Capital maintenance rules and voidance of third-party security

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Introduction

In a recent decision**(1)** the Supreme Court dismissed a bank's claim for enforcement of a third-party mortgage initially given to secure loans granted to two corporate entities managed by the security provider's brother. The underlying loan transactions, which were entered into in relation to a management buy-out-style acquisition of the target, were previously reviewed by the Supreme Court. In its first decision, **(2)** the Supreme Court took its already tough line regarding its interpretation of the capital maintenance rules one step further by holding that in order to determine whether these rules have been violated, the overall planning of the underlying transaction – rather than the single step of taking out a loan – must be taken into account. Based on this wide assessment criterion, the Supreme Court held that the loan transactions were void and the bank was liable to repay any payments received on the loans.

In the case at hand, the Supreme Court, irrespective of fierce (and mostly negative) discussions in legal literature, failed to question the nullity of the underlying loan further and thereby indirectly confirmed its previous decision on the 'overall planning' criterion. It held that the security for that loan was accessory to the loan. Since the loan was void, the security was found to be void as well. Thus, the third-party security provider could successfully defend herself by referring to the voidanceof the underlying loan transactions due to a violation of the capital maintenance rules.

Capital maintenance rules

One of the fundamental elements of Austrian corporate law is the principle of capital maintenance. The cornerstone of the Austrian capital maintenance rules**(3)** is that all of the assets of an Austrian corporation, even those exceeding its stated capital, are protected. Distributions to shareholders may be made only in accordance with statutory exceptions; the most important of these explicitly specified

circumstances is that shareholders have the right to receive dividend payments out of the annual distributable profits of the company. Any transaction qualifying as a violation of such rules will generally result in a prohibited repayment of equity, leading to the nullification of the relevant transaction. Pursuant to case law and unanimous doctrine, activities such as taking out loans and forwarding the proceeds to shareholders and providing up-stream and cross-stream guarantees or other security interests will – unless certain strict precautions are applied – violate the Austrian capital maintenance rules. In addition, the parties involved in such transactions (eg, shareholders, managing directors, supervisory board members and – in certain scenarios – third parties) are personally liable to repay the amounts paid by the corporation under such transactions and may also face criminal charges.

Facts

The structure of the management buy-out transaction in the case at hand was as follows. The brother of the defendant – at the time, one of the managing directors of the target – intended to acquire the target. The overall plan (as established by the Supreme Court) was for the defendant's brother to set up a special purpose vehicle (SPV). The SPV would then purchase the target's shares by using the proceeds of a loan to be acquired by the SPV. Finally, in the course of the business year following the acquisition, the target would be merged into the SPV for tax reasons.

When the transaction was implemented, the plaintiff granted a loan to the target for the purpose of acquiring the company (the first loan). The first loan was secured, among other security interests, by a third-party mortgage granted by the defendant. Pursuant to the Supreme Court, the defendant was not involved in the discussions between the plaintiff and her brother. Conditions precedent for drawing up the first loan were, among other things, a share purchase agreement regarding the shares in the target (ie, the borrower under the first loan). At the time the first loan was taken out, the exact details of the transaction were not yet fixed, but the plaintiff was fully aware that the proceeds of the loan granted to the target were going to be used to finance the acquisition of the target by the defendant's brother. The SPV was then incorporated and the plaintiff granted an additional loan to the SPV for the purpose of acquiring the target's shares. This second loan was secured by additional mortgages given by the defendant. At the time that the share purchase agreement was signed, the target and SPV entered into an agreement on the assumption of the first loan. The first loan was drawn up by the SPV following the signing of this debt assumption agreement. The target and SPV were subsequently merged. At the time of the merger, neither the SPV nor the target had sufficient funds to cover the net debts of the SPV. Approximately four years following the merger, the SPV went bankrupt.

Decision

In its first decision regarding the insolvency administrator's request for repayment of the loan instalments paid to the bank (the defendant in the first decision and the plaintiff in the second decision) by the SPV, the Supreme Court developed and applied the overall planning criterion. By applying this criterion, the Supreme Court held that the defendant's brother was the sole beneficiary of all loans taken out by the two entities.**(4)** As regards the plaintiff's role in the case at hand, the Supreme Court referred to previous case law and held that, in general, a third party is not obliged to carry out investigations and examinations in relation to compliance with the capital maintenance rules. However, in cases like the one at hand, where the suspicion of a prohibited repayment of equity is almost certain, this duty arises. Based on this finding, the Supreme Court again referred to existing case law and reiterated that due to the principle of capital maintenance, a (corporate) debtor has the right to refuse performance against a third party if that party

acted collusively or its lack of knowledge was based on gross negligence. Accordingly, the Supreme Court held that loan instalments paid by the SPV violated the capital maintenance rules and held the bank liable to repay the instalments.

In its decision in the case at hand, the Supreme Court confirmed the lower courts' decisions on the merits and reiterated previous case law, confirming that because mortgages are accessory security rights under Austrian law, a third-party security provider may defend itself by using any and all defences available to the original debtor in order to defend itself against such claims. The Supreme Court further held that while the plaintiff was fully aware of the unlawful repayment of capital in the course of the transaction, the defendant was not involved in the structuring of the transaction. Further, the Supreme Court held that the defendant could not be qualified as a shareholder of the entities involved or as a beneficiary of the transaction, nor were there any reasons to assume that she intended to provide security for her brother's personal repayment obligations (as beneficiary of the unlawful repayment of capital). Accordingly, the Supreme Court held that the defendant validly defended herself by addressing the absolute nullity of the underlying claim due to a violation of the capital maintenance rules.

Comment

This case is notable not for its legal assessment (which is materially based on settled case law), but rather for the unrestricted confirmation of the Supreme Court's earlier decision, despite the reasonable criticisms which have arisen in this regard (eg, *Walter Brugger* (NZ 2013/92) and *Manfred Umlauft* (NZ 2014/36)). These criticisms question whether the 'overall planning' criterion should cover all legal acts entered into in connection with a transaction. The court found that the overall beneficiary is the ultimate shareholder and therefore all of the loans were qualified as prohibited repayment of equity. The Supreme Court's strict view leads to the question of the extent to which special purpose vehicles can still be used in conformity with the law and how restructuring or financing within group structures may be affected by this, as there will always be an ultimate shareholder acting as the final beneficiary in this chain. In any case, this decision will lead to further uncertainties and will require further diligence when structuring finance transactions and security packages involving Austrian entities.

Notwithstanding that, the Supreme Court has clarified the impact of the nullity of loans based on a violation of the capital maintenance rules:

- Banks will have to take a closer look at suspicious transactions – in particular, by clarifying the short to mid-term planning of future reorganisation transactions.
- Third-party providers of security that are not involved in the transaction may defend themselves by invoking the nullity of the loan agreement secured due to a breach of the capital maintenance rules.
- Shareholders cannot rely on this defence if they have provided security because "it is not the intention of the Capital Maintenance Rules to protect the shareholder" (the beneficiary).

Finally, as long as an acquisition financing is still outstanding, lenders must diligently scrutinise any merger between the target and the acquiring entity or borrower – in particular, they must consider whether the assets of the borrower (acquiring entity) sufficiently meet the obligations under the acquisition financing or whether the target's assets will be needed. In the latter case, the overall planning criterion may apply and lead to a situation where the entire transactions violates the capital maintenance rules.

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Endnotes

(1) OGH 1 Ob 28/15x.

(2) OGH 6 Ob 48/12w.

(3) See Sections 82 *et seq* of the Companies with Limited Liability Act and Sections 52 and 65 *et seq* of the Stock Corporation Act.

(4) The uproar in the Austrian legal community was caused by the fact that the Supreme Court held that:

- the plaintiff's brother was also the beneficiary of the second loan taken out by the SPV in order to finance the acquisition of the target's shares; and
- from an economic standpoint, the economic burden of the acquisition had to be solely borne by the target, as the shareholders (ie, the SPV and the plaintiff's brother) both needed the dividends to be disbursed by the SPV in order to repay the loans.

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