Insolvency & Restructuring - Germany

Courts adopt clear position on subordination of shareholder loans

Contributed by Clifford Chance LLP

May 11 2012

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Introduction

Under German insolvency law, shareholder loans are generally subordinated in insolvency proceedings (unless certain exceptions apply). The claims of subordinated insolvency creditors have the lowest priority among all claims and are paid out only after the complete satisfaction of unsecured creditors.

Any repayments of shareholder loans before the insolvency are subject to potential challenges if they are made in the year prior to the filing for insolvency. The insolvency administrator or – in the absence of insolvency proceedings due to insufficiency of the insolvency estate – the creditors may claw back any repayment amounts paid by the company under a downstream loan to a shareholder within this one-year-period. In case of a secured shareholder loan, security will be subject to a claw-back right for a period of 10 years prior to the filing for insolvency.

The law governing the treatment of shareholder loans was amended by the Act for the Modernisation of Limited Liability Company Law and for the Prevention of Abuse, which entered into force on November 1 2008.

Previously, in cases where shareholders transferred their shares to an unrelated third party (without transferring the loan to such party), it was not entirely clear whether, and if so for how long, the former shareholder would still be subordinated to its claim, regardless of the transfer of shares. It was also questionable whether, and if so for how long, a loan would still remain tainted after it had been transferred to a third party. This question is not clearly addressed in the Insolvency Code and was therefore a point of controversy among German legal scholars. While the majority argued that the stigma of the shareholder loan should not exceed the one-year period, a minority suggested that the repayment of such claims should remain challengeable for a 10-year period. In order to avoid this potential risk, there is a general tendency in German M&A practice to transfer shares together with the shareholder loans to the purchaser of such shares.

Federal Court of Justice ruling

On November 15 2011 the Federal Court of Justice clarified this issue and concluded that a former shareholder will be subordinated to its claim under a loan only for a one-year period. Such a shareholder will thus be treated as a subordinated shareholder only if it ceased to be a shareholder within the year prior to the opening of insolvency proceedings or after the opening of such proceedings. The court held that in such cases the stigma of subordination should be limited to the foreseeable timeframe of one year.

This ruling has further clarified that the regime which existed before the Act for the Modernisation of Limited Liability Company Law and for the Prevention of Abuse entered into force no longer applies to shareholder loans granted before November 1 2008 (ie, the date on which the act took effect). Under the old regime, any loan granted by a shareholder to a German limited liability company (GmbH) was considered to be a so-called 'equity-replacing loan' if, at the time the loan was granted, the company was unable to obtain a third-party loan under standard market conditions due to financial difficulties and a prudent businessperson would rather have provided equity capital instead of granting a loan. In cases where a shareholder loan did qualify as an equity-replacing loan, the funds provided to the GmbH were subject to the capital maintenance rules and could not be redistributed to the shareholders, so that any repayment of such equity-replacing shareholder loan was strictly prohibited. The Federal Court of Justice has now ruled that this no longer applies, even if the loan was made under the old regime. However, the old regime will continue to apply for insolvency proceedings opened before November 1 2008.

Comment

The ruling has been widely accepted by German legal scholars and practitioners. However, some legal authors have criticised the ruling, since they think that it could create questionable incentives for delays in filings for insolvency in order to overcome the one-year period of subordination. Thus, they believe that the subordination period should be extended to 10 years.

Notwithstanding this minority view, there is no doubt that this ruling has brought a high degree of legal certainty regarding the treatment of former shareholder loans in German insolvency proceedings.

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