Corporate & Commercial

Share value guarantees are void (Supreme Court Judgment of 20 April 2023)

This paper analyses recent case law on the validity of share value guarantees (so-called "share price guarantees") from the point of view of the infringement of the prohibition of financial assistance.

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1. Factual circumstances

The Supreme Court (First Chamber) Judgment of 20 April 2023 has deemed void for breach of Art. 150 (prohibition of financial assistance) of the Spanish Companies Act (LSC) the agreement by virtue of which the company issuing the shares (capital increase of a listed company) undertakes in respect of the subscriber and within the framework of an investment agreement to:

- "compensate the difference in value to the investor in the event that the arithmetic mean of the daily prices of the 30 sessions immediately preceding the date on which the first anniversary of the date on which the shares were listed is less than €0.223. In such case, it shall pay within five (5) calendar days after such date the difference in value for each of the shares subscribed by the investor for the execution of the increase".

- Once the one-year period had expired, given that the average share price was 26% below the guaranteed value, the investor demanded payment of the agreed amount from the company (more than 700,000 euros). The company opposed this on the grounds that it was a void agreement, the fulfilment of which would

mean that the company would come under a case of prohibited financial assistance (Art. 150(1) LSC).

— The investor brought an action seeking a declaration that the clause was valid, that the defendant company had breached the agreement and, consequently, that it be ordered to pay the agreed amount plus statutory interest until payment was made. The claim was dismissed at all instances on the grounds that the agreement infringed the prohibition of financial assistance and, therefore, was void due to infringement of a mandatory rule whose enforcement could not be claimed in court (Art. 6(3) of the Spanish Civil code (CC) in connection with Art. 150(1) LSC).

2. Reasons in favour of the validity of the agreement

The claimant argued that the agreement is valid from the point of view of the prohibition of financial assistance on the basis of two considerations which constitute two separate grounds of appeal:

a) From an objective point of view, because the prohibition of financial assistance extends exclusively to guarantees securing the (principal) obligation to pay the price and in this case what is guaranteed is not the payment of the price (which was paid in full) but the value of the investment.

In fact, this argument is part of a broader one, which excludes financial assistance in respect of any act carried out by the company for any purpose other than to provide the shareholder with the funds necessary to carry out the acquisition of the shares, either directly (loan or advance) or indirectly (provision of guarantees).

b) From a subjective point of view, because the purpose of the agreement was not to facilitate investment, but to reward the investor's permanence in the company during the first year.

The issue has to do with the need to identify the so-called causal connection between the legal transaction of acquisition (or subscription) and the legal transaction of financing (the "for" of Art. 150(1) LSC), so that it can be stated that the financing (by the company) has been the determining reason for the acquisition itself. In this sense, scholarly writings had defended the full validity of share price guarantees, provided that they were ancillary.

3. The judicial response

3.1. *Basis and requirements of the prohibition of financial assistance.*

The Supreme Court posits that in our legal system the prohibition of financial assistance is maintained in its original terms and the Spanish legislator did not make use of the power offered by Directive 2006/28/EEC of 6 September to lighten this prohibition, without prejudice to the specific regulation for leveraged mergers in Art. 35 of the Spanish Conversions Act (LME). Thus, it is not possible to argue on the basis of the 2006 Directive.

It then points out that the purpose of the legal prohibition on financial assistance is "to avoid the risk of the acquisition of shares being financed out of the company's assets, since using the company's assets for the acquisition of shares

constitutes an anomalous use of those assets". The analysis of the internal structure of the prohibition of financial assistance makes it possible to highlight three essential elements or requirements:

> *a*) "an act or business of financing or 'financial assistance' by the company to or for the benefit of a third party (shareholder or not);
>
> *b*) an original or derivative acquisition of shares in the company providing the assistance (assisting person) by the third party (assisted person); and
>
> *c*) a teleological or causal link or relationship between the business or act of financial assistance and the acquisition because the purpose of that assistance is to favour or facilitate the acquisition".

As for the subject matter scope of the prohibited business or operations, the Court holds that there are three operations typified in the rule ("advance funds", "grant loans" and "provide guarantees") and a saving clause of an indeterminate nature that prohibits "providing any type of financial assistance", which "means sanctioning a numerus apertus criterion in this matter which, in principle, includes any act or business whose purpose is to finance, in the broad sense of the term, the acquisition of shares by a third party". In accordance with the legal doctrine of the Supreme Court, a case of prohibited financial assistance is constituted by:

> "any act the function of which is to finance the acquisition of the shares by a third party involving any actual or potential cost to the company, including all types of operations which, without constituting an advance of funds or the granting of loans or guarantees, have an equivalent economic-financial effect".

3.2. *Application to the case*

The Court acknowledges that the agreement reached between the parties is atypical, but that any agreement can be subsumed within the scope of the prohibition:

> "where by the assisting company guarantees or assures the shareholder or third party acquirer a certain financial return or value of the shares within a certain period of time. A variant of these agreements would be the granting by the company to the acquirer of an option to sell the shares for a price that ensures that return or value once the term in which the option can be exercised has expired. In this way, the acquirer can obtain the price agreed in the option while remaining immune to the risks of a fall in the value of the share on the market, which symmetrically means that it is the company itself that assumes the risk and, if applicable (if it materialises), the financial cost of the loss in value of the shares charged to its assets".

The agreement at issue infringes the prohibition because it involves an:

> "instrumental use of the company's assets in order to favour a

> third party in the acquisition of its shares, with the company assuming a contingent cost to or impairment of those assets (not actual, but potential at the time the agreement was entered into)".

In addition, the three characteristic elements of prohibited financial assistance are present:

a) an acquisition of shares (in reality, subscription to the capital increase);

b) the assisting company assumes a financial obligation as part of the services comprising the investment agreement (the obligation of financial compensation for the loss of value of the shares); and

c) there is a functional and teleological relationship (causal link) between the compensation obligation and the acquisition, so that the former constitutes an aid or financial benefit of the acquisition. This functional relationship (close relationship) is deduced from a threefold connection: temporal (all the obligations are entered into in a single act), financial (the compensation is set at the difference between the subscription price and the market value) and legal (everything is integrated in one and the same investment agreement).

The Court points out that, by virtue of such an agreement, the purchaser is exempted from the risk of a fall in the value of the shares and obtains a guaranteed return at the cost of passing on to the company the cost of any loss of value of the shares and, therefore, of that return. In so doing, the company assumes the cost of one of the risks inherent in the ownership of share capital, namely a fall in the share price, thereby committing its own assets, which are used, in the relevant part, for a purpose which is alien to it, namely to promote, facilitate or finance the acquisition of its own shares by a third party.

With regard to its legal nature, the Supreme Court considers that, rather than an "atypical guarantee" (as described by the Madrid Audiencia), the agreement constitutes a transaction for the attribution of assets that falls under the general or saving clause of Art. 150(1) LSC, which includes the prohibition of "all types" of financial assistance. By virtue of what was agreed, the company provided the investor with an asset advantage which, although it did not consist of an increase in value of the beneficiary's assets (through the addition of new rights or the extinction of an obligation), avoided a decrease in value of the assets (derived in this case from the loss of value of the shares). Thus, the fact that at the time the agreement was entered into, the company did not experience an outflow of funds, but only a contingent liability because the disbursement depended on the evolution of the share price, does not undermine the classification of the agreement as a case of prohibited financial assistance.

Lastly, as regards the personal element of the prohibition on financial

assistance, the question was settled at first instance: "by signing the compensation or guarantee agreement, the parties were pursuing a common cause: to ensure an uninterrupted return on the acquisition of the shares". It cannot be accepted that the purpose of the agreement was to guarantee the investor's permanence for one year because: "an exclusive reciprocal link between the value coverage agreement and the permanence commitment cannot be inferred". In conclusion, even if it can be said that this agreement 'partly' rewards the permanence commitment, its 'primary' purpose is to facilitate the acquisition of the shares corresponding to the agreed capital increase.

4. Conclusions for legal praxis.

1. The courts apply the prohibition of financial assistance not only to derivative acquisitions, but also to original acquisitions (capital increases). In support of this idea, it is recalled that Art. 158 LSC is systematically included in the regulation on treasury shares (Chapter VI of Title IV of the LSC).

2. It is not acceptable to interpret the current legal rules in accordance with the hermeneutics of the Directive as amended in 2006, since the Spanish legislature has not chosen to lighten the prohibition regime when it could have done so.

3. The prohibition of financial assistance does not only cover acts of assistance aimed at facilitating the acquirer in obtaining the resources necessary to fulfil the primary obligation of payment of the price (or of disbursement in the original acquisition), but may also extend to other financial inducements or advantages that facilitate or favour the acquisition and which should not be interpreted restrictively.

4. The prohibition of financial assistance does not only cover financing acts or operations (advance, loan, credit, discount or provision of guarantees) but also extends to any asset allocation agreements (donation) or even exchange agreements (sale and purchase) if they result in a financial loss (actual or potential) for the company. A share price guarantee falls within this type of allocation agreement, as it generates a contingent liability for the company that assumes the obligation to compensate and is prohibited because, according to case law, the purpose of the rule is precisely to protect the company's assets from any instrumental use aimed at favouring a third party in the acquisition of its shares.

5. In particular, asset allocation agreements that allow the acquirer of shares to ensure a return or value and be immune from the risks of loss or fall in that value, if the financial cost of the materialisation of that risk is borne by the company whose shares are acquired, are void. For these purposes, it makes no difference whether the agreement is instrumented by means of a put option to the company with a specific price or whether it is instrumented by means of an obligatory compensation agreement for the difference between the acquisition value and the assured return (as is the case in this ruling).

6. It makes no difference whether the company does not make a (direct or indirect) disposal of assets to the assisted third

party at the time of the acquisition (as is normally the case in a financing transaction). The important thing is to identify whether the acquirer is relieved of a risk that is symmetrically assumed by the company.

7. The fact that an agreement of this nature is not exclusively aimed at facilitating the acquisition (original or derivative), but has the concurrent purpose of facilitating the permanence of the shareholder does not exclude its voidance due to infringement of the legal prohibition. According to this ruling, only acts of assistance or financing in any of its forms whose purpose is unrelated (or at least not primary) to the acquisition of the shares are excluded from the prohibition.

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