New German Legislation on the Mandatory Subordination of Shareholder Loans

Introduction

Germany will be changing its laws on the subordination of shareholder loans. It is expected that the new regime will become effective as early as of 1 November 2008. The new regime does away with a web of complex rules found currently in various corporate laws and in case law. The new rules – which will form part of the German Insolvency Code (Insolvenzordnung) – comprise a bright-line-approach on (i) the incidence and the scope of the subordination and (ii) the conditions for a claw-back of payments on shareholder loans.

Rules – Old and New: The Basics

The Old Rules

Under the existing case law in Germany, loans made by a shareholder to a company with no personally liable individual will be deemed “equity replacing” if (i) the loan agreement has been entered into during a “financial crisis” of said company or (ii) the loans made have not been accelerated immediately after a “financial crisis” of the company has ensued. As a consequence, any payments on such subordinated shareholder loans are prohibited insofar and to the extent that the company’s net assets already do or would in consequence of such payment fall short of its stated capital. Any payments made in violation of the foregoing would be subject to the company’s claim for recovery (and trigger liability of the responsible managing directors towards the company) or a later claw-back by the insolvency administrator.

In an insolvency proceeding of the company, all shareholder loans then outstanding will – as a practical matter – be deemed “equity replacing” and thus no such loan may be recovered before full satisfaction of, inter alia, all claims of other creditors of the company. Moreover, any and all payments made on such a shareholder loan within a one-year period prior to filing for insolvency are subject to avoidance by the insolvency administrator.

The New Regime

Under the new rules, payments on shareholder loans outside insolvency proceedings of the company are generally permitted. However, the managing directors of the company may become obliged to reimburse the company for any payments made to a shareholder, if said payments necessarily led to the illiquidity of the company.

“...The new German regime governing the subordination of shareholder loans will provide more certainty as to the incidence and scope of the subordination."
company unless such an outcome was not conceivable for a managing director exercising due care.

Once insolvency proceedings over the company's assets have been formally opened, (i) shareholder loans will become automatically subordinated in payment to all other creditor's claims and (ii) any payments on the shareholder loan received within one year's time prior to the filing for commencement of insolvency proceedings will be subject to the insolvency administrator's claim for recovery.

The Main Changes and What Remains the Same
Under the new regime all shareholder loans are treated alike in terms of subordination in payment and claw-back-risk. It no longer matters whether the borrowing company was in a "financial crisis" when the loan was agreed to or not accelerated later on. Rather, (i) the shareholder loan will be subordinated in payment if an insolvency has formally opened and (ii) any payments on it will become subject to a claw-back if they were made within a one-year period prior to, or after, the filing for insolvency of the company. As under the old rules, it continues to be irrelevant in this respect whether the shareholder engaged in any kind of inequitable conduct towards the company or its creditors.

The safe havens from subordination- and claw-back-risk will remain basically the same: small shareholders and investors who acquire shares in an attempt to rescue the company will continue to be exempt from the rules governing the subordination and the claw-back of payments on shareholder loans (see further below).

What Constitutes a "Shareholder Loan"?

Any and all shareholder loans as well as claims of a shareholder against the company serving the same economic purposes as shareholder loans, will be treated as such. For example, any agreed deferral of payments by the company on shareholder claims will subject such company debt to the subordination regime.

Note: If a shareholder provided (gratuitously or for consideration) assets to a company for use (e.g. pursuant to a lease agreement), said assets may be precluded from being released to the shareholder for a period of up to one year following the commencement of the insolvency proceedings provided that these assets are significantly important for continuing the company's business. In this event, the shareholder is entitled to a consideration equaling the average payments made to the shareholder in a period of similar length prior to the company's insolvency.

Who "Qualifies" as a Shareholder?
The new regime applies to direct and indirect shareholders of the company as well as to persons who have an interest similar to those of a shareholder. Pursuant to case law, inter alia, the following persons are and will remain subject to the new regime: (i) sister companies, (ii) persons acting in their own name but on behalf of the shareholder, (iii) silent partners with a participation in the company's profits and/or taking a management role, (iv) usufructuaries (Nießbraucher) and (v) pledgees with rights enabling them to influence, similar to a shareholder, the business decisions of the company.
Note: The consequences of an assignment of shareholder loans to a non-shareholder and/or a change of shareholdings both within the one-year claw-back period are not dealt with within the framework of the new regime and are subject to evolving case law. One may expect, however, that in practice shareholder loans will most often be transferred together with the shares.

Which Companies are Affected?

The new regime applies to shareholder loans granted to (i) German limited liability companies (Gesellschaften mit beschränkter Haftung – “GmbH”), (ii) German stock corporations (Aktiengesellschaften – “AG”), (iii) German partnerships whose personally liable partners include entities with a liability limited to their share capital (e.g. a German limited partnership with a German limited liability company as general partner (“GmbH & Co. KG”)), and (iv) a German association limited by shares (Kommanditgesellschaft auf Aktien – “KGaA”). In addition, the regime extends to all other corporations with limited liability irrespective of their place and law of incorporation (e.g. the European company (societas europaea – “SE”)) and the limited company (“Ltd.”), provided, in each case, that such entities have their place of business and administration in Germany.

What Safe Havens are Available?

The already existing exemptions to the subordination of shareholder loans (i.e. small shareholders and the so-called restructuring privilege (Sanierungsprivileg)) continue to exist, albeit modified.

Small Shareholders

Loans granted by a shareholder not taking a managing role in the company and whose shareholdings (in terms of capital) do not exceed 10 percent of the company’s equity (and did not at the time the loan was agreed) will not be subordinated.

Note: Whereas in the past the threshold for stock corporations was substantially higher (25 percent), the new 10-percent-rule applies to all entities irrespective of their corporate form. Consequently, previously exempt shareholder loans owed by a stock corporation to a person or group of shareholders holding more than 10 percent of the shares will now be subject to the new provisions governing the subordination of shareholder loans.

Restructuring Privilege (“Sanierungsprivileg”)

If at a time when the company is either unable to pay its debts when they fall due (zahlungsunfähig), imminently illiquid (drohend zahlungsunfähig) or over-indebted (überschuldet) and a creditor acquires shares in the company for the purpose of its restructuring, the (existing and newly granted) loans of that creditor (who becomes, upon acquisition of the shares, a shareholder) will be privileged. Hence, such loans will not become subordinated even if the restructuring fails later on, provided, however, the restructuring was based upon a coherent concept. If after a successful and sustainable financial restructuring (nachhaltige Beseitigung der Krise) another, entirely new insolvency situation ensues, however, the restructuring privilege will no longer apply and the previously exempt loans will then be fully subjected to the new subordination regime.
How Will Collateral be Treated?

The insolvency administrator is entitled to avoid and claim any security interest granted by the borrowing company, provided that the collateral was granted to the shareholder within a 10-year period prior to the insolvency filing. The insolvency administrator may also oppose the enforcement of any such security. In both respects, however, certain exceptions apply – such as (i) for a lender who qualifies as small shareholder of the company, or (ii) under the so-called restructuring privilege (“Sanierungsprivileg”) (see above).

In case of a third-party loan secured by collateral granted by a company’s shareholder, the insolvency administrator is entitled to challenge any payment made by the company within one year prior to the filing for the commencement of insolvency proceedings. The only effect of such challenge is, however, that the shareholder has to reimburse the insolvent company for the payment made on the third-party loan. Said compensation, however, is capped at the value of the shareholder security when said payment was made or, in case of a guarantee of the shareholder, the amount thereof.

Do Shareholder Loans Matter in Determining Over-Indebtedness?

German law requires a company to file for insolvency if it is, inter alia, over-indebted (überschuldet). Over-indebtedness occurs when the company’s debts exceed the value of its assets being assessed by application of a special “insolvency-test”. Under the new regime, claims for the repayment of shareholder loans (and measures of equivalent economic effect) will not constitute debt for the purposes of determining whether the company is over-indebted or not, provided the loan (or its equivalent) is, by way of an agreement between the shareholder and the company, subordinated to all other third-party creditors’ debts relevant for such determination. It is not necessary, however, that said loan (or its equivalent) is ranked pari passu with the claims of the equity holders.

When Does the New Regime Become Effective? Will it be Retroactively Applied?

It is expected that the new regime will become effective as early as of 1 November 2008. It will apply to all shareholder loans subject to insolvency proceedings which formally open from then on. The old regime will continue to apply to all insolvency proceedings already opened.

Conclusion and Outlook

The new German regime governing the subordination of shareholder loans will provide more certainty as to the incidence and scope of the subordination. Unlike in the past, shareholder loans will only be automatically subordinated in cases where the insolvency proceedings over the assets of the company have been formally opened. In addition, a claw-back of any payments on shareholder loans is now generally limited to payments made within one year before the occurrence of the insolvency filing. Small shareholders and also investors who acquire shares in an attempt to rescue the company will continue to be exempt from the rules governing the subordination and the claw-back of payments on shareholder loans.
Under the old rules, an immediate acceleration after the incidence of a “financial crisis” provided – at least theoretically – for a further safe haven against subordination. In contrast, under the new laws, the shareholder loan (and security interest, if any) will be subject to subordination (and avoidance, respectively) unless it has been repaid more than one year prior to the filing for insolvency. It is doubtful, however, whether the abolition of this particular safe haven will give rise to incentives to postpone the insolvency filing until the one-year period has expired, as the voidance provision of the German Insolvency Code regarding fraudulent transfers will continue to apply.

Despite the modernization of the German laws on shareholder loans, some issues remain open which already gave rise to discussions in the past, e.g., when a third-party creditor will be deemed to be a (quasi-) shareholder. Answers to these and other questions of subordinating shareholder loans will continue to depend upon the specific facts of each single case/transaction.