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# Financial assistance under Slovenian law – the major points worth considering in structuring your deal

## 1. Introduction

In the light of the favourable economic climate and affordable financing sources, Slovenia has been facing a lively M&A market in the recent few years, especially in the area of commercial real estate. Further, companies are eager to refinance their existing debt or borrow new funds under the more favourable conditions currently available on the market. Since the majority of financing is done via standard bank financing, every deal poses the same old question: "How will be the loan secured"?

If the (re)financing is done on a shareholder or HoldCo level, the most usual solution would be to encumber the subsidiary's assets as collateral for obligations of the shareholder. The same principle applies to acquisition financing, where a potential target and its assets will usually represent the most important collateral for acquisition financing. A common denominator of the foregoing is the same – a company financially assisting some other company with providing its assets as collateral for obligations of the latter, which can result in its detriment.

Although the complexity and volume of the topic exceeds the capacity of this contribution, I have nonetheless tried to provide an introduction and a practical guide with respect to some

of the most important questions that will either significantly affect the deal structure or are usually overlooked despite their importance.

## 2. Is financial assistance even permitted in Slovenia and to what extent?

The term "financial assistance" is not explicitly defined in Slovenian law. Nevertheless, it is generally accepted that financial assistance refers to situations where a company directly or indirectly, with its own assets, assists someone to become its shareholder or to increase its interest in the company. Regardless of the fact that financial assistance in its most strict meaning represents financial assistance with acquisition of a joint company's shares, the term "financial assistance" is generally used to address questions with regard to any legal transactions between a company and its shareholders.

The Slovenian Companies Act[1] (**CA**) sets forth two different sets of rules regarding financial assistance and legal transactions between a company and its shareholders, which differ significantly depending on the different forms of incorporation. First and foremost, the rules governing limited liability companies (slo. *družba z omejeno odgovornostjo*) (**LLC**) are in general far less rigorous in comparison to those related to joint-stock companies (slo. *delniška družba*). Further, the CA regulates the financial assistance and legal transactions between a joint-stock company and its shareholders through provisions prohibiting fictitious transactions and return or payment of interest on equity contributions. Conversely, financial assistance with respect to LLCs is regulated via share capital maintenance provisions.

### *2.1 Financial assistance and acquisition financing*

<u>(a) Joint-stock companies</u>

In accordance with Slovenian law, financial assistance of a company for the acquisition of its own shares is strictly prohibited, save for two explicit exemptions under the CA. The prohibition of financial assistance must be interpreted broadly and also includes legal transactions with comparable effect. In relation to acquisition finance it may be worth pointing out that the prohibition of financial assistance also includes different forms of personal or in rem collaterals (for example, surety, mortgage or pledge) granted by a company for a loan, which is to be granted by the third party to an existing or future shareholder for acquisition of the company's

[1] Official Gazette of RS no. 65/09, as amended.

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shares. Special attention should be paid to any cross-subsidization effects or any other form of enabling acquisition financing (for example granting a security for working capital facility of the buyer). To summarize, all legal transactions that have the economic purpose of financing the acquisition of a company's shares out of or with assets of the company or otherwise enabling acquisition financing shall be deemed as financial assistance and therefore null and void.

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A variation on the prohibition of financial assistance is envisaged also in Article 32 of the Slovenian Takeovers Act, which would be relevant in case of a public takeover bid.

(b) Limited liability companies

Differently from regulations governing joint-stock companies, legal transactions in LLCs, which would be deemed a violation of prohibition of financial assistance in the case of joint-stock companies, are assessed in accordance with application of provisions regarding share capital maintenance under Article 495 of the CA. The latter lays down that the assets required for the maintenance of the share capital and restricted reserves (slo. *vezane rezerve*) shall not be paid to the shareholders. Certain assets (for example loans between associated persons) are excluded from calculation of assets required to maintain the minimum amount of the share capital (EUR 7,500).

The general rule is that the company is not allowed to pay to its shareholders any payment (or perform similar legal transaction with a similar economic effect) to the extent such payments would affect the company's assets required for maintenance of its share capital and restricted reserves. Such a legal transaction is null and void. Therefore, financial assistance with respect to LLCs is possible, but limited to the so called "excess balance sheet value", i.e. balance sheet value, which exceeds the value of the registered share capital and restricted reserves.

*2.2 Legal transactions between a company and its shareholders*

At the outset, it is worth pointing out that legal transactions between a company and its shareholders (except for actions described in point 2.1(a) above) should not be assessed in accordance with the rules regulating prohibition of financial assistance under the CA, but under the general rules on capital maintenance, in particular with the payment prohibition rule.

(a) Joint-stock companies

Article 227 of the CA sets forth that equity contributions shall not be returned and shall not bear any interest. The only permitted payments are payments of dividends and payments in accordance with permitted acquisition of treasury shares. Conversely to LLCs, all assets of the joint-stock company are protected with capital maintenance provision. Since the prohibition to return equity contributions must be interpreted broadly, it does not apply only to payments that would be explicitly declared as the return of the monetary or contribution in kind. In addition to the general prohibition to return or pay interest on equity contributions, CA also prohibits any kind of so-called concealed distributions of profit.[2]

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Having regard to the above, legal transactions between a joint-stock company and its shareholders (for example up-stream loans and up-stream security) are not prohibited per se, although it must not result in reduction of the company's assets. The latter is especially worth considering since intra-group transactions tend to be concluded on more favourable terms in comparison to those available on the market (loans with lower interest rates, security without premium, etc.). Therefore, all legal transactions should be subject to a prior accounting (balance sheet) assessment, considering the probability of repayment or enforcement, respectively, and if needed, adequately "neutralized" in the balance sheet with establishment of an appropriate security or recourse claim against the shareholder. Otherwise, such a legal transaction may be deemed as a prohibited (concealed) return of equity contributions.

The legal consequence of a prohibited return of equity contribution is a special (corporate) claim by the company against the shareholder (and not third persons), which cannot be waived or set off. Said claim can be also exercised by the qualified minority shareholders. Nevertheless, the question of validity of prohibited legal transactions in relation to third parties, i.e. recipients of collateral or similar benefit often arises on the side of the lenders . In principle, the recipient of the collateral as a third party is protected against company's corporate claims. However, in accordance with the latest case law of the Supreme Court of the Republic of Slovenia[3], this does not apply when a third party acted in bad faith. In such case, the company may have a claim towards such a recipient of the collateral due to its nullity.

[2] In accordance with the latest case law of the Supreme Court of the Republic of Slovenia , the fundamental rule in assessment of concealed return of equity contribution is whether a company would conclude such legal transaction with a third person in the same circumstances and under the same conditions in the moment of conclusion of that transaction (C.f. Decision of the Supreme Court of the Republic of Slovenia ref. no. III Ips 6/2017 dated 24 July 2018).

[3] C.f. Decision of the Supreme Court of the Republic of Slovenia ref. no. III Ips 6/2017 dated 24 July 2018.

(b) Limited liability companies

The main difference in comparison to joint-stock companies is that the whole assets of an LLC are not "restricted", rather only assets which are **required** for the maintenance of the share capital and restricted reserves. In the event of interference with restricted categories of capital, a company has the same special (corporate) claim by the company against the shareholder as in the case of joint-stock companies.

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Regardless of the less rigorous regulation of capital maintenance with respect to LLCs, the company's assets must not be equalled with shareholder's assets. Any unilateral actions for the benefit of an individual shareholder are not allowed, despite being performed in debit of un-restricted categories of the capital. Therefore, the validity of such legal transactions requires an approval in the form of a unanimous shareholders' resolution. The rules on equal treatment of shareholders are of course not applicable in the case of LLCs with a sole shareholder.

It can be concluded that in relation to LLCs even loans with higher risk, loans with lower interest rate in comparison to the market interest rate, security without premium or other more favourable legal transactions are permitted under general corporate law subject to the following two conditions: (a) a company has enough available categories of non-restricted categories of capital, so there cannot be any interference with categories of restricted capital and (b) (in case of an LLC with at least two shareholders) shareholders approve such legal transaction with a unanimous shareholders' resolution. However, care should be had to not overlook any applicable concern law and insolvency law rules.

If the parties want to err on the side of caution, it is still recommendable that decisions about up-stream loans or security are accompanied by a prior balance sheet assessment as it was contemplated above with respect to the joint-stock companies.

**3. What is the impact of concern law rules (germ. *Konzernrecht*)?**

In the case of affiliated companies, provisions of concern law rules must also be considered. When considering the simultaneous application of concern law and capital maintenance rules, an initial distinction must be made between a factual concern (slo. *dejanski koncern*) and contractual concern (slo. *pogodbeni koncern*). Nevertheless, the financial assistance in its strictest meaning (i.e. prohibition of assistance of a joint-stock company in acquisition of its

own shares) also applies in the event of affiliated companies and is therefore not suspended with concern law rules.

In relation to a contractual concern, the CA sets forth that payments made by a company under the control agreement or the profit transfer agreement shall not constitute a violation of prohibition of return of equity contributions and capital maintenance. General rules on capital maintenance are suspended with the conclusion of control agreement itself. Hence, a controlled company should, on the basis of instructions by a controlling company, also grant detrimental up-stream loans, security or enter similar legal transactions, which do not correspond to capital maintenance rules as explained above. Such loans or security can be granted to a controlling company or to other group companies, albeit subject to the condition that a controlling company is able to reimburse the occurred loss.

The situation gets a tad trickier in instances of factual concerns, where the controlling company is in principle not allowed to give detrimental instructions to a controlled company, unless it compensates the controlled company for the loss occurred due to such instructions. If the loss is not compensated during the financial year, it is necessary to determine when and how the loss is going to be compensated, by no later than the end of the financial year in which the controlled company suffers the loss. The controlling company must establish a claim for compensation of loss (slo. *izravnalni zahtevek*) for the benefit of the controlled company. The described possibility to suspend the compensation for the induced loss is called the "concern privilege" and is a crucial concept for assessment of legal transactions between companies within factual concern.

Considering the absence of relevant provisions of the CA with respect to factual concerns, the relationship between capital maintenance rules and concern law rules is not yet clearly settled. Legal theory and the Higher court in Ljubljana[4] have indicated that regime pertaining to factual concerns represents *lex specialis* in comparison to general rules under the CA. This argumentation is certainly persuasive, since strict application of capital maintenance rules with respect to factual concern would eliminate the purpose of the concern privilege. In addition, it must be noted that the concern privilege only temporarily suspends the capital maintenance rules, as long as it is probable that the controlling company will compensate the detriment. On the other hand, there are also arguments in favour of absolute prevalence of capital maintenance rules, for instance the protection of the company's creditors.

[4] C.f. Decision of the Higher Court in Ljubljana ref. no. I Cpg 1436/2015 dated 30 August 2016.

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In any case, due to the absence of provisions regarding legal transactions between a controlling and controlled company in a factual concern, it is recommended to assess such transactions in the light of the probability of compensation of a detriment. If management of a controlled company, in accordance with business judgement rule, estimates that the successful compensation of detriment is not probable, such a transaction will likely violate the prohibition of return of capital contribution and capital maintenance rules.[5]

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**4. What to consider when thinking of financial assistance?**

Are concerned companies joint-stock companies or LLCs?

The form of incorporation is one of the most crucial points to consider, since this will affect the answer if financial assistance is even permitted and to what extent. Namely, in case of joint-stock companies, the parties will face a stricter approach to dealings between shareholders and the company in comparison to LLCs.

Appropriately drafted financial documentation

Regardless of the party's status, it is very important that a loan agreement, pertaining transaction security documents and other relevant documentation include adequate limitation language covering, amongst others, relevant capital maintenance and insolvency law rules.

Consideration of concern law rules

The decision for financial assistance within companies, which form a factual concern, cause additional obligations for both the controlling and controlled company, especially in the controlling company's duty to establish a claim for compensation of loss (slo. *izravnalni zahtevek*). The latter is usually established with a special compensation agreement, drafting of which requires close cooperation between the legal and financial advisors. Due to its complexity and lack of generally available precedents, such documentation is still widely overlooked in the Slovenian market even by legal advisors, despite the severe consequences for included companies as well for their management.

The devil lies in the multidisciplinarity

[5] Correspondent obligation of management of a controlled company is to prepare a dependency report (slo. *poročilo o odvisnosti*) within the first three months of a business year. In the report, the management must, among others, state all legal transactions with the controlling company and all information with respect to possible detriment and compensation for such detriment.

Financial assistance represents a rainbow of at least general corporate law, concern law rules and insolvency law rules. Each set of rules should be appropriately considered with legal and financial advisors in order to find the most optimal structure of the deal.

Author:
Jože Stare, Junior Associate





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