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KIRKLAND **ALERT**

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German Supreme Court Impedes Equity Sponsors from Steering their Portfolio Companies Clear of Bankruptcy

In an opinion issued in March 2015, the German Supreme Court significantly limited the ability of equity sponsors to receive payment of principal and interest on their loans to their distressed portfolio companies even before an insolvency proceeding has been filed.

Portfolio companies increasingly take recourse to debt capital provided directly by their equity sponsors, whether to address working capital concerns or in the context of a restructuring. In Germany, shareholder debt, even though automatically subordinated in any later insolvency proceeding filed by the portfolio company (subject to certain exceptions),[1] registers as a liability on the company's balance sheet, including for purposes of determining whether the company is "overindebted" — balance sheet insolvent — under German insolvency law. Occurrence of balance sheet insolvency, in turn, triggers a 21-day clock within which (and in any event, as soon as possible) a German company's directors must discontinue all other than necessary trading and file the company for insolvency or face civil and criminal fines and sanctions and potentially incarceration.[2]

To help keep shareholder debt from triggering an unwanted insolvency, sponsors often agree to deeply subordinate their loans to a level just above equity.[3] Until recently, the practice has been to subordinate them *only if* an insolvency proceeding were later commenced over the relevant portfolio company's assets and *only for the purposes of* that later insolvency proceeding. In an opinion issued in March 2015,[4] however, the German Supreme Court (*Bundesgerichtshof*, hereinafter, the "Supreme Court")[5] significantly limited the ability of equity sponsors to receive payment of principal and interest on their loans *even before* an insolvency proceeding has been filed, effectively requiring agreed-upon deep subordination of sponsor debt to apply prior to bankruptcy if its purpose is to relieve the company and its directors of bankruptcy filing obligations.

In the case at hand, a lender under a mezzanine financing had agreed in a prepetition arrangement that financing it had provided to the debtor would be subordinated on insolvency and that the lender could receive payments, if at all, only where the company had sufficient liquidity or where its available assets exceeded its liabilities. The lender received interest payments prior to the insolvency filing and the insolvency administrator sought to claw them back as a payment not made for reasonably equivalent value during the four years prior to the petition date and under principles of unjust enrichment.[6]

The Supreme Court found for the administrator, ruling that the payment had been made contrary to the terms of the parties' subordination agreement. In doing so, the court opined, in *dicta*, on whether the parties' agreement would have sufficed to neutralize any prepetition balance sheet insolvency on the part of the debtor. It held that it did (a) because it had subordinated the financing below all other subordinated claims, but more importantly, (b) because it had prohibited payments to the lender *even prior to* commencement of an insolvency proceeding other than from surplus assets. The court emphasized that without that key provision, which subordinated the debt not just in an insolvency proceeding but also prior thereto, the subordination agreement would not have fulfilled its intended purpose: preventing balance sheet insolvency and eliminating the directors' bankruptcy filing duties.

While the Supreme Court's statements were *dicta*, its ruling was much anticipated and comprises the court's first pronouncement on the issue since the 2008 amendments.

The Supreme Court's ruling contradicts the plain wording of the 2008 amendments to the Insolvency Code, which, by their terms, require subordination only "in an insolvency proceeding" (*im Insolvenzverfahren*) as a necessary prerequisite to counteract balance sheet insolvency (and directors' insolvency filing duties).[7] And while its statements were *dicta*, its ruling was much anticipated and comprises the court's first pronouncement on the issue since the 2008 amendments. The opinion therefore has considerable relevance for equity sponsors, their financially threatened portfolio companies, and corporate law and insolvency practitioners. In particular, in the future, these parties will need to ensure that agreements to subordinate shareholder debt permit payment of principal and interest only from an asset surplus.

The court left sponsors some leeway to structure their subordination arrangements to protect their shareholder debt investments, but the wording of the agreement is critical. To preserve its ability to continue to receive payments from the debtor even prior to an insolvency proceeding, the sponsor should condition the subordination of its loan claims on its portfolio company no longer having a going concern and, solely to the extent the going concern assumption no longer applies, cap the amount of debt subordinated to the level actually needed to negate balance sheet insolvency.[8] However, for those equity sponsors already parties to a subordination agreement that does not condition the trigger of the subordination provisions on the portfolio company's going concern assumption falling away, the Supreme Court's opinion unfortunately provides little margin for flexibility to amend it after balance sheet insolvency has occurred. Per the court, a subordination agreement is a contract for the benefit of a third party governed by Section 328 of the German Civil Code, thus, once the debtor's liabilities exceed its assets, if the subordination agreement does not already provide for a conditional trigger mechanism, its terms generally cannot be amended without consent of *all* other company creditors.

The Supreme Court's opinion demonstrates the legal minefield that equity sponsors of German portfolio companies must navigate when it comes to insolvency law matters. Sponsors must take care to balance the portfolio company's and its director's interests in avoiding the need to file for insolvency with sponsors' own interests in ensuring repayment of their debt investment. The Supreme Court's decision does not make those two aims mutually exclusive, but does create a new, and more difficult, regime for achieving them.

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1 Pursuant to Section 39, para. 1, Nr. 5 of the German Insolvency Code, loans to a German company by a (direct or indirect) shareholder holding more than 10 percent voting equity are subordinated to all other secured and unsecured claims in a German insolvency proceeding and also to the subordinated claims set forth in Nrs. 1-4 of Section 39, para. 1 (specifically, postpetition interest and penalties, costs incurred by creditors in the proceeding, statutory fines and claims for which no consideration was provided to the debtor).

Section 39, para. 4 provides an exception to automatic subordination of shareholder loans where, generally, the shareholder acquired its +10% equity stake for the purposes of rehabilitating its cash flow insolvent or nearly cash flow insolvent company. However, once the company is rehabilitated on a long-term basis (among other things, where it can obtain third-party financing in capital markets), the exception no longer applies. See Wittig FS K. Schmidt 2009 at 1743, 1758; Gehrlein, WM 2011 at 577, 584 et seq.; KPB-Preuß § 39 ¶ 53. If the company later encounters financial difficulty and is forced to file, the shareholder loans will be subordinated in any subsequent insolvency proceeding.

2 See e.g. § 15a, para. 4 & 5 InsO; §§ 43 & 64 GmbHG.

3 Prior to a 2008 corporate law reform, subordination agreements were required to subordinate the debt at issue to the level of equity in order for it to address existing balance sheet insolvency.

4 BGH Judgment 5 March 2015 – IX ZR 133/14.

5 The Bundesgerichtshof is the court of last resort for all criminal and civil law matters. It can be reversed by the German Constitutional Court (Bundesverfasungsgerichtshof), but solely as to constitutional law matters.

6 Section 134 of the German Insolvency Code permits claw back of payments made by the debtor in the four years prior to filing to the extent the debtor did not receive value. Section 812 of the German Civil Code permits recovery for unjust enrichment.

7 See Section 19, para. 2, sent. 2 InsO.

8 The relevance of the going concern qualification derives from the differing definitions of "balance sheet insolvency" for accounting and insolvency law purposes. Under Section 19 of the German Insolvency Code, a company is "balance sheet insolvent" and required to file for bankruptcy only if (a) its liabilities exceed its assets and (b) its going concern assumption is repudiated. Thus, sponsors would be well advised to ensure that their subordination obligations kick in only when needed (i.e., only where the company otherwise would have a filing obligation).

Management has an ongoing obligation to evaluate (i.e., using third party auditors or financial advisors) whether the going concern assumption still applies and, in the event of litigation, carries the burden of proof of showing that its continued application relieved it from its obligation to file the company for bankruptcy.

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

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