On so-called "tracking shares"

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1. Concept

Although they are still virtually untested in Spanish praxis, increasingly often traders wonder about the possibility of issuing shares where the holders' participation in corporate earnings is modulated or defined by the financial performance of one of the issuer's lines of business.

Such tracking shares ("*azioni correlate*" in Italian and "*acciones sectoriales*" according to several Spanish academics [Vaquerizo, "*La emisión de acciones vinculadas a un sector de actividad de la sociedad emisora*", RdS, 41, 2013, pp. 59 et seq.]) exhibit an important feature: the dividend to which the tracking shareholder is entitled is determined (to a greater or lesser extent, depending on the particular arrangement under the articles of association) by the profits earned by a line, division, production unit or subsidiary. In graphic terms, these shares "track", as for the dividend right, the behaviour of a certain line of business (so that the profitability for the tracking shareholders is 'aligned' to some extent with such behaviour). Financially, the performance of the investment materialized in the purchase of these shares is in step with the performance of the line of business it tracks.

Sometimes tracking shares also exhibit other special features in respect of ordinary shares (which, however, are not defining elements of the same).

2. Characterisation and general ideas

From the standpoint of Spanish law, such shares have the following general characteristics:

a) Tracking shares represent parts of a company's share capital, not a portion thereof. Their owners are shareholders of the company, not of a part thereof. Hence, the rights they have must be exercised within said legal person, according to the terms provided in the law and the articles of association. And, to the extent that such articles do not provide otherwise, tracking shares are equivalent to ordinary shares in all that which does not refer to the distribution of corporate earnings.

b) In any event, the rules on the allocation of profits shall apply, whereby dividends can only be paid out of profit for the year or of unrestricted general reserves if the value of the share issuer or creator's equity is not or, as a result of the distribution, will not be less than the share capital (art. 273(2) LSC). Ultimately, this means that tracking shareholders may not receive dividends if the company as a whole has no apportionable profit, even if the specific line of business the shares track has generated profit. In other words, remuneration depends on the existence of a "two-fold profit" (of both the benchmark line of business or division and the company whose capital is represented by tracking

shares). In addition, for the birth of the specific dividend right, the appropriate resolution of the general meeting is necessary (art. 273(1) LSC). These two points demonstrate the importance of determining whether the "preferred" dividend has a cumulative nature and whether it is mandatory for the company to approve the payment of dividends if there are distributable profits (see below, point 4).

c) The existence of shares of this nature has no real effect on the company's equity. In short, their issue does not create any separation in equity that can be enforced against the company's creditors; all claims may be directed against the whole equity, regardless of whether they have arisen in connection with a line of business or in connection with residual or ordinary activities.

d) Tracking shareholders do not have any special rights in the assets integrated in the line of business or production unit their shares track (just as ordinary or common shareholders in other company assets!). A different matter is if the articles of association provide qualifications regarding the liquidating dividend right, consisting in preferences over the assets resulting from the liquidation of the assets attached to the line of business the shares track (which may lead therein to a reproduction of the criteria for determining the participation in corporate earnings).

e) The investment materialized through tracking shares is often envisaged as temporary; that is, as connected to a unit that eventually will be incorporated (from the point of view of returns) in the company's general business or, on the contrary, disposed of. Hence, in comparative practice, it is not uncommon for these shares to be issued as redeemable (usually, at the company's discretion, either after a certain period has elapsed, or after verification of certain events). In Spanish legislation, redeemable shares are expressly envisaged only in relation to listed companies (arts. 500 and 501 LSC); this stops us from stating categorically that Spanish unlisted companies may issue or create redeemable shares, although strictly speaking there does not seem to be a material or substantive reason supporting the validity of such a prohibition.

f) Given that to determine the participation of a tracking shareholder in corporate earnings it is necessary to distinguish which part of the company's profits has its origin in a production unit or line of business, the wording of the relevant company articles regarding these aspects is of particular importance. Consequently, special care must be taken in the wording of the articles' provisions, with regard to both the precise definition of the tracked line of business (line of business, subsidiary, establishment ...), as well as the fixing of the form and basis of accounting for the costs and expenses of the line of business and even the identification of the accounting information regarding the course of this business that should be provided to shareholders.

3. Admissibility in Spanish law[3]

In principle, and always bearing in mind what has been noted above (point 2) it seems that Spanish legislation does not contain insurmountable obstacles to the creation of tracking shares.

Leaving now aside the doubts that accompany the issue or creation of tracking shares that grant "special" rights during the company's life (insofar as it may affect individual or collective rights; cf. arts. 291-294 LSC), it can be said that there is no impediment to calculating dividends

[1] De lege ferenda, we should recall that the Commercial Code Draft Bill of 2014 contains the following provision: "Article 233(17). Shares tracking a line of business. 1. A public limited company can issue shares with a dividend right that track the profit earned in one or several lines of business from amongst those that constitute the company's object. 2. The articles must set out the criteria to determine the revenue and expenses of the line of business, the right conferred to this class of shares and the requirements for and methods of converting these into ordinary shares.3. If the losses suffered by the company do not absorb all the profit earned in the line or lines of business tracked by the shares, such shall participate to the extent that is appropriate in the part of profit not absorbed by the losses".

payable to certain shareholders on the basis of returns generated by a company's previously identified line of business.

The reason for this statement lies in the consideration that, concerning financial (equity-holding) rights – and especially as regards the participation in corporate earnings – the freedom as to the provisions of the articles of association is extraordinarily broad. In fact, in this area the LSC only sets a specific limit in art. 96(1): the issue or creation of shares entitled to receive interest (i.e., fixed or variable remuneration independent of the existence of apportionable profit and a company resolution to distribute such profit) shall be invalid. Moreover, and in accordance with the general principles, neither would a one-sided agreement wherein one or more of the shareholders should remain absolutely excluded from earnings be admissible (art. 1691 CC).

None of these limits would be exceeded with the issue in public limited companies or creation in private limited companies of tracking shares. Obviously not with the former; but neither with the latter, because in no case is there an intention to exclude tracking shareholders or other shareholders of "all and every part" in corporate earnings. This, however, notwithstanding that, under certain circumstances, it may come to pass – depending on the origin of the profit earned – that having the payment of dividends been agreed in a given year, nothing should fall to the holders of tracking shares or remaining shareholders.

Aside from the above, the provision that the "special" rights affecting the dividend must be specified, indicating in the articles their amount "by way of multiples of the unit" (184(2)(2) of the Register of Companies' Rules), must be understood, in my view, as an expression of what usually happens and as particularized expression of the rule – this one general – according to which qualifications must be sufficiently specified in the articles. But it does not seem plausible that the regulatory provision can impose a limit (and, moreover, of a formal type) in addition to statutory limits (thus, it should suffice that the "content and extent of the conferred right" appears in the articles, as required by the general rule under art. 184(2)(3) of the Register of Companies' Rules).

4. Make-up of the dividend right of tracking shares

As discussed, in Spanish companies limited by shares there may possibly be a class or category of shares which confers to its holders a right to participate in corporate earnings measured with reference to the return generated by a company's line of business.

However, this qualification can be defined with very different "strengths" and forms.

In an extreme case, the articles may provide that all of the corporate earnings attributable to the performance of the reference line of business should be assigned to tracking shareholders ('close tracking') and that these same shareholders lack the right to participate in the profit generated by other business. When this happens, the company is internally divided or dissociated: the shareholders remain grouped in blocks with interests that may diverge (and even be opposed to one another). In this regard, it has been suggested at times that such a make-up could be contrary to art. 1665 CC (although the intention of distributing corporate earnings is not, strictly speaking, eliminated) and could even, at times, collide with the essential pursuit of a common goal through the corporate organisation.

But it is equally feasible (and apparently more common in comparative praxis) that tracking shares are issued as shares entitled to a preferred dividend in relation to the profit of a production unit or line of business. Once this preference has been catered for, the remaining shareholders participate (with or without the tracking shareholders) in the profit arising from such line of business ('loose tracking'). And nothing prevents the articles either from providing that tracking shareholders participate (as the case may be and even on an equal footing with other shareholders) in the profits from remaining lines of business or production units.

It should be noted, therefore, that very often the particularity of these shares consists of the enjoyment of a preference as to the order of payment of dividends (strictly speaking, as to a part of these). But not always will – depending on the specific course of business of the different

company activities – the particularity result in an advantage in terms of the "amount" of dividends to be earned (unless the tracking shareholders participate in the same way as other shareholders in the profit from the lines of ordinary or residual business).

Apart from the above, it should be noted that the situation of tracking shareholders presents very different profiles depending on whether or not the company's obligation to agree on the payment of dividends, and whether or not a "cumulative" nature is afforded to any dividend payable to the tracking shareholders, is provided for in the articles of association.

As regards the former, there seems to be no obstacle to introducing in the articles the company's obligation to agree on the distribution of that part of the company's distributable profits which originates in the line of business taken in consideration for the issue of tracking shares (as it is not certain that this rule is entirely equivalent in its circumstances to that which by default – art. 95(2) LSC – governs in the case of unlisted companies – and mandatorily in the case of listed ones: art. 498 LSC – its express formulation in the articles is advisable if its validity is intended).

The possibility should also be considered of defining as "cumulative" the dividend linked to tracking shares. In this manner, the possibility could be provided for of adding to the dividends to be received in subsequent financial years (provided, of course, there is distributable profit) those unearned by tracking shares in the past, due to their distribution having not been agreed to by the general meeting when it could have, or because losses in the residual or ordinary business rendered a distribution impossible despite profits in the line of business tracked by the referred shares (this accumulation, if provided for in the articles, obviously can be limited in time, just as with non-voting shares: art. 99(3) LSC).

5. Conflicts of interest between shareholders: "sibling rivalry"

The coexistence of ordinary shares with tracking shares results in a multiplication of intracompany conflicts. The internal division in the company's structure is evident in the diversity of interests of different groups of shareholders. While for some the company's course of business as a whole is relevant, for others what is most important is the course of business of the specific line their shares track. Clearly, the internal conflict will be particularly acute if tracking shareholders are entitled to all income from the line of business concerned and do not participate in other corporate earnings (it is a borderline case where the divergence of interests can directly become a collision of interests). But even in less extreme situations, it is clear that such interests are not necessarily confluent.

In this regard, it should be noted that often the control of the company will be in the hands of the "ordinary" shareholders (who will usually hold the majority of non-financial [governance] rights). And this places tracking shareholders in a vulnerable position since the resolutions of corporate bodies could adversely affect their interests by reducing returns in the line of business their shares track in favour of the company's overall interest.

Note in this regard that resolutions passed at the general meeting may impact directly on the interests of tracking shareholders. Without prejudice to the possibility of challenging resolutions imposed unfairly (those adopted by the majority in their own interest and to the detriment of the other shareholders, even if they do not harm the company's equity: art. 204(1) LSC), one should consider introducing protection mechanisms, in addition to those already provided by law, for cases where an amendment to the articles of association is intended (arts. 292 and 293 LSC).

Indeed, one might wonder about the possibility of including in the articles a system that would require a "two-fold majority" (of the general meeting and of the special class consisting of tracking shares) for the adoption of company resolutions likely to affect the interests of tracking shares. However, the introduction of a mechanism of this kind hardly seems compatible with the rule of strict proportionality between capital and votes that governs in our law for public limited companies, raising too some doubts with respect to private limited companies (although art. 200(2) LSC could offer some argument in favour of its admissibility).

Alternatively, one could think of a system where certain resolutions under the articles of association require reinforced majorities which, in fact, involve the attribution to the majority of

tracking shareholders a veto right. Or, in private limited companies, one could examine the possibility of granting certain voting privileges to tracking shares in relation, specifically, to certain matters liable to affect them in particular (although doubts remain as to the legality of this solution).

The governing body's resolutions can also be potentially harmful to tracking shares (for example, those relating to the investment policy or the allocation of resources). In these cases, assuming there is no damage to the company's equity as a whole and that legal requirements are met, one might consider the filing of a non-corporate liability claim. One could also think of providing in the articles of association that certain resolutions on matters relevant to the line of business the tracking shares track must be authorised by the general meeting (and, if so, earlier considerations should be taken into account).

In general, the provision for resignation rights, under the articles of association, in favour of tracking shareholders in certain particularly significant cases (sale of the production unit such shares track, demerger, change of control ...) may also be an appropriate protection mechanism (though the difficulty of its inclusion in the company's life should be noted given the need for consent of all shareholders: art. 347(2) LSC), just as it would be to confer, under the articles and in the cases referred to or others, a right to "convert" tracking shares into ordinary shares.

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