegations that directors breached their fiduciary duties came up only recently in 1999. These cases dealt with actions brought against members of the GM Board of Directors by holders of GM Class H and Class E stock, respectively. In Solomon v. Armstrong, the plaintiff basically claimed that the director defendants who negotiated and approved a spin-off of a division of the corporation represented by a different tracking stock held a disproportionate number of shares and therefore had a personal financial interest and could not consider the terms of the transaction impartially. The Court of Chancery, however, dismissed the plaintiff’s claim and stated that directors often must resolve conflicts among classes of stock, and the fact that a majority of the directors own more of one class than another would not necessarily implicate the directors’ good faith and loyalty. Further, these allegations fail in the court’s opinion to rebut the business judgment standard of review because the plaintiffs could not prove that the directors’ interest was material.

Millennium: Strategic Deals, Tracking Stocks and the Duty to be Informed, supra note 5, at 199-200.

66 See Solomon v. Armstrong, 747 A.2d 1098 (Del. Ch. 1999), aff’d, 746 A.2d 277 (Del. Super. Ct. 2000); In re General Motors Class H S’holders Litig., 734 A.2d 611 (Del. Ch. 1999). For a comprehensive analysis of these cases, in particular, see Schick, supra note 7, at 1379-82.

67 The Class E and H stock were, as already described, two of the very first tracking stocks issued. See, e.g., Borek, supra note 7, at 1107, 1109-11 (describing GM’s use of Class E and Class H stocks as the “first well-documented use of tracking stock”).

68 For more information on this case, see Sparks & O’Neill, Merger Issues at the New Millennium: Strategic Deals, Tracking Stocks and the Duty to be Informed, supra note 5, at 204-06, 211-15.

69 Solomon v. Armstrong, 747 A.2d at 1118.

70 In considering the reasonableness of the process the court explained:

To the extent that in a given transaction different shareholder classes have mutually exclusive interests, the ability of the board to act in all of the shareholders’ best interests is seriously complicated. From a corporate governance perspective, it is precisely this danger that is endemic to companies with complex capital structures. Even if Delaware courts recognize that boards of directors routinely and properly have to make decisions that benefit one class of stock at the expense of another, where boards choose (or certificates require) a formal procedure to resolve conflicts due to diverging shareholder interests, the process by which those decisions are ultimately made must not fundamentally, without warning, disadvantage one class of stock.
In re General Motors Class H Shareholders Litigation is based upon a corresponding reasoning. The Delaware Chancery Court rejected the argument that disparate ownership rendered a board of directors "interested" with respect to a transaction involving one of the corporation's tracking stocks.\textsuperscript{71} Rather, the Chancery Court stated that the board of directors was entitled to the benefit of the business judgment rule in connection with approving the transaction and submitting it to stockholders, despite the directors' ownership of far more common stock than that stock, which tracked the performance of the company's electronics division. The court cited Freedman v. Restaurant Associate Industries,\textsuperscript{72} which stated that the mere fact that directors own more of one class of stock than another class does not deprive them of the benefits of the business judgment rule where directors are required to apportion consideration between two classes of stock. The Chancery Court further stated that the fact that the stock was a tracking stock "does not distinguish this case from those in which boards had to balance the interests of different classes of common and/or preferred stockholders."\textsuperscript{73}

\[\text{[And further:] [a]t the same time, where a board's task is to allocate value between two classes of stock, I do not think that it is Delaware law that the board has to set up an exacting process that actually replicates an arm's-length transaction between shareholders. As a matter of common practice a literal arm's-length negotiation happens when a soon-to-be-subsidiary tracking stock company is first merged into another company (e.g., when EDS first became part of the GM corporation). During that process negotiators for the prospective subsidiary can anticipate future conflicts of interest and draft appropriate provisions to deal with them under the certificate of incorporation. This is clearly a more efficient method of coping with potential divergences of interest between shareholder groups than having courts adapt procedural mechanisms (e.g., special committees, burden shifts, etc.) that are unnecessary or poorly adapted to new contexts. Where, as here, the pre-split-off certificate of incorporation provides for powerful procedural protections for all classes of stock, I think that it is inappropriate for a court to impose unhelpful requirements in the name of common law fiduciary duties.}\]

\textit{Id.} at 1124.

\textsuperscript{71} In re General Motors Class H S'holders Litig., 734 A.2d 611, 618-19 (Del. Ch. 1999).


\textsuperscript{73} In re General Motors Class H S'holders Litig., 734 A.2d at 619.
Although only superficially, this analysis shows that Delaware courts have, until now, been reluctant to develop a special standard for dealing with directorial duties in a tracking stock corporation. Rather, they still tend to apply the traditional fiduciary duties of care and loyalty to directors in corporations issuing tracking stock, and have also proposed to analogize to the directorial duties owed to preferred stockholders74 or to minority stockholders in a controlled subsidiary.75 In contrast, legal scholars argue that the traditional approaches to corporate governance—such as the fiduciary analysis, the contractual method or the entire fairness standard—are insufficient to determine the unique duty issues of directors in a tracking stock corporation.76 Thus, some recommend the application of a combination of the existing traditional standards depending on the transaction entered into by the corporation,77 whereas others who are even more extreme argue that the business judgment rule should not be applied altogether.78 Rather, this point of view attempts to establish a newly created "duty of fairness" when directors are making decisions and formulating policies that could have disparate impacts on the tracked business segments.

It is not the task of this investigation to contribute a convincing scholarly solution to one of the most interesting and challenging problems of tracking stock under American corporate law. Nevertheless, it might be helpful for the upcoming examination under German corporate law and to understand what is problematic. It is also interesting to see how American

74 See, e.g., Lawrence E. Mitchell, The Puzzling Paradox of Preferred Stock (And Why We Should Care About It), 51 BUS. LAW. 443 (1996) (explaining that preferred stockholders are like all other stockholders and are owed directorial duties over the "corporate entity itself"); Schick, supra note 7, at 1382-84 (describing how courts treat preferred stockholders). For the much more peculiar problem of the protection of preferred stockholders against common stock's direction of corporate affairs, see Victor Brudney, Contract and Fiduciary Duty in Corporate Law, 38 B.C. L. REV. 595, 648-53 (1997).

75 See Solomon v. Armstrong, 747 A.2d 1098, 1123 (Del. Ch. 1999) (arguing that a splitoff of a tracking stock line is radically different from freezing out minority stockholders).

76 Hass, supra note 2, at 2177; Schick, supra note 7, at 1367.

77 Schick, supra note 7, at 1393-97.

78 Hass, supra note 2, at 2092; cf. Stuart R. Cohn, Corporate Natural Law: The Dominance of Justice in a Codified World, 48 FLA. L. REV. 551, 557 (1996) (discussing the types of standards that should be applied and how well they address issues).
corporations attempt to handle the requirements of fiduciary duties and the business judgment rule in the praxis of tracking stock. To avoid conflicts among the several classes or series of shareholders and the involvement of the board, companies adopt as a prophylactic measure management and accounting policies in advance.\textsuperscript{79} These policies contain sets of rules as to the interactions between the groups of holders of the different classes of stock before certain actions are taken, e.g., dividend and accounting policies, the allocation of various expenses, and liabilities. Further examples of such policies are those requiring payment of fair value if one business group acquires an asset from the other, and policies requiring commercial arrangements between the tracked groups to be struck on arms-length terms. Operating Committees may also be useful to the board of directors in managing the tracked assets and resolving inter-group conflicts. These policies and institutions are helpful in order to provide the basis for financial statement preparation and to reduce the potential for fiduciary conflicts.

3.7. Preferences Regarding Other Methods of Diversification

Issuance of tracking stock has some similarities to spin-offs and equity carve-outs because all of them lead to diversification of the firm. However, the crucial differences lay in the details.

3.7.1. Spin-Off

For a long time in the United States the common attempt to enhance shareholder value has been the "spin-off," which is also referred to as the "split-off." A spin-off divides the existing asset base of a corporation into two or more separate units. The common structure is that the "tracked" assets of the parent are dropped into a new subsidiary that is then spun off to shareholders of the issuer. As such it usually does not involve any cash. Yet, the

\textsuperscript{79} For more details, see Hawthorne, Tracking Stock Terms, Methods of Issuance, Advantages and Disadvantages, supra note 5, at 55; Steinberger & Hass, Introduction to Tracking Stocks, supra note 5, at 540. See, e.g., RALSTON PROXY STATEMENT, supra note 19, at 30-32 (describing Ralston's policies and the implementation of these policies); SEAGULL ENERGY CORP., PROXY STATEMENT (May 2, 1994) [hereinafter SEAGULL PROXY STATEMENT], at 24-27 (detailing Seagull Pipeline Corporation's rules on shares and directorship); US WEST PROXY STATEMENT, supra note 19, at 42-45 (discussing the company's accounting and financing policies and how those policies are implemented).
investor has two types of common stock as a result of the spin-off in her or his portfolio: one representing a direct equity interest in the parent corporation minus the spun-off subsidiary, and the other representing a direct equity interest in the spun-off subsidiary. Thus, a spin-off is a clear-cut separation of the two divisions because after the transaction there are no connections between the entities either at the firm (management) level or at the shareholder level. Nonetheless, the financial engineering idea corresponds to the implementation of tracking stock. Each type of stock will trade independently in the market and presumably mirror the value of each tracked segment.

3.7.2. Carve-Out

An equity carve-out is the distribution of stock in a subsidiary. The shares of the subsidiary can be sold through a secondary offering by the parent company or through a secondary offering by the subsidiary itself. Usually, the “tracked” assets are dropped into a subsidiary and the subsidiary engages in an initial public offering (“IPO”) of its stock. The parent and the new subsidiary often remain consolidated for tax purposes. Equity carve-outs are the source of cash to the parent firm through the public sale of equity that has a claim on the subsidiary’s assets alone. The difference between an equity carve-out and an issue of tracking stock is that the latter does not lead to a parent-subsidiary relationship. In addition, issuance of tracking stock usually entails no external financing, so there is no dilution of the ownership interest of the original shareholder.

3.7.3. Prevailing Reasons for Tracking Stock

Although all of these structures can basically lead to the same economic result, a tracking stock equity structure has several advantages over the other mentioned corporate strategies. The major benefit lies in the financing capacity and flexibility of

---

80 Hass, supra note 2, at 2109.
81 For more details, see D'Souza & Jacob, supra note 6, at 7-9 (comparing targeted stocks with equity carve-outs and spin-offs); Hass, supra note 2, at 2109-11 (discussing the advantages of a tracking stock equity structure over traditional spin-off strategies); Logue et al., supra note 6, at 48 (summarizing the advantages of targeted stock).
tracking stock. Unlike equity carve-outs or spin-offs, the business groups underlying a tracking stock are managed by a single board of directors that is able to maximize synergies between the tracked group and the remaining group. Tracking stock also permits the continuation of synergies arising from the operation of a larger enterprise (e.g., counter-cyclical nature of distinct lines of business; sharing of administrative costs; lower borrowing rates, etc.). The result is only a fictive separation of diverse businesses while the corporation maintains full control and enjoys the advantages of a large-scale organization. All of this, in principle, increases a firm’s total debt capacity because it still retains the effect of diversification. Regarding the equity capacity, each of the tracked segments still can be used separately to raise funds and may enhance the corporation’s flexibility to raise new equity.

Table 2: Comparison of Structural Options for Diversification

<table>
<thead>
<tr>
<th>Legal Form</th>
<th>Tracking Stock</th>
<th>Equity Carve-Out</th>
<th>Spin-Off</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No impact on legal form; single Board of Directors</td>
<td>Separate legal entity; two boards of directors</td>
<td>Separate and independent entity, two boards of directors</td>
</tr>
<tr>
<td>Control</td>
<td>Maintain full control; Impact on fiduciary duties</td>
<td>Control depending on levels of ownership of parent</td>
<td>Entire loss of control</td>
</tr>
</tbody>
</table>

82 A good example is the Tele-Communications ("TCI") deal, in which existing common stock was redesignated as TCI Group Common Stock, and in a recapitalization, each share of TCI Group Common received one quarter of a share of Liberty Media Group Stock. The plan separated the media businesses from other communications businesses. TELE-COMMUNICATION, INC. (TCI), REGISTRATION STATEMENT 12 (filed Nov. 9, 1995), available at http://www.sec.gov/Archives/edgar/data/96903/0000950123-95-003220.txt; see Brown & Handler, Tracking Stock, supra note 5, at 161.

<table>
<thead>
<tr>
<th></th>
<th>Tracking Stock</th>
<th>Equity Carve-Out</th>
<th>Spin-Off</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting</td>
<td>Consolidated and individual statements of units</td>
<td>Consolidation depending on level of control</td>
<td>Deconsolidation; split companies completely independent</td>
</tr>
<tr>
<td>Tax</td>
<td>No taxes if deemed as stock of the parent</td>
<td>Taxable</td>
<td>No taxes under the requirements of I.R.C. § 355</td>
</tr>
<tr>
<td>Financing</td>
<td>Flexible group financing</td>
<td>Separate financing</td>
<td>Separate financing</td>
</tr>
<tr>
<td>Valuation</td>
<td>Uncertain; quasi pure equity market or discount</td>
<td>Full value to subsidiary; maybe discount to parent</td>
<td>Independent valuation; group structure can have impact</td>
</tr>
<tr>
<td>Parent Funding</td>
<td>Parent equity funding</td>
<td>Parent sells shares to public; dividends</td>
<td>Generally no proceeds to parent</td>
</tr>
</tbody>
</table>

4. TRACKING STOCK BASICS UNDER AMERICAN LAW

4.1. Salient Corporate Features of Tracking Stock

Although each tracking stock culture in most cases is unique, some variations on primary corporate characteristics typically distinguish tracking stock from normal common stock. The specific terms of the tracking stocks that matter in this context and require delineation include: (1) voting rights; (2) dividend policy; (3) liquidation rights; and (4) redemption and exchange provisions.

4.1.1. Voting Rights

Holders of tracking stock typically have voting rights and generally exercise them as shareholders of the issuer, i.e., one vote for each share on all matters upon which common stockholders are
entitled to vote. So far as the certificate or the articles of incorporation do not provide such a right, the corporate law of the state in which the corporation was organized grants it. However, tracking stockholders usually do not have special voting rights regarding the tracked assets or businesses. Certificates or articles of incorporation of tracking stock generally provide that, unless the state otherwise requires, all holders of tracking stock vote together as one class on all issues coming before common shareholders. Delaware corporate law requires a separate class vote on matters that could adversely affect the rights of the holders of a particular class of stock and on any other matter specifically set forth in the corporation’s certificate or articles of incorporation. Thus, it is likely that, in all cases concerning an economic or legal cut in the tracking stockholders’ position, they will vote together as one class.

Voting rights may be fixed at the time of issuance or floating. The issue of fixed versus floating voting rights is important because, in many cases requiring a shareholder vote, tracking stock investors vote as a single class when, e.g., the structure of the firm will be affected. Hence, voting rights can potentially impact the ability of holders of one class of tracking stock to control the outcome of a shareholder vote and thus affect the possibility of a change in corporate control.

In the first case, each class typically receives either one vote or some fraction of one per share. The vote per share of the tracking stock is fixed at the time that the proposal creating the class is approved. This loosely tracking stock approach is easy to handle in praxis, but does not pay attention to changes in the market valuation and relative importance of the different tracked business segments in the whole company. In the second and more common case, the voting rights are subject to periodic adjustments based on relative market values. This closely tracking stock approach can be

---

85 See id. §§ 102(b)(4), 242(b)(2).
87 See Hawthorne, Tracking Stock Terms, Methods of Issuance, Advantages and Disadvantages, supra note 5, at 52; Steinberger & Hass, Introduction to Tracking Stocks, supra note 5, at 534.
88 Logue et al., supra note 6, at 46.
further broken down in the different times of the adjustments. They can be made either prior to each shareholder vote or at fixed temporal periods, such as monthly or annually. For instance, the already mentioned tracking stock structure in the case of USX provided to be periodically adjusted to conform to the relative market values, whereas GM's tracking stock had fixed voting rights which could cause distortion if the relative market values of the stocks changed.

There are a couple of reasons why a floating voting system does matter.\(^9^\) First of all, it complies with the economic and legal reasoning that in corporations, ideally the power of voting should correspond to the value of the investment of each shareholder. Moreover, because floating voting systems are tied directly to a targeted segment's relative value they vest more decision-making in those business segments representing a greater portion of overall company value. This offers a disincentive for the management to divert resources to the less successful business groups.

However, while floating related voting systems are provided with these mentioned economic rewards and represent the classic tracking stock culture approach, even under American corporate law they are faced with serious legal and practical problems. Although beyond the scope of this paper, in order to prepare the investigation under German law these issues should be touched upon. Because the relative market capitalization of each class of tracking stock naturally changes from time to time and virtually can never remain at the same level, the holder of shares of the different classes of tracking stock in the same corporation become an unequal number of votes per share.\(^9^0\) Even more evident is the case in which only the voting rights of the tracked stock will be adjusted to equal the quotient of the weighted average market value of one stock, whereas the voting rights of the remaining outstanding are always fixed at one vote.\(^9^1\) This raises some questions because the general rule determines that the voting

\(^8^9\) Id.

\(^9^0\) See Hass, supra note 2, at 2096-97.

\(^9^1\) See, e.g., US West Proxy Statement, supra note 19, at 56-58 (discussing how each outstanding share of its communications stock will have one vote, while the number of votes of its outstanding Media Stock will be a fraction calculated according to the Average Market Value).
rights of the shares of stock of a particular class or a particular series within a class cannot be varied.\textsuperscript{92} Delaware corporate law only provides that the right to vote associated with shares of a particular class or series within that class may be denied outright or may be limited to specific matters. Moreover, more or less than one vote per share may be granted to the share of any class or series, and the separate vote of a class or series may be required before specific corporate actions may be taken.\textsuperscript{93}

Furthermore, in order to preserve favorable tax treatment, care must be taken that the nature of any class vote does not delegate too much control over the specified unit to holders of the targeted stock so that the targeted stock continues to be considered equity of the parent. However, in most cases holders of tracking stock will not have direct voting power in the tracked entity or assets. Even if the voting power in the corporation switches to the benefit of the holders of tracking stock, they have voting rights only as to the issuer. Therefore, of the primary characteristics of tracking stock, voting rights are typically the least problematic when making the determination of whose stock the tracking stock represents.\textsuperscript{94}

\textbf{4.1.2. Dividend Rights}

Of the four primary characteristics, none defines tracking stock more than dividend rights. At the time the tracking stock plan is enacted, issuers may announce the proposed dividend policies of the respective units in order to appraise the market of the equity characteristics of the security. However, the dividend policy (i.e., how much of the tracked business' earnings are to be distributed) still remains at the discretion of the Board of Directors of the issuer. This discretion—exercised in good faith and regarding the restrictions on dividend distributions—encompasses the legal power to declare and pay dividends exclusively on one or another class of tracking stock, and further to all classes in equal or unequal amounts. However, according to the idea of this financial tool,


\textsuperscript{93} DE\textsc{L.} CODE ANN. tit. 8, §§ 102(a)(4), 102(b)(1), 102(b)(4), 151(a), 212(a) (1991).

\textsuperscript{94} Dahlberg & Perry, \textit{Tracking Stock: Virtual Equity, Virtual Entities, and Virtual Mergers and Acquisitions}, supra note 5, at 259.
dividend rights of tracking stock generally are based on the earnings of the tracked business.95

As determined by state corporate law, dividends are solely payable out of the funds of the corporation that are legally available. Therefore, it is important to understand that the dividend payments of any tracking stock are subject to the same limitations that exist on other classes of common stock and to clearing up dividends in arrears on outstanding stock. In Delaware, corporations can pay dividends only out of surplus (i.e., assets minus liabilities minus capital) or net profits, each calculated at the parent level and not the business unit level.96 Thus, corporations cannot pay a dividend on tracking stock, even though the business unit is fabulously successful, if the company as a whole has no surplus or net profits. This important result must be retaken for the analysis under German corporate law.

A further important restriction on the dividend policy of the board in tracking stock cultures might be the charter of the corporation.97 In a closely structured tracking stock culture dividends are restricted by the charter of the corporation to paid-in surplus and consolidated net income attributable to the business segments related to those stocks. In this case, dividend policy corresponds to the outcome of the tracked class ("stand alone basis").98 High earnings in the profit center lead to equally high dividends, whereas in times when the tracked segment fails to

95 Logue et al., supra note 6, at 46.
96 DEL. CODE ANN. tit. 8, §§ 141(a), 170(a).
97 See Steinberger & Hass, Introduction to Tracking Stocks, supra note 5, at 531-32. Furthermore, in praxis cash distributions to shareholders are also typically constrained by covenants in corporate bonds and loan agreements. These covenants limit the total amount of funds that can be distributed to shareholders, thereby preventing management from activities that benefit shareholders at the expense of creditors.
98 This amount equates substantially to the amount that would be legally available for the payment of dividends if the tracked segment were a separate, stand-alone corporation. See, e.g., GENZYME PROXY STATEMENT, supra note 32, at 43-44 (explaining Genzyme's dividend policy); TCI PROXY STATEMENT, supra note 19, at 55-57 (discussing that their Liberty Media Group Available Dividend Amount is to be similar to what is legally obtainable to pay the Liberty Media Group common stock's dividends); US WEST PROXY STATEMENT, supra 19, at 47-48 (detailing how their Communication Group's financial statements are credited with an amount equal to the Media Stock's dividends, according to certain calculations); USX-MARATHON PROXY STATEMENT, supra note 10, at 15 (explaining the limitations placed upon dividend distribution).
generate earnings, the board is precluded from declaring and paying a dividend, even if the company as a whole has performed very profitably and earned a fund legally available for the payment of dividends on common stock. As a result, this means that the company—corresponding to a group of certain entities—is not allowed to transfer profits from a successful to a less successful business segment. However, a dividend policy like that can be reached in a tracking stock culture that corresponds more "loosely" to the performance of the particular business segments. In this case, for instance, the company's charter permits the board payment of dividends on every class up to legally available amounts; i.e., the profitability is just one element in the dividend policy of the board.

However, although the charter may link the shareholders' earnings to the performance of a tracked unit on a stand-alone basis, the above-mentioned restrictions on state law prevent the treatment of holders of tracking stock in terms of tax law as shareholders of the underlying business segment. Due to possible negative earnings of other divisions or subsidiaries of the issuing company, dividends linked to the performance of one business unit do not equate tracking stock with stock of this unit.99

4.1.3. Liquidation Rights

Holders of tracking stock do not have a special right to the tracked assets.100 Upon the liquidation or winding up of the corporation, holders of common stock share ratably, based on the number of shares held in any assets of the corporation remaining once creditors and preferred stockholders have received all amounts owed to them.101 Liquidation rights among the shareholders are often based on the relative values of the tracked and total assets at the time of issuance (predetermined ration) but

---

99 Dahlberg & Perry, Tracking Stock: Virtual Equity, Virtual Entities, and Virtual Mergers and Acquisitions, supra note 5, at 260.

100 See GENZYME Proxy Statement, supra note 32, at 46 (explaining that in the event of liquidation or winding up of affairs, the holders of the tracked stock would receive the remaining assets for distribution to common stockholders, but would not have a direct claim against any particular asset of the company); SEAGULL Proxy Statement, supra note 79, at 38; TCI Proxy Statement, supra note 19, at 30; US WEST Proxy Statement, supra note 19, at 29.

can also be fixed in proportion to relative market capitalization immediately prior to liquidation (relative market capitalization).\textsuperscript{102} On one hand, the latter construction avoids a distribution of funds that is not reflective of the relative market values of the divisions at the time of liquidation and represents a closer tracking stock culture. One the other hand, it leads again to unequal treatment regarding each single share and might therefore trigger legal problems.\textsuperscript{103} However, as long as holders of tracking stock must look to the net of the issuer's assets in excess of liabilities and have no security interest in or special liquidation rights to receive the tracked assets, there will be, from a tax perspective at least, no treatment as a taxable tracking stock transaction.\textsuperscript{104}

4.1.4. Exit: Conversion and Redemption Rights

In organizing capital structure, consideration should always be given to exit strategies in case the objectives of the firm or the investor are reached or changed. Like other corporate finance tools, the establishment of tracking stock need not be an irreversible "one way" decision.\textsuperscript{105} This means future restructuring options of the company are not blocked because tracking stocks, if properly structured, typically contain an "unwind" feature, allowing the corporation, at the board's discretion, to reverse the transaction and reinstate the status quo ante.\textsuperscript{106} Such an exit may be dependent on dividend history, market capitalization, or the passage of some minimum period of time.\textsuperscript{107} As this provides, the issuer can elect to convert the tracking stock, often at a designated

\textsuperscript{102} See Ralston Proxy Statement, supra note 19, at 41; Seagull Proxy Statement, supra note 79, at 59; TCI Proxy Statement, supra note 19, at 71; USX-Delhi Proxy Statement, supra note 11, at 14.

\textsuperscript{103} This may be the reason why US West switched to fixed liquidation rights for its classes of tracking stock and thus to a more "loosely" tracking stock culture. See US West Proxy Statement, supra note 19, at 58-59.

\textsuperscript{104} See Brown & Handler, Tracking Stock, supra note 5, at 133; Finkelstein et al., Tracking Tracking Stock, supra note 5, at 187.

\textsuperscript{105} Conversion rights and redemption at the option of the corporation are generally permissible under Delaware corporation law. See Del.Code Ann. tit. 8, §§ 151(b)-(e).

\textsuperscript{106} Steinberger & Hass, Introduction to Tracking Stocks, supra note 5, at 528.

\textsuperscript{107} Dahlberg & Perry, Tracking Stock: Virtual Equity, Virtual Entities, and Virtual Mergers and Acquisitions, supra note 5, at 250.
premium\textsuperscript{108} or at a prescribed formula,\textsuperscript{109} into another class of stock, consequently leaving only one class of common stock outstanding that represents the entire equity in the company (call exchange).\textsuperscript{110} The construction that permits the issuer to "split-off" or to "carve-out" the tracked assets under defined circumstances is possible. In some transactions, the tracking stock automatically converts to another class of stock. A mandatory exchange of tracking stocks or redemption is generally triggered if the issuer sells the tracked assets.\textsuperscript{111} In other instances, conversion may be one of several options.\textsuperscript{112}

4.2. Implementation and Issuance of Tracking Stock

4.2.1. Implementation

In its executive function, the board has to plan, structure, and implement a tracking stock culture. The most important and demanding task of the board here is to determine and to design the segments or subsidiaries into which each particular business the company should be tracked. The parent must then allocate its assets, liabilities, profits, and expenses (including interest, taxes, and overhead) between the specified units or between the specified unit and the remainder. Further, explicit decisions include the allowable dividends for each category of stock. As already emphasized, there must be a clear understanding within the firm

\textsuperscript{108} One example of this is the sale of Continental Baking's subsidiary by Ralston Purina and conversion of CBG shares (which tracked Continental Baking) into RPG shares (residual) at a fifteen percent premium. See Brown & Handler, Tracking Stock, supra note 5, at 154.

\textsuperscript{109} For the wealth consequences for shareholders depending on the alternatives, see Logue et al., supra note 6, at 46-48.

\textsuperscript{110} See Del. Code Ann. tit. 8, § 151(e) (1991). Under Delaware corporate law, such convertibility may be at the option of the stockholder, the corporation, or both. The specific provision detailing the convertibility features of classes of stock must be set forth in the corporation's certificate of incorporation. See id. §§ 102(a)(4), 151(a)-(e) (requiring a provision in the articles of incorporation to specify the qualifications, limitations, and restrictions with respect to any class of stock).

\textsuperscript{111} Hawthorne, Tracking Stock Terms, Methods of Issuance, Advantages and Disadvantages, supra note 5, at 53.

\textsuperscript{112} See Brown & Handler, Tracking Stock, supra note 5, at 126.
itself about how joint costs will be allocated across different types of the target business units.

After the financial and management issues are handled, the board is almost only concerned with technical legal matters regarding the implementation of the new stocks. A proxy statement describing the proposed amendments to the company's charter must be prepared and filed. Shareholder approval of the amendment to the certificate of incorporation of the company is required to issue common stock as tracking stock. Such an amendment will define the number and the kind of the particular business groups, designate the classes of tracking stock and the number of authorized shares of each class, and establish the already discussed rights, powers, and limitations of the different classes of tracking stock. Then, different kinds of issuance are contemplated.

4.2.2. Issuance

4.2.2.1. Recapitalization

Tracking stock commonly has been issued by a recapitalization of existing common into new common ("other stock") and tracking stock or by a distribution of tracking stock on the common stock. The former method is more declarative in nature because other stock automatically becomes a tracking stock since it tracks other business (including any "retained" interest in tracked business).[113] The latter method means that the company redesignates the outstanding share of common stock, for example, as a share of Group A common stock (which stock is established to track the performance of the remaining, but also newly defined business segment named "Group A"), and, simultaneously, distributes shares of the other newly created class of Group B common stock (which is designed to track the performance of the other new business segment named "Group B") to all existing shareholders on the basis of a predetermined distribution ratio.[114] Both methods are practiced.[115] Some companies, such as Sprint Corporation,

---

[113] Id. at 127.
[115] See Hawthorne, Tracking Stock Terms, Methods of Issuance, Advantages and Disadvantages, supra note 5, at 52.
have chosen to reclassify the core stock to express the notion that the shares reflect the performance of a tracked business segment. Other companies, such as General Motors, have chosen to continue to refer to their core stock as "common stock" of the corporation.

4.2.2.2. Initial Public Offering

It is increasingly coming into vogue that companies sell shares of a special class of tracking stock in an IPO. Tracking stock sold in an IPO usually represents only a portion of the tracked business with the remaining interest retained as an element of the other stock. The prevailing advantage of an IPO is that, by broadening the shareholder base, the company can raise new cash, which can be allocated to the newly created tracked segment or to the core segment, i.e., raising capital in connection with a new business. In addition, an IPO provides the chance to actively market the shares on a roadshow, where new potential investors can be better reached and informed about the new tracking stock.

4.2.2.3. M&A Currency

The third common method of distribution arises in M&A contexts. Target company shareholders receive tracking stock in the acquiring firm in exchange for their ownership stake in the target company. As already demonstrated, this approach allows target firm shareholders to still keep their investor objective, rather than invest in the combined conglomerate after the deal.

5. TRACKING STOCK UNDER GERMAN CORPORATE LAW

Given the advantages of such a powerful financial innovation like tracking stock, one might wonder why tracking stock transactions have neither been completed nor announced yet in Germany. Indeed, whereas German firms and their legal and financial advisors are still reluctant to launch a tracking stock culture, German scholars have already caught up with the

---


117 See, e.g., *DLJ-PROSPECTUS*, supra note 56, at 3 (redefining DLJ common stock to exclude interest in performance of online services of DLJ Direct and public offering of DLJ Direct Stock to track the company's online brokerage business). For more information on this deal, see Finkelstein et al., *Tracking Tracking Stock*, supra note 5, at 195-202.
discussion in the United States. Until now, several investigations have scrutinized the implementation of tracking stock in terms of financial issues,\(^\text{118}\) as well as in terms of corporate law,\(^\text{119}\) tax law,\(^\text{120}\) and accounting principles.\(^\text{121}\)


Like the situation in the United States, there is no special law governing the issuance and handling of tracking stock. The only legal entity in Germany that is able to offer publicly traded shares is the stock corporation (Aktiengesellschaft). An Aktiengesellschaft is a joint stock corporation governed by a special and very strict law, the Stock Corporation Act (Aktiengesetz/AktG or “the Act”). This statute is surely not a product of a “race to the bottom.” The Stock Corporation Act is so strict and inflexible that many American lawyers wonder how German companies manage to reasonably accomplish corporate transactions under this statute. It is for the most part a relatively old law, having been adopted in 1965, whereas its general provisions and principles are more than one hundred years old.

---

122 See §§ 38, 71, 78 German Exchange Act (Börsengesetz/BörsG); see also Theodor Baums, Aktienmarkt und Finanzierung kleiner Unternehmen, 18 Zeitschrift für Wirtschaftsrecht [ZIP] 1942, 1943 (1997).

123 Aktiengesetz [German Corporation Act] v. 10.8.1965 (BGBI. II S. 1089) [hereinafter AktG].


125 For the history of the Aktienrecht, see, for example, Karsten Schmidt, Gesellschaftsrecht 769-74 (3d ed. 1997); Susan-Jacqueline Butler, Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate
Because of the general preponderance of codes and statutes, German law is generally described as code or civil law, especially when compared to such common law jurisdictions as the United Kingdom and the United States. In the context of a comparison of American and German corporate law, the differences between these two law systems and their impacts must be taken into account and will also influence the following investigation. Because Delaware corporate law is so flexible and open for innovations, American lawyers tend to create comprehensive contracts and deal documentation, similar to short custom-made codes. Doing this, they provide themselves with the necessary legal basis. German lawyers, in contrast, are generally not so busy in paper work, although the approach of American lawyers has its impacts. The documentation of corporate transactions relies to a large extent on general rules laid down in statutes and on the methods of generally accepted methods of interpretation. In doing this, one of the most serious concerns under the German corporate law is whether a deal structure is permissible under the Stock Corporation Act.

This investigation gets started with a short overview of the structure of the German stock corporation and recent changes. Then it raises the question whether the Stock Corporation Act indeed provides serious hurdles to structure a tracking stock culture and for an efficient corporate governance. Eventually it will prove how a tracking stock can be implemented and which exit strategies are available.

5.1. Basics of the German Stock Corporation

The stock corporation is a legal entity strictly separate from its stockholders. The stock corporation has a tripartite structure. The mandatory organs are the shareholders' meeting (Hauptversammlung),\textsuperscript{126} the supervisory board (Aufsichtsrat),\textsuperscript{127} and the executive or management board (Vorstand).\textsuperscript{128} The shareholders elect the members of the supervisory board and the

---

\textsuperscript{126} §§ 118-147, AktG.
\textsuperscript{127} §§ 95-116, AktG.
\textsuperscript{128} §§ 76-94, AktG.
supervisory board appoints the members of the executive board. Besides the principal functions of appointment, supervision, and removal, the supervisory board is also involved in major corporate transactions and the development of long-range company goals. The management board administers and represents the stock corporation. Its power to represent and bind the stock corporation is unrestricted and cannot be limited against third parties (intra vires). Thus, unlike in the United States, in Germany there is not just one board of directors, but a two-tier system, under which the management board and the supervisory board are separated.

The shareholders generally act only through the shareholders’ meeting, which management and supervisory board members are expected to attend. The functions of the shareholders’ meeting are basically limited to passing resolutions concerning the corporation’s legal and financial structure, electing and recalling members of the supervisory board, appointing auditors and discharging the responsibility of or pursuing claims against board members. Resolutions regarding the firm’s legal structure requiring shareholder approval include amendments to the articles, consent to control agreements (intercompany agreements), mergers, transformation of legal form, transfer of all assets or, according to case law, transfer of major assets of the

---

129 § 84, AktG.
130 § 111, AktG.
131 § 84, AktG.
132 In particular, see §§ 90, 111, AktG.
133 §§ 76(1), 78(1), AktG.
134 However, it has to be taken into account that in the United States, there are de facto two boards as well. The board of directors on the one hand and the formal or informal “executive committee” of the executives on the other.
135 § 118, AktG.
136 Most routine matters, including the election of shareholder representatives to the supervisory board, require a majority of the votes actually cast at a shareholder meeting. § 133, AktG. Generally, the Stock Corporation Act provides that most extraordinary matters need the approval of seventy-five percent of the votes cast. See, e.g., § 179(2), AktG.
137 § 119, AktG.
138 See §§ 291-307, AktG.
corporation. In addition, and of importance for the following analysis, the shareholders' meeting must consent to allocation of the earnings of the company.\textsuperscript{140} Although at first glance there might be significant parallels between the German stock corporation law and many U.S. corporate law jurisdictions, it has to be taken into account that the American and German systems of corporate governance are still fundamentally different.\textsuperscript{141}

5.2. Important Changes to the Stock Corporation Act

During the last few years German stock corporation law has undergone far-reaching changes which were achieved with a broad parliamentary consensus. The international competitiveness of Germany as a common industrial center and newly flourishing financial market has been considerably improved with these new laws. The major amendment in this context is the Business Control and Transparency Act of 1998 (Gesetz zur Kontrolle im Unternehmensbereich ("KonTraG")).\textsuperscript{142} This act is one of the most

\textsuperscript{140} § 174, AktG.

\textsuperscript{141} See therefore the landmark article of Thomas J. André, Jr., Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany, 73 Tul. L. Rev. 69 (1998) [hereinafter André, Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany]; see also Butler, supra note 125, at 555; Jeffrey N. Gordon, Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany, 5 Colum. J. Eur. L. 219 (1999) (using the cases of the Deutsche Telekom privatization and the merger of Chrysler and Daimler-Benz to argue that cross-border acquisition will lead to a greater convergence of corporate governance systems); Helmut Kohl, Path Dependence and German Corporate Law: Some Skeptical Remarks from the Sideline, 5 Colum. J. Eur. L. 189 (1999) (inquiring whether the Path Dependence theory explains why certain German merchant and corporate laws continue to exist); Dennis E. Logue & James K. Seward, Anatomy of a Governance Transformation: The Case of Daimler-Benz, 62 Law & Contemp. Probs. 87 (1999) (using a case study of Daimler-Benz to show the trend from communitarian to the contractarian system of corporate governance); Edward B. Rock, America's Fascination with German Corporate Governance, 40 Die Aktiengesellschaft [AG] 219 (1995) (dealing with the different perspectives of corporate governance).

\textsuperscript{142} See Bundesgesetzblatt (Federal Law Gazette) I 786 (1998). See thereto in English, Butler, supra note 125, at 559 (discussing the reasons behind the 1993 amendments to the Aktiengesetz). Regarding stock options, see Christian Roschmann, Stock Options Plans in Germany, 12 SFG Int'L L. Practicum 29 (1999). Thereo in German, see for example, Peter Hommelhoff & Daniela Mattheus, Corporate Governance nach dem KonTraG, 43 Die Aktiengesellschaft [AG] 249 (1998); Bernhard Pellens, Andreas Bonse & Joachim Gassen, Perspektiven der deutschen Konzernrechnungslegung – Auswirkungen des Kapitalaufnahmeverleichterungs gesetzes und des Gesetzes zur Kontrolle und Transparenz im Unternehmensbereich, 51
important amendments to the Stock Corporation Act in the last decades. It has introduced many important changes, amending internal control mechanisms, limiting the exercise of proxies by banks, and introducing provisions on the issuance of stock options to board members. The changes regarding the corporate governance system were prompted by the failure of the management board, the supervisory board, and auditors to prevent spectacular collapses, and by discussions about the power of banks in German stock corporations, due to their participation in many corporations and their depository voting rights. Moreover and interesting in this context, the German legislature, aware of the progressing globalization of markets, intended to foster the competitiveness of German companies and to open international capital markets to German stock corporations. The KonTraG amendments were envisioned as creating transparency and capital market orientation, which is especially demonstrated by liberalization of the provisions regarding the acquisition of the corporation's own stocks.

5.3. Structuring Tracking Stock under the Stock Corporation Act

As stated previously, the Stock Corporation Act is an extremely strict law. This principle is especially expressed in section 23(5) of the AktG, which states that "[t]he articles of incorporation may only contain provisions that deviate from those contained in the Act when expressly permitted under the Act. Supplemental provisions in the articles of association are permitted unless the Act contains provisions that conclusively address such issues." The consequence of this principle (Grundsatz der Satzungsstrenge) is a deep restriction of the liberty to structure corporate transactions.

DER BETRIEB [DB] 785 (1998). For an excellent discussion about corporate governance in Germany within an international comparison, see CARSTEN BERRAR, DIE ENTWICKLUNG DER CORPORATE GOVERNANCE IN DEUTSCHLAND IM INTERNATIONALEN VERGLEICH (2001) [hereinafter BERRAR, DIE ENTWICKLUNG DER CORPORATE GOVERNANCE IN DEUTSCHLAND IM INTERNATIONALEN VERGLEICH].

143 See, for example, the comprehensive overview on that German phenomena, André, Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany, supra note 141, at 127-46; Butler, supra note 125, at 560, 572-75.

144 § 23(5), AktG.
Moreover, a tracking stock structure that violates section 23(5) of the AktG is likely to be totally invalid.\textsuperscript{145}

5.3.1. Dividend Rights

The most important monetary right is the right to receive dividends. The German stock corporation is characterized by the principle of maintenance of the capital (\textit{Grundsatz der Kapitalerhaltung}), which leads to several restrictions for the distribution of dividends and will be discussed soon below. Many lawyers see herein the most serious concern against a tracking stock culture in Germany. The statutory regime of maintenance of the capital triggers in this context primarily two questions: (1) whether the payment of dividends may be legally linked in the articles to the performance of a particular business unit; and (2) how the financial outcome in the core business or other segments influences the ability of the company to distribute dividends to the holder of tracking stock. The latter question raises the supplemental issue of how restrictions of the Stock Corporation Act regarding the distribution of dividends can be compensated through additional features.

5.3.1.1. The Modification of the Distribution of Profits

A crucial point to establish a tracking stock culture is the distribution of profits to the different classes of shareholders in the charter. Commonly the dividends of the shareholder of a stock corporation correspond with their share capital.\textsuperscript{146} According to section 60(1) of the AktG the shareholders participate in the profits of the stock corporation in proportion to their holdings in the share

\textsuperscript{145} However, the legal consequences of the violation of section 23(5) of the AktG are still not sufficiently settled; see, for example, the discussion by UWE HÜFFER, AKTIENGESETZ KOMMENTAR § 23 margin no. 43 (4th ed. 1999); KARSTEN SCHMIDT, GROSSKOMMENTAR AKTIENGESETZ § 241 margin no. 55, 60 (Klaus J. Hopt & Herbert Wiedemann eds., 4th ed. 1996).

\textsuperscript{146} The AktG puts great emphasis on the integrity of the stated share capital. According to section 1 of the AktG, the stock corporation has to have a stated share capital (\textit{Grundkapital}) divided into shares. This means that the \textit{Grundkapital} must be divided into different and at least two shares. The number of shares it is divided into must be mentioned in the articles of incorporation. Assume, for instance, that a stock corporation has a stated capital of EURO 100,000 and 1000 shares; then every share has a share capital of EURO 100.
capital. At first glance, the idea of tracking stock violates this provision because its right to the dividends is not linked to the proportion in the stock capital, but only to the performance of the tracked segment. Nonetheless, section 60(3) of the AktG allows an exemption for the case that the corporation’s charter provides for another method of payment. It is settled that this leeway is wide enough to link the dividends of shares to the financial performance of a distinct business segment, subsidiary, or revenue stream.

Because the shares confer different rights with respect to the distribution of profits and corporate assets, the tracking stocks contribute, according to section 11 of the AktG, a particular class of shares. Under German corporate law, however, unequal treatment of shareholders is always an issue which should not be underestimated. As a general unwritten constitution of German corporate law, all shareholders shall be treated equally by the corporation under equivalent circumstances. This is explicitly aligned by section 53a of the AktG. However, this direction is not so restrictive as it seems. Reasonable modifications of the principle of equal treatment are permissible. The Act shows by itself that some modifications are acceptable. The Act authorizes in sections 60(3) and 271(3) of the AktG to treat shareholders differently regarding the distribution of dividends and assets, and section 11 of the AktG constitutes different classes of shareholders. Especially, section 11 of the AktG demonstrates that even under the Stock Corporation Act shareholders provided with different rights can be treated differently. The principle of equal treatment in general is not up to the disposition of the

---

147 § 60(1), AktG.
148 § 60(3), AktG.
149 Baums, *Spartenorganisation, “Tracking Stock” und deutsches Aktienrecht*, supra note 35, at 29-30; Brauer, supra note 119, at 325; Müller, supra note 119, at 58.
150 § 11, AktG.
151 Brauer, supra note 119, at 326.
152 § 53, AktG.
153 HÖFFER, supra note 145, § 53a margin no. 5; MARCUS LUTTER, KÖLNER KOMMENTAR ZUM AKTIENGESETZ, at § 53a margin no. 22 and 28 (Wolfgang Züllner ed., 2d ed. 1988); Brauer, supra note 119, at 332.
154 §§ 60(3), 271(3), AktG.
155 § 11, AktG.
156 Id.
corporation, but the reference of comparison can be modified. At least the shareholder is in the position to waive his right of equal treatment, for instance when he participates in the approval of unequal distribution of dividends to the benefit of other shareholders. In sum, to link the dividends of tracking stock to the performance of the underlying business unit in the articles of incorporation or in other corporate provisions is basically permissible and does not conflict with the principle of equal treatment of shareholders.

5.3.1.2. The Influence of the Outcome in the Core Business

The last paragraph consequently leads to the issue of how the corporation has to apply this dividend policy provided by the articles. The management board of the German stock corporation, according to sections 242 and 264(1) of the General Commercial Code (Handelsgesetzbuch / HGB), is responsible for the creation of the annual financial statements and the management report. Upon completion, the management board shall promptly submit the documents to the supervisory board. The annual financial statements shall be deemed to have been approved upon acceptance thereof by the supervisory board. To the extent that the shareholders’ meeting is not responsible for it, the stockholders are bound by the establishment of the annual accounts by the management board and supervisory board. This procedure of approval of annual financial statements is differentiated from the appropriation of profits, which is assigned to the shareholders’ meeting. The stockholders in any event retain control over the allocation of the balance sheet profits.

---

157 HÜFFER, supra note 145, § 53a margin no. 5; LUTTER, supra note 153, § 53a margin no. 29, 30.
158 THIEL, SPARTENAKTIEN, supra note 7, at 232; Brauer, supra note 119, at 332-33.
159 Handelsgesetzbuch [Generell Commercial Code] of v. 05.10.1897 (RGB1. S. 219) (BGBl. III 4100-1), last changed through the Act of 03.02.2000 (BGBl. I S. 330) [herninafter HGB].
160 § 170(1), AktG.
161 § 172(2), AktG.
162 The management board and the supervisory board, however, can resolve that the annual reports be established by the shareholders meeting. § 172, AktG.
163 § 174, AktG.
However, according to sections 57(3) and 58(4) of the AktG, dividends may be distributed only from the balance sheet profit (Bilanzgewinn) and only to the extent that the distribution of the profit to the shareholders has not been excluded pursuant to the articles or by resolution of the shareholders’ meeting.\(^{164}\) Any distributions going beyond the balance sheet profit or otherwise determined expenditure may be made only after liquidation of the company.\(^{165}\)

The shareholder’s monetary right to obtain dividends initially means only that the shareholders’ meeting is required to resolve the appropriation of profits,\(^{166}\) but the entitlement to receive dividend payments accrues only after the resolution is passed. For instance, a resolution of the stockholders’ meeting or of the management board, together with the supervisory board, can require the allocation of the respective balance sheet profit to the reserves of the company or a resolution of the shareholders’ meeting can carry such amounts forward.\(^{167}\) Consequently, even if the company gained a surplus it does not legally mean that the shareholders are entitled to receive dividends.

Like the legal outcome under Delaware law, it is also the case in the German stock corporation that dividends are solely payable out of those funds of the corporation that are legally available. Section 58(4) of the AktG makes undoubtedly clear that the shareholders only are entitled to the receipt of net retained profits—and that such profits can moreover be excluded from distribution by law, the articles of association, or a resolution of the shareholders’ meeting.\(^{168}\) There is also no doubt that the Stock Corporation Act refers to the retained profits of the entire company and not of several business segments.\(^{169}\) Therefore, a stock

---

\(^{164}\) §§ 57(3), 58(4), AktG.

\(^{165}\) The violation of this principle of maintenance of the capital triggers massive civil liability. According to section 62(1) of the AktG, shareholders shall repay the stockholders for any benefit they have received from the firm contrary to the provisions of the Act. Moreover, according to sections 93(3) and 116 of the AktG, the management board and the supervisory board can be held liable to the extent they have violated the provisions for the protections of the company assets.

\(^{166}\) §§119(1) Nr. 2, 174, AktG.

\(^{167}\) See §§ 58(2)–(3), 174, AktG.

\(^{168}\) § 58(4), AktG.

\(^{169}\) Baums, Spartenorganisation, “Tracking Stock” und deutsches Aktienrecht, supra note 35, at 29.
corporation cannot pay a dividend on tracking stock, even though the business unit, for instance doing business in an extremely profitable digital broadcasting service, is fabulously successful, if the company as a whole has no net profits. Then, the income of tracking stock holders consists of only potential increases in the price of the shares. This shows that, although the business segments in a tracking stock culture are treated economically on a stand-alone basis, as far as the payments of dividends are concerned, their legal and financial roots cannot be cut entirely.

Only if the company as a whole performs well and gains net profits will there be funds legally available to distribute as dividends and to link to the performance of the particular tracked business segments. High earnings in the profit center can lead then to equivalent high dividends, whereas in times in which the tracked segment fails to generate earnings it is precluded from dividends, even if the company as a whole has performed very profitably and earned a fund legally available for the payment of dividends. But that is not necessary. As long as funds are legally available, the company can be entitled to transfer profits from a successful to a less successful business segment. It is imaginable, for instance, that the shareholders’ meeting permits the management board payment of dividends on every class up to legally available amounts; i.e., the profitability is just one element in the dividend policy of the management board.

5.3.1.3. Dividend Preferences

The question is whether there is any option to relax this strict regime of maintenance of capital under sections 57(3) and 58(4) of the AktG to the benefit of the holder of tracking stock. A look at the rights of preference shareholders without votes under the Stock Corporation Act gives some support. Many articles of incorporation of German stock corporations provide, in analogy to

170 Müller, supra note 119, at 59; Sieger & Hasselbach, Tracking Stock, supra note 119, at 395.

171 The often used German terminology for a transfer from a profitable segment to a less successful segment is “Quersubvention.”

172 See §§ 57(3), 58(4), AktG.

173 See §§ 139-141, AktG.
section 140(2) of the AktG,\textsuperscript{174} that in the case that a preference dividend is not paid or is not paid in full in any given year and if the amount in arrears is not paid in the next year together with the full preference dividend for such year, the holders of preference shares have a right to receive dividends prior to all other shareholders ("cumulative preference").\textsuperscript{175} In other words, cumulative preference means that in the event of a dividend being passed, it accumulates and must be paid before the dividends of common stock. Although technically quite difficult to structure, there is no concern that such a method of distribution can legally be implemented in the articles of incorporation of a tracking stock corporation.\textsuperscript{176} Consequently, the fact that a tracking stock dividend is not paid equivalent to the performance of the tracked unit gives rise to a claim for any tracking stock dividend due which is contingent upon later resolution regarding the distribution of profits. If one business segment causes overall loss, shares tracking the profitable business segment have the priority to catch up dividends when payments resume.

\textsuperscript{174} At this point, the American reader might ask whether preferred stock could not directly be the appropriate way to provide German tracking stockholders with additional dividend rights. Indeed, it is essential to differentiate "preferred shares" under U.S. law and "preference shares" under German corporate law. §§ 139-141, AktG. Both are a class of stock giving its holder a preferential claim to dividends and to corporate assets upon liquidation but that "usually" carry no voting rights. However, whereas the denial of voting rights under Delaware law is discretionary under Delaware General Corporation Law § 212(a), which states, "[u]less otherwise provided . . . each stockholder shall be entitled to vote for each share of capital stock held by such stockholder;" (emphasis added) German preference shares have, according to section 139 of the AktG, basically no voting rights—except in the case of section 140(2) of the AktG.

\textsuperscript{175} See Tilman Bezenberger, Vorzugsaktien ohne Stimmrecht 44 (1991); see also Theodor Baums & Matthias Möller, Venture Capital: U.S.-amerikanisches Modell und deutsches Aktienrecht, in CORPORATIONS, CAPITAL MARKETS AND BUSINESS IN THE LAW. LIBER AMICORUM RICHARD M. BUXBAUM 33, 43-44 (Theodor Baums et al. eds., 2000) (discussing cumulative preferences and their application in the venture capital context); Sieger & Hasselbach, Tracking Stock, supra note 119, at 395 (affirming the permissibility of cumulative preferences in a tracking stock corporation).

\textsuperscript{176} Baums, Spartenorganisation, "Tracking Stock" und deutsches Aktienrecht, supra note 35, at 29-30; Sieger & Hasselbach, Tracking Stock, supra note 119, at 395.
5.3.1.4. Issuance of Participation Rights

In publicly held companies, the compensation of previous failures in dividends with later balance sheet incomes might frequently be a sufficient method to guarantee the financial interests of the holders of tracking stock. However, the approach will often lead to a loss in net present value and will be absolutely worthless if the company has a negative forecast and is for a longer time not able to gain a distributable balance sheet profit. The issuance of participation rights is an interesting feature used to separate the ability to pay dividends to tracking stock from the existence of a balance sheet income in this context. According to section 221(3) of the AktG, the corporation may issue participation rights on the basis of a resolution of the shareholders (Genußrechte). Like convertible bonds or bonds with warrants, participation rights are securities and may be issued in the form of certificates. A participation right entitles the holder to certain benefits but does not grant any ownership rights. Such benefits include participation in profits or participation in remaining assets after liquidation. The leeway of structuring participation rights is very broad and thus allows the linking of their yields to the performance of a particular business unit. Because participation rights certificates are merely a contractual claim against the stock corporation and not a corporate right similar to the position of a shareholder, the strict dividend restrictions of the stock corporation do not apply. Therefore, in contrast to tracking stock, participation rights can basically confer the right to receive dividends even though the entire company has no balance sheet profits.

According to the underlying premise of this Article, however, tracking stock is a class of common stock and therefore belongs to the equity of the parent corporation. This conclusion leads first to

177 § 221(3), AktG.
178 See Judgment of November 9, 1992, BGHZ 120, 141(146-147); GÜNTER HENN, HANDBUCH DES AKTIENRECHTS § 36 margin no. 1294 (6th ed. 1993).
179 See MARCUS LUTTER, in 5 KÖLNER KOMMENTAR ZUM AKTIENGESETZ § 221 margin no. 208 (Wolfgang Zöllner ed., 2d ed. 1995); Müller, supra note 119, at 60.
180 §§ 57(3), 58(4), AktG.
181 LUTTER, supra note 179, § 221 margin no. 201. However, in praxis usually the payment of dividends to participation rights depends on the existence of any balance sheet profits. See id. § 221 margin no. 210.
the absolutely unsettled question under German corporate law of whether participation rights can be structured in a manner similar to equity. Whereas some scholars deny equity structured participation rights due an alleged illegal bypass of the provisions of preference stock, 182 others emphasize the historical intention of the legislature to provide the economy with flexible features to raise corporate funds. 183 The Federal Court of Justice (Bundesgerichtshof/BGH), Germany’s highest court for civil causes, has not yet decided this question. 184 In any case, as long as German courts do not establish a secure guideline on this matter, firms will continue to be reluctant in issuing equity structured participation rights.

Second, regardless of the equity question, participation rights lack important administrative features required to become equivalent to tracking stock. 185 German law principally reserves some original rights exclusively to shareholders that contractually cannot be assigned to third parties. This exclusion especially encompasses the right to vote, 186 to call a shareholders’ meeting, 187 or on actions to set aside resolutions of the shareholders’ meeting 188 , 189 whereas holders of participation rights, for example,

---


184 See the landmark decision “Klöcker-Genüsse” of October 5, 1992, BGHZ 119, 305 (311-12).

185 See, e.g., Müller, supra note 119, at 60.

186 § 134, AktG.

187 §§ 121-122, AktG.

188 §§ 243-248, AktG.

189 See Judgment of October 5, 1992, BGHZ 119, 305(316-17); HÖFFER, supra note 145, § 221 margin no. 26; LUTTER, supra note 179, § 221, margin no. 219. But see also Lothar Vollmer & Bernhard Lorch, Der Schutz des aktienähnlichen
can only be entitled to several information rights. This recognition leads to the assumption that participation rights provided by the Stock Corporation can basically not substitute a financial tool like tracking stock; rather, they can only serve as a monetary appendix of tracking stock to ensure that a positive performance of a tracked business segment, even in times without overall-profits, leads to corresponding dividends. However, in this case the company has to issue both tracking stock and participation rights, which makes the structure even much more complicated than it already is.

Indeed, it has to be taken into account that the above conclusion is predetermined by the underlying definition of this elaboration that tracking stock is a part of equity. Therefore, depending on the investor’s objectives, it is not a compulsory right that participation rights cannot provide a substitute item for tracking stock. Rather, if the investor is focused on just holding a security in which yields are linked to the performance of a distinct business segment and she or he further does not care about other administrative and monetary rights which equity usually confers, participation rights might match her or his objectives absolutely. From the company’s perspective, the question of capital structure is raised, that is the mix of equity and debt by which the firm most efficiently finances its operations. Corporate finance theories provide general applications to figure out the proper ratio of debt to equity for every individual firm. Consideration of the above-discussed typical tracking stock transactions, however, shows that tracking stock usually has to be equity to potentialize the desired unique benefits of this financial tool. The topic “unlock hidden value” is connected with the expectation that tracking stock has the potential to avoid a conglomerate discount and thereby increase the firm’s market value. But, in order to allow the issue to unbundle the business for the purpose of selling its parts without having to separate the operations, tracking stock must naturally be equity. The employment of tracking stock as an M&A currency, like in the GM case, usually also necessitates equity to accomplish an exchange tender offer or a merger because the target

---


Hüffer, supra note 145, § 221 margin no. 26; Lutter, supra note 179, § 221, margin no. 220.
shareholders want to maintain their economic and legal status. Eventually, the use of tracking stock as an employment consideration needs equity as well because the underlying idea is to make the management into owners of the firm in order to reduce agency costs. What remains for debt structured participation rights is a means to raise corporate funds. However, the outstanding and interesting benefits embodied by tracking stock, such as the creation of separate public equity securities while preserving certain advantages of remaining a consolidated entity, are then lost.

5.3.1.5. Preliminary Conclusion

As already pointed out, German lawyers recognize that, in the strict regime of maintenance of capital under sections 57(3) and 58(4) of the Stock Corporation Act, one of the highest barriers is to establish a tracking stock culture. This statement is not convincing. It is true that the stock corporation is legally prevented from paying dividends to the holders of tracking stock if the entire firm did not gain a balance sheet profit. Even a fabulously successful business segment does not entitle dividend payments when the other profit centers have a negative performance and clear away the outcome in the tracked unit. However, the outcome of the legal analysis of the German rights to dividends in the stock corporation does not differ from the situation in the United States. In fact, under Delaware corporate law, the corporations cannot pay a dividend on tracking stock if the company as a whole has no surplus or net profits, even though the business unit is spectacularly flourishing.¹⁹¹ This issue alone has never prevented Wall Street lawyers and investment bankers from introducing tracking stock in an American company. Moreover, the appropriation of annual net income under the Stock Corporation Act can be modified with a catch-up feature; for example, if the remaining business segment causes overall loss, shares tracking the profitable business segment have the priority to catch up dividends when payments resume. Eventually it should be contemplated to combine tracking stock with participation rights to guarantee holders of tracking stock that a positive outcome of

the tracked unit, even in times without overall profits, will always lead to corresponding dividends.

5.3.2. Liquidation Rights

According to section 271(1) of the AktG, any assets of the stock corporation remaining after the discharge of all its liabilities shall be distributed among the shareholders. Section 271(2) of the Act states parallel to section 60(1) in that the assets shall be distributed in proportion to the share capital held by each shareholder. However, as far as shares with different rights regarding the stock corporation’s assets exist, another provision in the charter is legally possible. This enables the company to design the charter according to the requirements of tracking stock, i.e., to grant for instance liquidation preferences.

It is important to note that the discussion of liquidation rights is academic, rather than a matter of upcoming practices, since the economic significance of liquidation rights to the holder of tracking stock is wholly dependent on the likelihood that the corporation may in fact liquidate. The possibility of insolvency or liquidation due voluntary reasons is, for the most quoted stock corporations in Germany, so remote that the market would not take it into account for evaluation; however, with respect to a start-up company listed on the German innovation exchange (Neuer Markt), the probability of liquidation may be and is more real.

---

192 § 271(1), AktG.
193 § 271(2), AktG.
194 § 60(1), AktG.
195 See HÜFFER, supra note 145, § 271 margin no. 2; Baums & Müller, supra note 175, at 53; SIEGER & HASSELBACH, Subsidiary/Divisional shares, supra note 119, at 1283.
196 THIEL, SPAREN/AKTIEN, supra note 7, at 236-37; Brauer, supra note 119, at 325.
197 For the German discussion, see SIEGER & HASSELBACH, Subsidiary/Divisional shares, supra note 119, at 1283. For the American discussion, see DAHLE & PERRY, Tracking Stock: Virtual Equity, Virtual Entities, and Virtual Mergers and Acquisitions, supra note 5, at 249.

198 The “Neuer Markt” is the German equivalent of the American NASDAQ. The “Neuer Markt” was designed by the Deutsche Börse AG to attract mainly high technology “growth” stocks satisfying selected governance criteria and intended to appeal to international investors. See HOWELL E. JACKSON & ERIC J. PAN, Regulatory Competition in International Securities Markets: Evidence from Europe in 1999-Part I, 56 BUS. LAW. 653, 679-80 (2001).
5.3.3. Voting Rights

The most important administrative right of a shareholder is the voting right pursuant to section 134 of the AktG because it enables him or her to influence the stock corporation on those matters that fall within the competence of the shareholders' meeting. It is a principle of the stock corporation that each share confers the right to vote in proportion to its par value. Like the analysis under American law there are basically no differences between the voting rights of tracking stock and voting rights of common stock. The right to vote proportionally to nominal value or number of shares applies equally to tracking stock and other common stockholders. Also, tracking stockholders in a stock corporation do not have special voting rights regarding the tracked assets or businesses.

5.3.3.1. Class Voting

Usually the holder of tracking stock and common stock vote together in a single class. However, in fundamental corporate changes, the Stock Corporation Act provides mandatory class voting. According to section 179(1) of the AktG, any amendment of the articles requires the approval, by resolution, of the shareholders' meeting. Unless the articles provide otherwise, section 179(2) of the AktG entails that these shareholders' resolutions must be passed by a majority of three-quarters of the stated capital presented at the meeting. If the existing relationship between classes of shares is to be amended to the disadvantage of any class of stock, the resolution of the shareholders' meeting shall, pursuant to section 179(3) of the AktG, require the consent of the adversely affected shareholders, representing three-quarters of the capital of this class, in order to

---

199 § 134, AktG.
200 §§ 12(1), 134, AktG.
201 Thus, if tracking stock and common stock of different par values have been issued, a common stock share having a par value of EURO 100 represents twice the voting power of a EURO 50 par value tracking stock share.
202 Brauer, supra note 119, at 328.
203 § 179(1), AktG.
204 § 179(2), AktG.
205 § 179(3), AktG.
become effective (Sonderbeschluß). Since, according to section 11 of the AktG, common stock and tracking stock also constitute different classes under German corporate law, any amendments to the articles that do not affect holders of tracking stock and holders of common stock equally or that place additional obligations or burdens on these individual classes require the three-quarters approval of those affected. For instance, this is the case if the definition of the core business in the articles should be changed to the disadvantage of the tracked business unit. Such resolution shall be adopted either at a separate meeting of the concerned shareholders or by a separate vote.

5.3.3.2. Floating Voting

As already shown, in the majority of the American tracking stock corporations voting rights are subject to periodic adjustments based on relative market values. This floating system claims to prevail over fixed voting rights because it complies with the legal and economical reasoning that the power of voting should correspond to the value of the investment of each shareholder. However, even under Delaware corporate law, the floating voting system is the subject of serious legal concerns because as the relative market capitalization of each class stock naturally changes, the holder of shares of the different classes become an unequal number of votes per share. Whereas the legal analysis under Delaware is uncertain, the outcome under the German Stock Corporation Act is absolutely clear: Each share confers without exception one vote and, according to section 12(1)(i) of the AktG, multiple voting rights (Mehrfachstimmrechte) are prohibited. This

---

205 See Sieger & Hasselbach, Tracking Stock, supra note 119, at 392. Class voting is also provided, for example, when there are changes in status of preference shareholders, section 141(2) of the AktG, capital increases for contributions, section 182(2) of the AktG, or ordinary capital reductions, section 222(2) of the AktG.

207 § 11, AktG.

208 § 138, AktG.

209 § 12(1)(i), AktG.

210 § 12(1)(i), AktG.

211 Section 134(ii), AktG allows only for a stock corporation whose shares are not listed on a stock exchange that the articles of incorporation may limit the voting rights of shareholders owning more than one share by setting a maximum amount of the share capital or a sliding scale (Höchststimmrechte). For the previous
restriction was introduced in 1998 through the KonTraG. Before then it was at least possible to get a governmental exception in order to safeguard overriding interests of the public welfare. Thus, right now it is not possible to implement a floating voting system in a stock corporation. Nonetheless, there is a rumor that the German Legislator (Deutscher Bundestag) is reviewing the voting rights under the Stock Corporation Act to allow again multiple voting rights under special circumstances.

5.3.3.3. Cumulative Voting

Most U.S. state laws, like those of Delaware, authorize corporations to adopt cumulative voting for director elections, and some federal laws (such as those governing public utilities) require it. Cumulative voting is the privilege of multiplying the number of shares held by the number of directors to be elected and casting the product for a single candidate or distributing the product among two or more candidates. This device is intended to accord board representation to minority shareholder interests by enhancing the ability of the minority shareholders to elect at least one director. Thus, in the tracking stock context, shareholders surely could place at least one person on the board who is dedicated to representing

legal situation in Germany, see André, Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany, supra note 141, at 166-68.

Hochststimmenrechte might be structured, e.g., in the way that the first 100.000 EURO of par value carry full voting rights, the second 100.000 EURO half of the normal rights, and shares in excess of 200.000 EURO par value do not confer any voting rights.

212 See André, Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany, supra note 141, at 168-70.

213 JAEGER, TARGETED STOCK ALS RESTRUKTURIERUNGSINSTRUMENT, supra note 118, at 222; Sieger & Hasselbach, Subsidiary/Divisional shares, supra note 119, at 1283; Sieger & Hasselbach, Tracking Stock, supra note 119, at 396.


their interests. With cumulative voting, however, each stock has as many votes as vacancies to be filled; one vote is not cast for each of the vacant positions. For this reason, German stock corporation law does not permit cumulative voting. Each election of a director is considered independent because each involves a complete shareholder vote. This process involves more than just the appointment of the entire board. Rather, there are as many corporate decisions to be made as there are directors to be chosen.216 To argue that the cumulative vote outcome of the election is the only aspect that matters is to disregard this structure of shareholder voting. In the end, cumulative voting is just an impermissible modification of multiple voting rights.217

5.4. Corporate Governance Issues

The impact of the implementation of tracking stock on corporate governance under German corporate law is basically the same as under Delaware corporate law. The legal structure of management and supervision does not change.218 The management board is still responsible for the management of the entire stock corporation.219 The management board retains full operating control of all tracked business groups and only a single supervisory board sits for the entire corporation.220 A separate management or supervisory board related to each individual class of stock does not legally exist. Only the single management board is responsible for ensuring compliance with the legal requirements

---

216 This is not necessarily due to any lack of concern with minority shareholders, but instead is a sort of reflection of the existence of a whole separate body of German law (called the Concern Law) dedicated to protecting minority shareholders. Some German stock corporations provide so named global voting concerning the members of the supervisory board; i.e., the shareholders can only reject or approve the list of directors which is provided by the management of the corporation. In these cases, however, cumulative voting makes no sense at all, because minority shareholders have only the ability to agree or to disagree instead of having the opportunity to concentrate all votes on their favored director.

217 Another opinion is that of Carsten Berrar, Die Zustimmungspflichtigen Geschäfte nach § 111 Abs. 4 AktG im Lichte der jüngsten Corporate Governance Diskussion, 4 Neue Zeitschrift für Gesellschaftsrecht [NZG] (forthcoming Nov. 2001).

218 Sieger & Hasselbach, Subsidiary/Divisional shares, supra note 119, at 1283-84.

219 § 76, AktG.

220 § 111, AktG.
within the group and to ensure their observations by the business segments themselves. Indeed, it is also likely in a German stock corporation that an issuance of tracking stock would potentially create conflicts among the multiple groups of shareholders because they are usually provided with different legal rights and are concerned with different financial interests. The board faces potential conflicts of interest in reconciling demands of several business and several shareholder bases. Thus, it is essential to determine the legal means of safeguarding the rights of tracking stockholders through mandatory or facultative rules under the German Stock Corporation Act. First of all, it is important to assure the portfolio of the different business segments. Then the question arises as to how far shareholders can participate in the management decision-making process beyond the explicit voting provisions of the AktG, i.e., whether shareholders can be granted more matters on which they can vote. This proves how shareholders can at least influence decisions of the management board and supervisory board. Further, the management’s responsibility under German law will be scrutinized. Eventually, the role of the supervisory board comes into play.

5.4.1. Determination of the Business Segments and Management Guidelines

In order to guarantee the rights of the holders of tracking stock, the portfolio of the particular segments, the allocations between them, and the entire standing in the conglomerate have to be defined in an obliging manner. The shareholders must know in advance to which assets their stocks are “virtually” linked and must be ensured that this allocation is not up to the discretion of the management board. Indeed, the divisional organization of the corporation is encompassed by the comprehensive power of the management board pursuant to section 76(1) of the AktG.221 Unless a management board member has been granted sole management authority, the members are only entitled to manage the company jointly.222 The rights and duties of the management board members are normally regulated in internal rules

---

221 § 76(1), AktG.
222 § 77(1), AktG.
(Geschäftsordnung) which especially address the allocation of responsibilities among the management board members and rules on the board’s voting. Therefore, it is legally possible to assign an individual member of the management board with the responsibility of managing a tracked business unit.\textsuperscript{223} However, this delegation may not impair the general decision-making authority of the entire management board granted by section 76(1) of the AktG.\textsuperscript{224}

The management board itself may establish rules, if the articles do not provide them, that only the supervisory board may establish the internal rules or the supervisory board may not do so.\textsuperscript{225} According to section 77(2)(ii) of the AktG,\textsuperscript{226} the articles of incorporation may contain binding provisions that govern specific matters regarding the rules of procedure. The sections give thereby—as under Delaware corporate law—the legal basis to adopt a prophylactic measure for management in a tracking stock company to handle conflicts among the several classes of shareholders and to direct the involvement of the management board in advance, for instance the definition of the director’s duties and disclosure aspects.\textsuperscript{227} This also includes particular management decisions, especially the definition of the portfolios of the different segments.\textsuperscript{228} In that case the management is prevented from restructuring the determination of the business segments without shareholder approval. The internal rules can also provide for committees to which the management board can assign certain duties.\textsuperscript{229} In the tracking stock context such committees may give further support in managing the tracked assets and resolving inter-group conflicts.

\textsuperscript{223} Schiessl, supra note 119, at 67.

\textsuperscript{224} See id.

\textsuperscript{225} § 77(2)(i), AktG.

\textsuperscript{226} § 77(2)(ii), AktG.

\textsuperscript{227} Sieger & Hasselbach, Tracking Stock, supra note 119, at 394; see also Thiel, Spartenaktien, supra note 7, at 222-24.

\textsuperscript{228} Baums, Spartenorganisation, “Tracking Stock” und deutsches Aktienrecht, supra note 35, at 30-31.

\textsuperscript{229} Schiessl, supra note 119, at 77-82; Sieger & Hasselbach, Tracking Stock, supra note 119, at 394.
5.4.2. Unwritten Shareholder Vote in Material Transactions
(Holzmüller Doctrine)

Section 138(i) of the AktG permits, according to its language, the implementation of separate resolutions of certain shareholders, i.e., class voting, in the articles of incorporation. However, because of the strict character of the Stock Corporation Act expressed by section 23(5) of the AktG, this provision has no practical effect. In particular, the system of corporate governance here is very rigorous. To grant the shareholders the exclusive right to decide about the effectiveness of a transaction regarding assets of a tracked business unit complies in no case with the system of the stock corporation because, according to section 76(1) of the AktG, only the management board is responsible for running the corporation. The wholesale delegation of the day-to-day management responsibilities to the shareholders’ meeting is prohibited; rather, the management board may only present the shareholders’ management matters to prevent personal liability. So the management board determines the details of management, even though the real power lies with the supervisory board and the shareholders’ meeting, especially when both are dominated by majority shareholders.

Although the shareholders’ meeting is, according to the Stock Corporation Act, not entitled to interfere with the management of the corporation unless the management board asks for its decision or approval pursuant to section 119(2) of the AktG, the Bundesgerichtshof has held in the landmark case “Holzmüller” that the management board nonetheless must ask for shareholder approval in instances where the rights or interests of shareholders may be infringed. If a transaction is regarded to be vitally

230 § 138(i), AktG.
231 § 23(5), AktG.
232 § 76(1), AktG.
233 § 119(2), AktG.
234 See, e.g., Baums & Möller, supra note 175, at 67.
235 § 119(2), AktG.
236 See Judgment of February 25, 1982 BGHZ 83, 122. In this case the management board (Vorstand) planned to transfer a part of the business to a subsidiary. Id. For an excellent description in English language, see Joachim Rosengarten, The Holzmüller Doctrine: Still Crazy after All These Years? – The Impact of a Doctrine in the Days of Mergers of Equals, in CORPORATIONS, CAPITAL MARKETS
important for the overall structure, approval of the shareholders' meeting is required ("Holzmüller doctrine"). The case is therefore so important because the Bundesgerichtshof granted shareholders, for the first time, rights beyond of the provisions of the Stock Corporation Act. It is a real caselaw extension of shareholder rights to vote on all fundamental corporate transactions, and it complies with American standards to find the law rather than with the common style of interpretation of provisions under German law. The decision further gives to individual shareholders a derivative action against acts of the management board which, through valid and binding relationships with third parties, infringe upon the rights of the shareholders' meeting.237 If such transactions have been consummated, the stockholder may sue for a declaratory judgment that the management exceeded the limits of its authorization and must endeavor to restore the previous condition. If the transaction has not been consummated yet, the stockholder may have the right to obtain a court injunction.

According to this caselaw, it is obvious that the underlying reasoning could also apply to transactions in a tracking stock corporation. It is indeed likely that courts would require shareholders' approval, although not provided by the provisions of the Stock Corporation Act, if the corporation transfers an essential portion of assets from one business segment to another within the firm or to a third party.238 The sale of the entire business unit would certainly be regarded as an essential transaction within the meaning of the aforementioned Bundesgerichtshof case.

---


238 Sieger & Hasselbach, Subsidiary/Divisional shares, supra note 119, at 1281, 1283.
Unfortunately, and this is still one of the unsolved problems of the Stock Corporation Act, nobody knows exactly at which levels the terms “transfer of a significant portion of assets,” “vitaly important for the overall structure,” or “instances where the rights or interests of shareholders may be infringed” triggers the requirement of shareholders’ approval. Moreover and unfortunately, whether a Holzmüller approval requires an ordinary fifty percent majority or a supermajority of seventy-five percent of the votes cast is absolutely uncertain. The prevailing interpretation of the Holzmüller judgment presumes that a majority of fifty percent of the votes cast is sufficient. Courts have never touched this issue because the outcome of shareholder voting in German stock corporations almost always reaches majorities of more than ninety percent. However, it has to be taken into account that some German scholars have a different understanding of the Holzmüller doctrine and argue in favor of a seventy-five percent majority. German literature is still guessing when exactly and how far this Holzmüller doctrine is applicable and whether is should be extended on other similar important transactions.\(^\text{239}\) There is a great uncertainty in the German


For a synopsis of the discussion, see York Schnorbus, Gestaltungsfreiheit im Umwandlungsrecht – Das Verhältnis des UmwG zu Strukturmassnahmen
corporate community, and lawyers tend to advise their clients to ask for shareholder approval in any doubtful case. In light of this confusion the German Government Commission on Corporate Governance is considering whether and how to amend this.20

5.4.3. Legal Means of Influencing the Decision-Making Process

5.4.3.1. Regarding the Management Board

Under the Stock Corporation Act, it is not legally possible to confer to the holder of tracking stock the right to appoint individual members of the management board to preserve their rights and interests.21 The supervisory board22 exclusively makes appointments and revocation of appointments of management board members. The supervisory board may remove members of the management board according to section 84(3) of the AktG23 only for an “important cause” (wichtiger Grund).24 The supervisory board can neither directly nor indirectly be influenced in its decision to appoint or revoke an appointment.25 All personnel matters regarding the management board are its sovereign decision.26 Any contract or provision in the articles of

20 Baums, General Meetings in Listed Companies—New Challenges and Opportunities, supra note 215, at 9.
21 Sieger & Hasselbach, Subsidiary/Divisional shares, supra note 119, at 1283.
22 § 84, AktG.
23 § 84(3), AktG.
24 By contrast, in the United States senior executives typically serve at the will of the board, subject only to whatever contract rights they have. Finally, the fact that the AktG requires supervisory board meetings in publicly held stock corporations only four times annually further underscores the independence of the management board. § 110(3), AktG; see Thomas J. Andre, Jr., Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards, 70 TUL. L. REV. 1819, 1824-25 (1996) [hereinafter Andre, Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards] (illustrating the differences between the German supervisory board structure and that of Anglo-Saxon countries).
25 Baums & Möller, supra note 175, at 68.
26 HÜFFER, supra note 145, § 84 margin no. 5; 2 HANS-JOACHIM MERTENS, IM: KÖLINER KOMMENTAR ZUM AKTIENGESETZ, at § 84, margin no. 8 (Wolfgang Züllner ed., 2d ed. 1988).
incorporation violating this sovereignty is invalid. Thus, except in circumstances where a given shareholder or group of shareholders is in the position to control the makeup of the shareholder side of the supervisory board, shareholders have no direct impact on the appointment or removal of the management board members.

5.4.3.2. Regarding the Supervisory Board

The most direct pressure point for investors is not on those who actually manage the business, but rather on the supervisory board. However, this impact should not be overestimated either. According to section 101(1) of the AktG the members of the supervisory board are elected by the stockholders (and, if applicable, by the employees). The common, and usually the only, way for shareholders to influence management is by voting for members of the supervisory board who are willing to appoint persons to the management board who represent the interests of particular groups of shareholders. In some stock corporations the articles grant, exceptionally, the right to appoint members of the supervisory board to certain shareholders or the holders of certain shares. Such a delegation is permissible under the requirements of section 101(2) of the AktG and applies also in respect to holders of tracking stock.

Nonetheless, the duties and rights of the supervisory board are strictly separate from those of the management board and the

247 See § 134 German Civil Code (Bürgerliches Gesetzbuch / BGB); § 23(5), AktG; see also Höffer, supra note 145, § 84 margin no. 5.
248 § 101(1), AktG.
249 See, for example, Butler, supra note 125, at 561-64, for the labor representatives on the supervisory board. See also Andre, Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards, supra note 244, at 1826-28 (explaining that labor representatives on supervisory boards have less relative power than their numbers would suggest).
250 The resolution of the shareholders' meeting regarding the appointment of the members of the supervisory board usually requires, according to section 133(1) of the AktG, a majority of the votes cast ("simple majority") unless the law or the articles of incorporation provide for a larger majority or additional requirements. Section 133(2) of the AktG states that the articles may set forth different rules with respect to elections.
251 § 101(2), AktG.
252 Sieger & Hasselbach, Subsidiary/Divisional shares, supra note 119, at 1283.
SHAREHOLDERS' MEETING. Although elected by the shareholders' meeting, the supervisory board is never subject to stockholder instruction but rather must fulfill its duties independently.253 Neither the shareholders' meeting nor individual shareholders are by law entitled to instruct members of the supervisory board in any way. This principle applies also to members of the supervisory board who have been delegated by stockholders. Thus, supervisory board members delegated according to section 101(2) of the AktG254 have the same duties and rights as elected members according to section 101(1) of the AktG.255 They must place the interests of the company before the interests of the delegating parties and must safeguard company interests, and are by law not subject to instructions of the delegating party.256

Disregarding this lack of influence, delegation rights may, due to section 101(2),257 only be granted to specific shareholders named in the articles ("personal right of delegation") or to the holders of certain shares ("transferable right of delegation"). Both alternatives barely make sense, at least in a publicly held company.258 Whereas the personal right of delegation is connected with a particular person named in the articles and therefore is not transferable to a third party, the delegation right to holders of certain shares necessitates, pursuant to section 101(2)(ii) of the AktG,259 that these shares are in registered form and their transfer depends on the consent of the stock corporation.260 Consequently, such stocks only have difficulties or are not even fungible and thus unsuitable for trading on a stock exchange. In sum, there is no special provision to accomplish the interests of tracking stockholders on the supervisory board. Rather, all shareholders are still equal.

253 HÜFFER, supra note 145, § 101 margin no. 10.
254 § 101(2), AktG.
255 § 101(1), AktG.
256 Judgment of January 29, 1962, BGHZ 36, 296 (306); HÜFFER, supra note 134, § 101 margin no. 10; KARSTEN SCHMIDT, supra note 125, at 840.
257 § 101(2), AktG.
258 For a dissenting opinion, see Sieger & Hasselbach, Tracking Stock, supra note 119, at 393.
259 §101(2)(ii), AktG.
260 Such a restriction on transferability in the stock corporation is possible according to section 68(2) of the AktG.
5.4.4. Management Liability

The liability of the management does not only compensate damages of shareholders after the fact, but it is also a prophylactic measure of compliance with the legal requirements in a tracking stock corporation. The practical importance of directors' liability under German law, however, is still quite limited.261 Court decisions are comparatively rare, albeit with greater frequency in recent years.262 In the following section, the paper will explain the principles of management liability under German law, and examine recent American impact, i.e., whether the business judgment rule also protects German managers, and if there is a special standard in tracking stock corporations.

5.4.4.1. Basics of Civil Liability Under Section 93, AktG

In conducting business, the members of the management board have to employ the care of a diligent and conscientious manager263,264 As in the United States, this standard places a burden on management to act in a fiduciary capacity and undertake activities which are bona fide in the company's best interest (Unternehmensinteresse). Delaware corporate law differentiates between the "duty of care" and the "duty of loyalty." German law applies a similar standard, whereby management's fiduciary duties toward the corporation under German corporate law are repeatedly referred to as Sorgfalt und Treuepflichten.265

---

261 For a general overview about management liability under the German Stock Corporation Act in English, see, for example, Klaus J. Hopt, Directors' Duties to Shareholders, Employees, and other Creditors: A View from the Continent, in COMMERCIAL ASPECTS OF TRUSTS AND FIDUCIARY OBLIGATIONS 115-32 (Ewan McKendrick ed., 1992).

262 However, it should be taken into account that liability disputes between directors and their companies may well be settled outside the courtroom, and the relative lack of court decisions does not say anything about the preventative function of such rules.

263 § 93(1), AktG.

264 This is the standard of a manager acting with similar obligations as a fiduciary. HÖFFER, supra note 145, § 93 margin no. 4.

265 Willi Joachim, The Liability of Supervisory Board Directors in Germany, 25 INT'L LAW. 41, 56 (1991); Bernd Singhof & Oliver Seiler, Shareholder Participation in Corporate Decisionmaking under German Law: A Comparative Analysis, 24 BROOK. J. INT'L L. 493, 551 (1998). At least in practice these standards on management conduct will lead to the same conclusions, although the common law system seems somewhat wider and more developed than its German counterpart. For a
Members of the board who violate their duties shall be jointly and severally liable to the stock corporation for any resulting damage.\textsuperscript{266,267}

The circumstances of each case must be examined by the court to determine whether a particular management board member has acted with the care of a diligent and prudent executive.\textsuperscript{268} "The controlling criterion in this regard is not 'customary' diligence or carelessness, but 'necessary' diligence."\textsuperscript{269} It is a high objective standard, which does not depend on the knowledge and abilities of the particular member.\textsuperscript{270} A director therefore will not succeed with the defense that he has acted with such care as he would apply in his own affairs. Directors need not take all possible care but must take more than the usual care that might be expected of an ordinary person.

\textsuperscript{266} § 93(2)(i), AktG.

\textsuperscript{267} Besides this general standard, the Stock Corporation Act sets out specific requirements of conduct. Members of the management board shall not disclose confidential information and secrets of the company, in particular trade and business secrets, which have become known to them as a result of their services on the board. § 93(1)(ii), AktG. They have special duties relating to insolvency and bankruptcy of the corporation. § 92, AktG. Section 93(3) of the AktG specifically enumerates instances in which members of the management board themselves may be held liable. The respective board member bears the burden of proving he has complied with this standard of care. § 93(2)(ii), AktG.

\textsuperscript{268} At least in theory German law differentiates between the breach of a contractual or statutory duty and the question whether the director has acted negligently. In practice however, both aspects reduce in most cases to one question, that is, how a prudent and diligent manager would have acted. That is an objective and comparatively high standard.

\textsuperscript{269} HÜFFER, supra note 151, § 93 margin no. 3-4.

\textsuperscript{270} Because an individual member may be deemed to have breached this standard by tolerating the mismanagement of others, he must take reasonable steps to prevent breaches of this standard by the board, or any of its members. In other words, diversification in a single company does not prevent managers' liability. If a member believes that a resolution on a business measure passed by the board is tantamount to a breach of this standard of care, he must clearly express his view and do everything in his power to prevent the transaction from being carried out. If not otherwise possible, he or she must involve the supervisory board. See Judgment of October 15, 1996, BGHZ 133, 370, 377-78; HÜFFER, supra note 145, § 93 margin no. 13b; Walter Oppenhoff & Thomas O. Verhoeven, The Stock Corporation, in BUSINESS TRANSACTIONS IN GERMANY, 24-52 (Dennis Campbell et al. eds., 2000).
5.4.4.2. The Business Judgment Rule Under German Corporate Law

The question is whether German courts always apply this objective standard immediately under section 93(1) of the AktG\(^{271}\) or whether there is place for a reasoning like the "business judgment rule" under Delaware corporate law corresponding to judicial self-restraint. A comparison of Delaware and German decisions might suggest at first glance that the business judgment rule gives the American board of directors broader discretion than their German colleagues.\(^{272}\) Indeed, German courts sometimes do not hesitate to question whether members of the management board took unreasonable risks or if the board crossed a line drawn by the corporation's benefits.\(^{273}\) This can lead to second-guessing of decisions made by the board, which Delaware courts try to avoid.

However, recent developments in German corporate law tend to lead to the conclusion that corporate law should encourage, and afford broad protection to, informed business judgments in order to stimulate risk taking, innovation, and other creative entrepreneurial activities. But the German approach is somewhat different. As already pointed out, the standard of "prudent business conduct" says more about how a director has to act rather than what he has to do or should have done, i.e., the courts themselves develop and crystallize the directors' duties in a given situation. This gives leeway for judicial self-restraint. Doing so, the Bundesgerichtshof has only recently explicitly acknowledged a standard of judicial self-restraint.\(^{274}\) In the landmark case ARAG/Garmenbeck,\(^{275}\) the highest court for corporate causes

\(^{271}\) § 93(2)(i), AktG.

\(^{272}\) According to the analysis of Butler, supra note 125, at 559.

\(^{273}\) It is a historical self-understanding of German judges that they are appointed to decide cases and therefore have the power to scrutinize all legal matters of a case. In particular, this includes the question whether someone has conducted himself with due care or not.

\(^{274}\) See Judgment of April 21, 1997, BGHZ 135, 244.

concluded that there is a borderline between the violation of the duty care and loyalty on the one hand and entrepreneurial faults in the conduct of the company on the other hand. The latter imperfection encompasses, for example, the burden of risks and the danger of wrong forecasts, i.e., circumstances and developments to which every manager is faced. When the manager fails in this course of business, the supervisory board might be entitled to revoke his or her appointment of a member of the management board, but, according to this judgment, the granted discretion as an entrepreneur gives the protection against civil liability.276

Whether, through this ruling, the business judgment rule derived from the American corporate law has entirely found its way into German jurisprudence might be still uncertain because the court did not explicitly refer to this discussion and the majority of the scholarly literature is confused. However, prominent commentators argue with good and convincing reasons that at least the basic ideas of the business judgment rule have become current law in the German stock corporation.277 This point of view is chiefly supported by a particular statement in the court’s opinion which is quite similar to the requirements of the business judgment rule. According to these crucial sentences in the decision, a board member can only be held liable if he has clearly departed from the bounds of responsible action aimed exclusively at furthering the welfare of the corporation and based on a careful investigation of the underlying facts, or if he has been prepared to take entrepreneurial risk to an irresponsible extent, or if his actions must be deemed to have been committed in disregard of his

276 See Judgment of April 21, 1997, BGHZ 135, 244, 253.

277 Some commentators argue in this way. See Horn, supra note 275, at 1134-35. Also, before the decision from April 21, 1997 of the Bundesgerichtshof, see, for example, Burkhard Bastuck, Enthaftung des Managements 23 (1986); Herbert Wiedemann, Organverantwortung und Gesellschafterklagen in der Aktiengesellschaft 13 (1989).
obligations for any other reason. Obviously, this is in other words nothing more than the business judgment rule.

The language of section 93(1) of the AktG is broad enough to implement the caselaw and the experiences under American law, and the management of stock corporations is at least well advised and on the safe side if it complies with a standard equivalent to the business judgment rule. That means a management board member is free from liability if he proves: (1) that he has obtained sufficient information, to the available extent, prior to taking his decision; (2) that he was not in a conflict of interest in making that particular decision; and (3) that in taking his decision he had reasonable grounds to believe that he was acting in the best interests of the corporation.

5.4.4.3. Different Standards in a Tracking Stock Corporation?

The general conclusion that, at a minimum, the basic ideas of the business judgment rule also apply under German stock corporation law leads to the corresponding issues in the tracking stock context, inasmuch as there exist no significant differences.

278 The court stated in German:

Diese kann erst dann in Betracht kommen, wenn die Grenzen, in denen sich ein von Verantwortungsbewusstsein getragenes, ausschließlich am Unternehmenswohl orientiertes, auf sorgfältigen Ermittlung der Entscheidungsgrundlagen beruhendes unternehmerisches Handeln bewegen muß, deutlich überschritten sind, die Bereitschaft unternehmerische Risiken einzugehen, in unverantwortlicher Weise überspannt worden ist oder das Verhalten des Vorstandes aus anderen Gründen als pflichtwidrig gelten muss.

BGHZ, 135, 244 (253-54).

279 § 93(1), AktG.

280 For instance, the process-oriented approach of the Delaware courts has provided American attorneys with a checklist of procedural rituals that a board should follow in making a decision. See therefore the summary Balotti et al., supra note 58, at 663-64, which states:

Whenever possible, a board should not act in haste because hasty action has been criticized as indicative of a lack of due care. Written materials should be available to the board, preferably in advance, and the board should consider the materials during its deliberations. Directors should participate actively in the decision-making process and question management and any consultants or advisors who make presentations to the board.

These guidelines could also be applied under German corporate law.

281 See Horn, supra note 275, at 1134.
However, some German lawyers mention the threat of uncertain civil liability of management board members if their compensation—especially through stock option plans—is linked to the performance of different business segments. The application of the American experiences under the business judgment rule brings light to this question. The analysis under Delaware corporate law has shown that courts are reluctant to modify or even to increase the requirements under the business judgment rule. The Court of Chancery stated in a convincing manner that directors often must resolve conflicts among classes of stock, and the fact that a majority of the directors potentially own more of one class than another would not necessarily implicate the director’s good faith and loyalty. Sometimes it is merely indispensable for the management to make decisions that benefit one class of stock at the expense of another, disregarding their own holdings in the company. A financial stake must not have a material effect on director action. Rather, in order to make the business judgment rule inapplicable, the concerned shareholder must plead that the amount of such holdings in one business segment and the predominance of such holdings over other segments, was of a sufficiently material importance as to have made it improbable that the director could perform her fiduciary duties to the shareholders without being influenced by her overriding personal interest in the performance of “their” tracked segment. An unequal potential investment in the different classes of tracking stock cannot automatically deny the application of the business judgment rule. Furthermore, sometimes it is not even technically possible or not desired to guarantee an identical investment in all tracked units.

To deprive management’s entrepreneurial discretion in such cases could obviously not be in the interest of any party. Corporate governance is not an issue particular to tracking stock, but rather a general issue, and in all quoted stock corporations it is to be achieved through implemented guidelines like a Code of Best Practice, in a responsible, value-oriented management and control.

---

282 Sieger & Hasselbach, Subsidiary/Divisional shares, supra note 119, at 1284.
283 For instance, in case that tracking stock is introduced as a merger currency or to give the management special incentives.
5.4.5. The Role of the Supervisory Board

The supervisory board’s primary and original function is only to supervise and to advise the management board but not to capture management assignments. Management responsibilities may not be delegated to the supervisory board.284 A very important relaxation of this principle is provided by section 111(4)(ii) of the AktG.285 If required by the articles or resolved by the supervisory board, certain legal acts or management transactions are permitted only with the prior consent of the supervisory board.286 The catalog of acts subject to prior consent may be more detailed, more comprehensive or more restricted, depending on the intended scope of the management board’s independence, and may give sufficient legal basis to implement a further prophylactic measure management in a tracking stock company.287 It is important to recognize that the principle of equal treatment of shareholders unrestrainedly applies to the supervisory board. That means that the supervisory board, for every consent under section 111(4)(ii) of the AktG289 has to consider all striking interests of the different groups of shareholders and to seek a fair and objective settlement. The supervisory board members are also personally liable to the stock corporation. The applicable duty of care and responsibility as set forth for the management board in section 93 of the AktG290 applies analogously to members of the supervisory board291,292

284 § 111(4)(i), AktG.
285 § 111(4)(ii), AktG.
286 In practice this means that, since the supervisory board has been empowered to grant or to withhold its consent, the management board includes the supervisory board in the decision-making process from the beginning in order to avoid a veto.
287 However, the right to take the initiative always remains with the management board, even in such cases; this means that the supervisory board may not, by excessive consent requirements, impair the management board’s function as sole manager of the corporation and the consent may be required only in particular cases. See, e.g., Baums & Möller, supra note 175, at 70-71.
288 § 53a, AktG.
289 § 111(4)(ii), AktG.
290 § 93, AktG.
291 § 116, AktG.
292 Disregarding the acknowledgment of an entrepreneurial discretion, the ARAG/Garmentbeck case has its problems and insufficiencies in the context of the
5.5. Implementation of a Tracking Stock Culture

liability of the supervisory board. The enforcement of directors' duties by the shareholders themselves is generally rendered difficult by German law. Vis-à-vis its managing directors, a stock corporation is represented by its supervisory board. § 112, AktG. This includes the power to commence an action against a wrongdoing director in the company's name. The problem with this solution is that very often in the case of fault of the managing directors, the supervisory board could equally be blamed for not having fulfilled its monitoring tasks correctly. Hence, the supervisory board will normally be reluctant to take action against the members of the management board ("old boys networking"). Therefore, the Bundesgerichtshof held in the ARAG/Marenbeck case that the supervisory board can even be obligated to sue management.

However, that leads to the problem that the foregoing extenuation of liability of the management board is balanced, via the court ruling quoted above, by the imposition of increased obligations on the supervisory board, which is now required to examine the existence of any damage claims of the stock corporation against executive board members on its own responsibility and to assert such claims on behalf of the corporation! In this process the supervisory board must first determine the likelihood of the charges. If it considers them to be indeed conclusive, i.e., if the executive board is convinced that the management board member is liable for damages, it shall examine the chances for success in court. In doing so, it must take into account potential difficulties in adducing evidence. The decisive question is whether, by filing suit, it will actually be possible to achieve full or partial compensation for the damage sustained; in this context the recoverability of the sum in question (i.e., the enforceability of its collection) will also have to be addressed. If the foregoing examination demonstrates that the stock corporation does have an enforceable damage claim, the executive board is basically required to assert such claim. It may decide against such assertion only in the exceptional case that there exist weighty reasons, related to the welfare of the corporation, which speak against a pursuit of the matter and outweigh the reasons in favor of such pursuit. Such considerations may include negative effects on the company's business operations or its public image, an obstruction of the executive board's work, or a degradation of the working atmosphere within the company. Aspects related to the person of the relevant executive board member(s) shall not be taken into account in the supervisory board's deliberations, except in exceptional cases. As a rule, therefore, the supervisory board is not allowed to spare an otherwise meritorious executive board member, or to consider the social consequences of a court action on that executive member and his family. If the supervisory board, although the foregoing prerequisites are met, fails to assert the corporation's liability claim against an executive board member, it itself becomes liable for damages vis-à-vis the corporation. In sum, nothing has changed. The court has just decreased the level of liability of one organ (management board) in order to increase the level of liability of another organ (advisory board). Thus, the ruling has a somewhat "catch 22" flavor.

For more criticism, see the landmark article of Meinrad Dreher, Das Ermessen des Aufsichtsrats—Der Aufsichtsrat in der Aktiengesellschaft zwischen Verbandsautonomie und Richterkontrolle, 158 ZEITSCHRIFT FÜR DAS GESAMTE HANDELSREcht UND WIRTSCHAFTSREcht [ZHR] 614 (1994); especially addressing this decision in question Grooterhorst, supra note 288, at 1117; Dreher, Anmerkung zu BGH, Urt. v. 21.4.1997 – II ZR 175/95, supra note 275, at 1074.
Because the contemplation of establishing a new tracking stock corporation is rather unlikely, the Article will focus on the following two main ways to implement a tracking stock culture: (1) the issuance of new tracking stock; and (2) the transformation of already outstanding tracking stock.

5.5.1. Issuance of New Tracking Stock

5.5.1.1. Capital Increase

From the company’s point of view, the obvious way to create new tracking stock is, at first glance, to increase share capital. This method neither affects liquidity nor reduces profits, but rather results in an increase in the company’s funding. There are exclusively293 three types of increases in share capital which are available in this context: the ordinary share capital increase in return for contributions (ordentliche Kapitalerhöhung),294 a conditional share capital increase (bedingte Kapitalerhöhung),295 and an authorized share capital increase (genehmigte Kapitalerhöhung).296

---

293 To create new tracking stock via bonus stock, i.e., stock that is issued for no consideration, as, for example, an enticement to buy some other type or class of security, is not achievable under the Stock Corporation Act. See Sieger & Hasselbach, Subsidiary/Divisional shares, supra note 119, at 1280.

294 §§ 182-191, AktG. The aim of the ordinary capital increase is to raise the fixed amount of share capital stipulated in the articles of incorporation and to provide the company with fresh cash.

295 §§ 192-201, AktG. A conditional capital increase enables a stock corporation to offer shares with a conversion or subscription right without knowing the extent to which these rights will be exercised. The completion of the capital increase and therefore the actual increase in the share capital are conditional both with respect to scope and timing.

296 §§ 202-206, AktG. Authorized capital means that the management board has been authorized by a shareholders’ resolution to increase share capital at its own discretion, within the limits set by the shareholders’ resolution and the law. Authorized capital is accordingly very common among German stock corporations. It gives the management board freedom to issue new shares as are necessary to preserve the company. Authorized capital is also employed to provide the management with M&A currency or defense measures. An increase of authorized capital by contributions in kind is permissible only if expressly approved by the shareholders’ meeting. The management board decides on the class of the new shares, the rights resulting therefrom and the conditions of the issuance. Such decision needs the approval of the supervisory board. Thus, even if the shareholders’ meeting has approved an authorized capital some time ago, the shareholders through their representatives on the supervisory board have the power to control the issue of new shares.
The resolution to increase the share capital requires a vote by a majority of three-quarters of the share capital represented at the shareholders' meeting. The articles of incorporation may set forth a different capital majority; only in the case of a conditional capital increase or in the case of an authorized capital increase is a higher capital majority permissible. If, at the time of the issuance of new stock, there are tracking stock already outstanding and therefore different classes of stock exist according to section 11 of the AktG, class voting in the manner of section 138 of the AktG is required.

Although comparatively easy to accomplish, the implementation of tracking stock via a capital increase can under some circumstances be faced with the drawback that common stock still remains. Thus, for a reorganization of the company towards a complete tracking stock culture, this method is inappropriate. Nonetheless, the capital increase structure is the primary choice if it is the goal to track merely one particular business segment or to provide only a special group of persons with tracking stock. This will, for instance, especially be the case to finance a merger and to convince the shareholders of the target company to join the deal or to track a whole subsidiary.

5.5.1.2. Preemptive Rights

The issuance of new tracking stock via a capital increase raises another and, under German law, very crucial issue. From the current shareholders' point-of-view a capital increase is connected with a row of disadvantages. In particular, this structure results in a capital dilution of their respective ownership. That triggers the question of whether the existing shareholders are entitled to a

---

297 §§ 182(1)(i), 193(1)(i), 202(2)(ii), AktG.
298 §§ 182(1)(ii), 193(1)(ii), 202(2)(iii), AktG.
299 § 11, AktG.
300 § 138, AktG.
301 §§ 182(2), 193(1)(ii), 202(2)(iv), AktG.
302 Sieger & Hasselbach, Subsidiary/Divisional shares, supra note 119, at 1278, 1281.
303 See Heribert Hirte, Bezugsrechtsausschluss und Konzernbildung - Minderheitenschutz bei Eingriffen in die Beteiligungstruktur der Aktiengesellschaft at 7 (1986), [hereinafter Hirte, Bezugsrechtsausschluss und Konzernbildung], for a comprehensive analysis.
proportionate part of the newly issued shares. Such rights are designated “preemptive rights” (Bezugsrecht). From the company's perspective, however, it will often be desirable or even mandatory to distribute the new shares only to persons outside the corporation, for instance, to finance a tender offer or a merger. While most U.S. jurisdictions legally do not grant shareholders preemptive rights and typically provide that shareholders do not have preemptive rights unless set forth in the charter,\textsuperscript{304} the presumption under German stock corporation law is exactly the opposite. Shareholders do have preemptive rights to subscribe for any issue of shares, convertible bonds or debt instruments in proportion to the shares held by such shareholder in the existing capital of such corporation,\textsuperscript{305} unless the corporation opts out of this rule by a shareholder resolution approved by the super-majority of seventy-five percent of the shares voting upon its proposal.\textsuperscript{306}

Moreover, the exclusion of the preemptive rights (Bezugsrechtsausschluß) is, from the German corporate law perspective, such a deep encroachment on the ownership position of the stockholder, that courts have for a long time required a further “unwritten” justification for the shareholder approval to be deemed legal.\textsuperscript{307} In preliminary terms the elimination of the preemptive rights must be reasonable and necessary. As a rule of thumb, the transaction is only justifiable if it is in the corporation's interest and if the purpose for the capital increase cannot be attained in the normal legal way, i.e., granting complete preemptive rights to all shareholders. For instance, elimination is

\textsuperscript{304} Originally, the preemptive right was recognized by the courts as mandatory, but now every state by statute allows the corporate charter to limit or deny the common law preemptive right or eliminates the preemptive right unless it is affirmatively granted by corporate charter. See JAMES D. COX ET AL., CORPORATIONS 474 (1997), and now DEL. CODE ANN. tit. 8, § 102(b)(3) prior to the amendment in 1967, for the elimination of preemptive rights as a general rule.

\textsuperscript{305} For more information on the comprehensiveness of preemptive rights in general terms as well as in terms of tracking stock see THIEL, SPARTENAKTIEN, supra note 7, at 237-39.

\textsuperscript{306} § 186, AktG.

\textsuperscript{307} However, the German legislator admitted in 1994 by law a special case of a permissible exclusion of preemptive rights: according to section 186(3)(iv) of the AktG, the exclusion of preemptive rights is permitted if a capital increase for cash contributions does not exceed ten percent of the stated share capital and the issue price is not substantially less than the stock exchange price.
justified by significant and reasonable business interests if it can be assumed that the resulting benefits for all stockholders would outweigh the proportionate loss experienced by the excluded stockholders.308 This assessment means that the exclusion of preemptive rights is always exceptional rather than usual.309

So far as financial innovations and extraordinary legal situations are involved, it should be noted that the determination of whether this cut of shareholder rights is reasonable and necessary is mainly made on a case-by-case basis and is strictly construed. Thus, uncertainties in the deal structure to introduce tracking stock are preprogrammed. Companies always have to take into account that preemptive rights of existing shareholders affect the manner of creation of a tracking stock culture, e.g., preemptive rights are not automatically excluded from shares issued to finance an asset or share deal, rather, the company has additionally to prove that there are no other ways available to finance the transactions to equal conditions with cash.310 Further, if a company is already characterized by a complex share structure, it might not be desirable to grant preemptive rights to all classes of

308 See the landmark decision “Kali+Salz” of March 13, 1978, BGHZ 71, 40 (46); see also Judgment of March 7, 1994, BGHZ 125, 239(241); Judgment of November 9, 1992, BGHZ 120, 141(145-146); Judgment of April 19, 1982, BGHZ 83, 319(321); STEFAN GRUNDMANN, DER TREUHANDVERTRAG—INSBESONDERE DIE WERBENDE TREUHAND 460-65 (1997); HIRTE, BEZUGSRECHTSAUSSCHLUSS UND KONZERNBILDUNG, supra note 303, at 15-30.

309 However, the major reasons that prevent German stock corporations from excluding preemptive rights are litigation issues. Although courts tend to be more liberal on this matter, the outcome of legal proceedings is often unclear. German corporate law leaves room for opportunistic behavior of dissenting shareholders in this point. In order to become valid, the amendment of the articles of association regarding the capital increase and the exclusion of the preemptive rights must be filed with and registered by the commercial register (Handelsregister). Within one month after shareholder approval, a shareholder could file an annulment action with the district court (Landgericht). A law suit can, but must not prevent the commercial register to approve the capital increase. Nonetheless, as long as the court does not conclude that the law suit is a strike suit that misuses the right to sue and turns it down on these grounds, the law suit may hinder the closing of the deal since the capital increase will not be executed in the commercial register. So far as there are any doubts left regarding the legality of the transaction, the commercial register will refuse to approve the capital increase. Thus, the implementation of tracking stock could be blocked for more than a year.

310 HIRTE, BEZUGSRECHTSAUSSCHLUSS UND KONZERNBILDUNG, supra note 303, at 77; HÜFFER, supra note 145, § 186 margin no. 34.
stock. However, the exclusion of preemptive rights of a particular class to the benefit of another class always needs a special justification. At least it seems to be settled that a company can exclude the subscription rights for new shares to introduce incentive programs for the benefit of employees.

5.5.2. Transformation of Outstanding Stock

Instead of issuance of new tracking stock, the company can also transform already existing common stock into tracking stock. For this approach different structures can be contemplated under the Stock Corporation Act, including the modification of the already existing dividend and liquidation rights in the articles, a share split, and a merger with a subsidiary.

5.5.2.1. Modification of Already Outstanding Stock

The modification of the monetary rights granted by the articles of incorporation of already outstanding stock in order to transform them to tracking stock is permissible under the Stock Corporation Act. It needs a vote by a majority of three-quarters of the share capital represented at the shareholders’ meeting. In the case that previously different classes of stocks have been established class voting is also required. Because such an approval of the shareholders leads to an extraordinary interference of monetary rights of dissenting shareholders, the prevailing and correct opinion in the literature calls for a unanimous vote of all shareholders in the concerned class ("unanimous class voting").

Even though at first glance it appears to be a very convenient way, the modification of the articles in order to establish a tracking stock.

---

311 See, e.g., Judgment of October 6, 1969, BGHZ 33, 175(186).
312 See Judgment of April 19, 1982, BGHZ 83, 319(323); Höfffer, supra note 145, § 186 margin no. 39.
313 The American counterparts of this transaction are the recapitalization of existing common into new common and tracking stock or by a distribution of tracking stock on the common stock.
314 § 179(2)(i), AktG.
315 § 179(3), AktG.
316 BAUMS, Spartenorganisation, "Tracking Stock" und deutsches Aktienrecht, supra note 35, at 29; Höfffer, supra note 145, § 60 margin no. 8; Lutter, supra note 153, § 60 margin no. 16; Sieger & Hasselbach, Subsidiary/Divisional shares, supra note 119, at 1279.
stock culture confronts the company with nearly insurmountable impediments.\footnote{317 For this discussion, see Sieger & Hasselbach, Subsidiary/Divisional shares, supra note 119, at 1279.} This method raises allocation problems because in reality a company can never be divided in the manner that all business segments reflect exactly the equivalent value. Even if it would be executable to create tracking stock linked to different business segments with the equivalent value per share, the economic value of the newly created financial tool tracking stock will not be the equivalent to the former outstanding common stock for all the shareholders. Whether the undertaking of an investment like tracking stock has a positive net present value is an individual question and depends on other available investment opportunities in the shareholder’s portfolio and the degree of risk the investor wants to bear. This subjective component of the valuation process leads unavoidably to a negative net present value for some shareholders and triggers their unanimous class voting. But in a publicly held company unanimous voting—even in only one particular class of shareholders—is barely possible. Eventually it is hard to figure out which shareholders are indeed deprived and who belongs, therefore, to the concerned class. Lawsuits are therefore more than probable.\footnote{318 Any shareholder could bring a lawsuit, an “annulment action,” challenging the bona fides of the new issuance, which could lead to postponement of the registration until final disposition of the matter. See § 243, AktG.} Considering all of these described pains with the benefits of a tracking stock culture, companies are usually not well advised to choose exclusively the way over a modification of the monetary rights of already outstanding stock.

5.5.2.2. Stock Split

This allocation problem can be prevented through a distribution of the new several tracking stock in one chunk, i.e., every shareholder gets in exchange for one common stock the equivalent amount of, for example, A, B, and C tracking stock. This block of tracking stock is equivalent in terms of value to the common stock with the consequence that no shareholder is disadvantaged and unanimous class voting is not required.\footnote{319 Sieger & Hasselbach, Subsidiary/Divisional shares, supra note 119, at 1279.} This method necessitates a stock split; here that is the issuance of three new shares in exchange for each old share without changing the
proportional ownership interest of each shareholder.\textsuperscript{320} According to section 23(3), number 4 of the AktG,\textsuperscript{321} the articles of incorporation must contain the division of the share capital into either par value shares (\textit{Nennbetragsaktie}) or non par value shares (\textit{Stückaktie}). For the par value shares, the articles have to name the par value of shares and the number of shares; for non-par value shares, the number of such shares. The Stock Corporation Act allows amendment of its certificate to split its outstanding shares, so that the number of shares held by each shareholder is increased, but requires a resolution of the shareholders’ meeting pursuant to section 179(2) of the AktG.\textsuperscript{322} In sum, the modification of the articles regarding the monetary rights in order to transfer common stock into tracking stock, combined with a stock split to provide every shareholder with a single block of all new stocks, can be an appropriate method. It is only necessary to recognize that the par value shares must have at least a minimum par value of one EURO\textsuperscript{323} and that the portion of the share capital attributable to a non-par value shall also not be less than one EURO.\textsuperscript{324} Shares with a lower face value shall be void.\textsuperscript{325}

5.5.2.3. Merger with Subsidiary

A further possibility, although pretty complex and risky concerning lawsuits of dissenting shareholders, is the introduction of tracking stock through a merger of the parent corporation into a fully owned subsidiary ("downstream merger").\textsuperscript{326} The subsidiary, a so named Special Purpose Vehicle (SPV) or NewCo, is especially established for this transaction and already includes tracking stock structured accordingly to the requirements of the parent company. Under section 2, number 1 of the German Transformation Act

\textsuperscript{320} This is not an increase in the capital. Generally, the purpose of the split is to cut the price of shares that are visually more expensive and increase their attractiveness for the shareholder.
\textsuperscript{321} § 23(3) Nr. 4, AktG.
\textsuperscript{322} § 179(2), AktG.
\textsuperscript{323} § 8(2), AktG.
\textsuperscript{324} § 8(3), AktG.
\textsuperscript{325} §§ 8(2)(ii), 8(3)(iv), AktG.
\textsuperscript{326} Also imaginable is an upstream merger, i.e., the parent corporation is merged into its mother company. \textit{See} Sieger & Hasselbach, \textit{Subsidiary/Divisional shares}, supra note 119, at 1280.
legal entities may merge by dissolution without winding-up by way of acquisition, by transfer of the undertaking as a whole of one legal entity ("transferor entity") to another existing legal entity ("transferee entity") in return for the grant of shares in the transferee entity to the owner of shares in the transferor entity. For the present case, the transaction is somewhat exceptional because the parent will be merged into its wholly-owned subsidiary. In downstream merging, the shares of the subsidiary to be granted in exchange for shares of the parent company, which were property of the parent company before the merger, are transferred directly from the parent company to the shareholders of the parent company in the course of the merger. Pursuant to section 65(1) of the UmwG, the merger resolution of the shareholders meeting at the parent company requires a majority comprising at least three quarters of the stated capital represented at the voting of the resolution.

5.6. Exit Strategies

Under American law, structuring a unique corporate financial tool like tracking stock should always contemplate an exit strategy. A couple of American companies have already employed an exit procedure in order to take the tracking stocks from the market. Especially in Germany, where no practical experience with this

---


329 Downstream mergers are problematic because they may cause the surviving corporation (subsidiary) to acquire the shares in itself previously held by the disappearing corporation (parent). However, this transaction is also permissible under German Transformation law. See, e.g., HEINZ JOSEF WILLEMSEN, in UMWANDLUNGSGESETZ § 5 margin no. 71 (Harald Kallmeyer ed., 1997).

330 To prevent some concerns against the downstream merger and to carry out the transaction, the subsidiary can—controlled by the parent company—execute a capital increase. The newly issued tracking stock will be offered to the shareholders of the parent company in contribution of their stocks in the parent company.

331 So far as several classes of shareholders would exist, § 65(2) UmwG requires, in addition, the same majority of the shareholders entitled to vote in each class (class voting).
innovation exists, an "unwind" feature to reinstate the status quo can help to convince the involved parties to accomplish the transaction. American tracking stock structures usually provide that the issuer can elect to convert the tracking stock into one class of common stock, consequently leaving only one class of common stock outstanding that represents the entire equity in the company. Often a mandatory exchange of tracking stocks or redemption is generally triggered if the issuer sells the tracked assets ("triggering events").

As one might guess, German stock corporation law recognizes all involuntary impacts on the legal and economic position of shareholders very skeptically. Indeed, unwind features, allowing the corporation, just at the board's discretion, to reverse a transaction and to deprive the shareholders of their rights conferred by the shares, do not comply at all with German visions of protection of majorities in a stock corporation. However, the Stock Corporation Act also allows exit features like the voluntary stock repurchase or the mandatory redemption.

5.6.1. Voluntary Stock Repurchase

As is apparent from former discussions, the Stock Corporation Act places great emphasis on the integrity of the stated share capital. One expression about this issue is the repurchase of own stock.\(^{332}\) The acquisition and holding of its own shares by a stock corporation is basically prohibited under the German Stock

\(^{332}\) For a comprehensive investigation comparing stock repurchase under German Common law and German corporate law, see Johannes Stawowy, *The Repurchase of Own Shares by Public Companies and Aktiengesellschaften* (1994), available at http://www.jura.uni-osnabrueck.de/institut/hwr/pdf/paper18.pdf. The author notes, "[f]or the German observer the idea of a Company repurchasing its own shares seems to resemble the picture of a snake eating its own tail. It appears to be highly unnatural and one wonders how the tail can possibly be eatable for the snake." *Id.* at 2. However, the authentic reasons are much more serious. In fact, for more than 100 years it has been settled under German law that legal entities like the stock corporation are able to hold their own stocks. Rather, the general concern of the Stock Corporation Act is the protection of the raised capital. Therefore, section 57 of the AktG forbids any repayment of contributions. This obviously includes the repurchase of the stock because the cash for this purpose is derived not from the balance sheet profit, but from other corporate assets which are designated to provide the corporation's business and to ensure the claims of the creditors.
Corporation Act. The most important exception in this context is provided in section 71 of the AktG. This section contains a catalogue of circumstances in which a stock corporation may acquire and hold its own shares.

5.6.1.1. Section 71(1) Nr. 8, AktG

According to section 71(1) Nr. 8 of the AktG, which is newly introduced by the KontraG, a company may now offer its own shares on the basis of an authorization from the shareholders' meeting which does not exceed eighteen months and which sets forth the lowest and the highest price for the share and that such purchase may not exceed ten percent of the share capital. Because the articles do not provide for a larger majority, the resolution requires only a majority of the votes cast (single majority). This method may, therefore, be used in the future for the repurchase of outstanding tracking stock. Because, under section 53a of the AktG, the principle of equal treatment of all shareholders shall apply to each purchase and sale of own stock, the offer must be granted to all shareholders in proportion to their holdings in the share capital. If the company offers redemption only to the holders of tracking stock, the principle of equal treatment of shareholders might be violated at the first glance. However, the discrimination between holders of tracking stock and holders of common stock, i.e., two different classes of stock according to section 11 of the AktG, should at least be deemed as

---

333 Of course, the corporation may in no case subscribe for its own shares.

§ 56(1), AktG.

335 § 71, AktG.

337 For the scope of this provision—especially regarding management stock plans—see Roschmann, supra note 142, at 30.

338 § 133(1), AktG.

339 § 53, AktG.

340 See § 71(a) Nr. 8 (iii), AktG.

341 See Baums & Möller, supra note 175, at 60.
justified. Section 11 of the AktG\[^{342}\] and other provisions like sections 60(3) and 271(3)\[^{343}\] of the AktG prove that even under the Stock Corporation Act shareholders supplied with different rights can be treated differently. A further reason for this justification can be seen in the opportunity for the company to explore new methods of raising corporate funds and nevertheless to be provided for special circumstances with an exit option.\[^{344}\] Thus, on the one hand section 71(1) Nr. 8 of the AktG\[^{345}\] imparts yet generally a quite handy way for redemption of stock holders. However, for the interesting purpose here this method will, due to the strict limitations in terms of time (shareholders' meeting does not exceed eighteen months) and share available capital (purchase may not exceed ten percent of the share capital), in most cases fail.\[^{346}\]

5.6.1.2. Section 71(1) Nr. 6, AktG

Exempted from these limitations is the repurchase rule under section 71(1) Nr. 6 of the AktG.\[^{347}\] This section allows the purchase of an unlimited amount of own stock on the basis of a shareholders' resolution to redeem shares pursuant to the provisions governing a reduction in share capital. The capital reduction by redemption of shares (Kapitalherabsetzung durch Einziehung von Aktien)\[^{348}\] is a subdivision of the ordinary capital reduction (Ordentliche Kapitalerhöhung).\[^{349}\] Whereas the ordinary capital reduction decreases share capital by reducing the par value of the shares or by consolidation shares, the capital reduction by stock redemption results in the cancellation of individual shares with the effect that share capital decreases by the aggregate par value of the redeemed shares. Redemption eliminates membership rights connected with the redeemed share, whereas the other

\[^{342}\] § 11, AktG.
\[^{343}\] §§ 60(3), 271(3), AktG.
\[^{344}\] See Baums & Möller, supra note 175, at 60.
\[^{345}\] § 71(1) Nr. 8, AktG.
\[^{346}\] See Baums & Möller, supra note 175, at 60.
\[^{347}\] § 71(1) Nr. 6, AktG.
\[^{348}\] §§ 237-239, AktG.
\[^{349}\] §§ 222-228, AktG.
shares remain without consequences in their legal position. Unlike an ordinary capital decrease, a redemption does not by law affect all shareholders equally, but only those whose shares are redeemed. Therefore, the principle of equal treatment of shareholders is not an issue.

The Stock Corporation Act distinguishes in section 237(1) of the AktG between an "involuntary" mandatory stock redemption (Zwangseinziehung) and a "voluntary" stock redemption through acquisition by the stock corporation (Einziehung von Aktien nach Erwerb durch die Gesellschaft). Section 71(1) Nr. 6 of the AktG serves to prepare the voluntary alternative. The repurchase relying on section 71(1) Nr. 6 of the AktG must precede the resolution of the shareholders' meeting concerning the capital reduction by redemption of shares. This resolution requires a majority of at least three-quarters of the share capital represented at the passing of the resolution. Since in a tracking stock corporation there exists more than one class of voting shares, the resolution requires additional class voting with a majority of at least three-quarters of the represented tracking stock capital in order to become effective. Thus, if the management accomplishes to get the required majorities of both all shareholders and the tracking stock holders, the transaction can be reversed and the company exists again only of common stock.

5.6.2. Mandatory Redemption

The Stock Corporation Act also permits that shares may be redeemed by mandatory redemption. This is the means of the choice if repurchase of own stock is either not possible or not desired. A mandatory redemption may, pursuant to section

350 HÜFFER, supra note 145, § 237 margin no. 5.
351 § 237(1), AktG.
352 § 71(1) Nr. 6, AktG.
353 Unlike the mandatory redemption, the voluntary redemption via stock repurchase does not require any authorization in the articles. Nobody is affected when the stockholders voluntarily contribute their shares.
354 See § 237(2)(i), AktG in conjunction with § 222(1)(i), AktG.
355 See § 237(2)(i), AktG in conjunction with § 222(2), AktG.
356 For more details—especially regarding the pricing for the redeemed shares—see Baums & Möller, supra note 175, at 60-62.
357 § 237(1)(i), AktG.
237(1)(ii) of the AktG,\textsuperscript{358} only be made if prescribed or permitted in the original articles of incorporation or by an amendment to the articles prior to the acquisition or subscription of the shares. Thus, each shareholder who is joining a company knows in advance that a mandatory redemption and, consequently, the loss of the shareholder position, are potential threats. However, such a mandatory redemption must not always lead to an involuntary process. The articles can also provide that a mandatory redemption will be triggered by the will of a particular class of shareholders.\textsuperscript{359} For example, if the issuer sells the tracked assets, the articles can provide that tracking stockholders may call for redemption of their shares.

In the case that a mandatory redemption is prescribed by the articles, a further resolution of the shareholders' meeting to approve a mandatory redemption prescribed by the articles of incorporation is not required pursuant to section 237(6)(i) of the AktG.\textsuperscript{360} Then, with respect to applicability of the provisions regarding an ordinary capital reduction, the decision of the management board regarding the redemption shall be substituted for the resolution of the shareholders' meeting.\textsuperscript{361} That means, while voluntary redemption requires shareholder approval, mandatory redemption is effected by the management board invoking the appropriate provisions of the articles. This necessitates that the articles of incorporation or the resolution of the shareholders' meeting determines exactly the conditions governing a mandatory redemption and the particulars of its execution.\textsuperscript{362}

6. CLOSING

Tracking stock is a unique equity-based method of structuring and restructuring corporations that provides many of the benefits associated with the creation of separate public equity securities like

\textsuperscript{358} § 237(1)(ii), AktG.
\textsuperscript{359} HÜFFER, supra note 145, § 237 margin no. 12; Baums & Möller, supra note 175, at 62.
\textsuperscript{360} § 237(6)(i), AktG.
\textsuperscript{361} § 237(6)(ii), AktG.
\textsuperscript{362} See § 237(2)(ii), AktG. For further details and explained drawbacks, see Baums & Möller, supra note 175, at 62-63; Sieger & Hasselbach, Tracking Stock, supra note 119, at 398.
spin-offs and equity carve-outs, while preserving certain advantages of remaining a single, consolidated entity. Among the rewards of diversification, tracking stock has its financial performance tied to a particular business unit, rather than the company as a whole. It gives shareholders a "pure play" and the opportunity to extend their investment objectives. Tracking stock can create a distinctive M&A currency: the acquiring company tracks the business of the target company, and the selling shareholders keep their participation in the success and future of their original investment. Since the stock tracks the performance of a particular business segment, companies can reward and motivate the business unit's management by giving them equity in their own "enterprise." It is also a great feature to measure performance and to hold management on the board in the context of restructures and tender offers. At the same time, tracking stock enables issuers to retain the benefits of remaining a consolidated entity, such as a high level of operating and management control, retention of operating synergies that would be lost if an integrated business becomes independent or retention of consolidated debt capacity and existing lending arrangements.

Unique benefits are faced with unique risks. Implementing tracking stock adds complexity to a typical company's capital structure. Tracking stock, despite its name, remains a class of stock in the parent company. Therefore, the targeted business retains full exposure to the performance of the core business and to the liabilities of the consolidated business group. The success or failure of the whole company will inevitably influence the value of tracking stock. Even if the tracked segment performs tremendously well, the loss of dividends or, moreover, at a long term basis loss of the entire investment (bankruptcy), is still impending when the core business does not earn any profits. Not only in terms of the distribution of dividends, but generally, unavoidable conflicts of interest between different business segments arise in a tracking stock culture and can literally create decision-making nightmares for the board of directors. As a result, agency costs might be imposed by creating conflicts of interests over cost allocations, liquidation rights, and internal transfer payments.

In particular, the analyses of the dependence of the tracked unit on the outcome of the entire firm and of corporate governance in a
tracking stock corporation lead to comparable answers. The ability of the firm to pay dividends is, under the Delaware General Corporation Law as well as under the presumably so strict and inflexible German Stock Corporation Act, absolutely linked to the outcome of the consolidated business. Under both jurisdictions the corporation can basically distribute dividends only out of net earnings (balance sheet profit), each calculated at the parent level and not the business unit level.

Both Delaware and German law generally require a corporation’s board to discharge its fiduciary duties in the interests of all of the corporation’s stockholders—which may not always be easy to do where the holders of the tracking and the ordinary common stock may be seen as having diverging interests. Tracking stock companies therefore need sophisticated corporate governance guidelines. In this context this article demonstrated that, in both jurisdictions, judicial review of resource allocations is limited by the business judgment rule. Whereas recent Delaware decisions suggest that there will not be any radical differences in the availability of the business judgment rule simply because a corporation has a tracking stock structure, due to the 1997 landmark case ARAG/Garmenbeck of the German Federal Court of Justice (Bundesgerichtshof) the business judgment rule, derived from the American corporate law, has basically also found its way into German jurisprudence. Although there is little developed law dealing with these issues and thus boards need to proceed with the appropriate caution, basically the management in both countries can be protected against a judicial “second guessing.” Thus, management’s discretion is granted insofar as the board has acted on an informed basis, in good faith in the interest of the company, upon due inquiry, and without self-interest in a situation involving disparate impacts on the respective classes.

Another important issue in the corporate governance context is to insure the rights of the shareholders against the discretion of the management. Therefore, like Delaware law, German Corporate Law also provides sufficient means to set forth a clear definition of the tracked business versus the core business and to make clear from the outset the management duties, revenue/expense allocation, cash management, and other accounting policies to be in effect between the tracked business and the parent’s remaining businesses. The Stock Corporation Act further enables the
institution of committees to oversee issues affecting the interests of tracking stock holders. Moreover, unlike the unitary American board system, the German two-tier board system provides a second organ, the supervisory board, to seek equilibration between the interests of tracking stock holders and the duties of the management board.

If, apart from implementation and restructuring, a tracking stock culture is faced with the same problems and the same legal resolutions in both jurisdictions, the putatively inefficient German corporate law cannot be the whole truth of why German firms are still reluctant to employ this financial innovation. Rather, whether tracking stock programs will flourish in Germany, of course, depends essentially upon how the capital market estimates the value of this investment. Thereby it has to be taken into account that the German capital market is still behind the development in the United States.\textsuperscript{363} For instance, even now the German capital market is minted through simply conservative, risk-averse investors who prefer the relative security of savings accounts, debt instruments with low yields, or real estate.\textsuperscript{364} Generally, the lack of German investor experience with financial innovations could be a factor for a higher initial discount. Companies will therefore consider very carefully why and under what conditions floating the shares of a distinct business segment will trigger a favorable response in the market place. In any case, the market may require ongoing education to fully understand the interests represented by the tracking stock, and there is always the risk that the market will be less forgiving of the inherent limitations of tracking stock securities in less optimistic environments.

Nonetheless, as corporations worldwide continue to seek methods of maximizing the value of their equity, tracking stock also seems to offer a highly attractive tool in Germany. With the

\textsuperscript{363} For statistical facts and a broad examination of European and German securities markets and their recent growth, see John C. Coffee, \textit{The Future As History: The Prospects for Global Convergence in Corporate Governance and Its Implications}, 93 NW. U. L. REV. 641 (1999).

\textsuperscript{364} Even though the privatization of Deutsche Telekom AG and the establishment of the new high-tech market segment "Neuer Markt" (New Market) have already increased the tendency to invest in stocks. For an overview about German equity markets in English, see, for example, Andrö, \textit{Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany}, supra note 141, at 97-104.
appropriate application, this innovation can also function in Germany to unlock otherwise inaccessible value, to create a formidable M&A currency, or management and employee incentive programs. Maybe it is just a similar constellation to that of GM's acquisition of EDS in 1984, which led the involved parties to the conclusion that only the introduction of this particular tool can accomplish the contemplated transaction, that is necessary to launch the first tracking stock in Germany.

The signs are optimistic. The German stock market is experiencing a renaissance. Shareholder value has become the guideline principle of numerous German companies. This includes shareholder-friendly accounting methods, stock options, and share repurchases. The common observation is that American investment advisors bring not only a dedication to shareholder value and innovative financial products to the German markets, but also an ability of the market participants and the legislator to react quickly and alter the legal situation corresponding to American standards. There is no doubt that legislative and court changes that have liberalized various features of the German Stock Corporation Act, which were increasingly influenced by the requirements of the international capital markets, helped to create an investor friendly environment. The introduction of tracking stock could be a further step on the road to a shareholder culture in Germany.

---


366 With respect to the liberalization debate regarding German corporate law, see, for example, Schnorbus, Gestaltungsfreiheit im Umwandlungsrecht, supra note 239, at 131-34; Hans-Joachim Priester, supra note 239, at 187; Volker Röhrich, Von Rechtswissenschaft und Rechtsprechung, 28 Zeitschrift für Unternehmens- und Gesellschaftsrecht [ZGR] 445 (1999); Harm Peter Westermann, Der Fortschrittsgedanke im Privatrecht, 50 Neue Juristische Wochenschrift [NJW] 1 (1997); Harm Peter Westermann, Probleme mit der Rückbildung im Gesellschaftsrecht, in Festschrift für Wolfgang Zöllner, Band I, 607-633 (Manfred Lieb et al. eds., 1999).