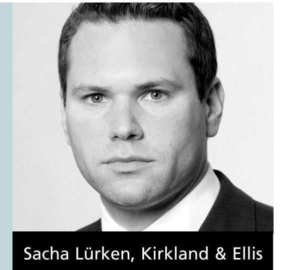
This article first appeared in the July 2007 issue of Global Turnaround

GLOBALTURNAROUND
The international magazine for company rescue and insolvency specialists

German law reform could halt migration


Sacha Lürken, Kirkland & Ellis

German legislators are proposing changes which could halt the practice of 'migration'. The technique used in Deutsche Nickel, Hans Brochier and Schefenacker, of migrating a German business to England to take advantage of more user-friendly insolvency laws, will become much more difficult under the German Draft Act on Modernisation of GmbH law (MoMiG).

Sacha Lürken of the Munich office of US law firm Kirkland & Ellis writes that few people outside Germany have picked up on the implications of the proposed changes. The extra-territorial approach taken by the Act's drafters means that even if a business does not have its COMI in Germany, it might still be forced to file for insolvency in Germany.

German corporate law is often seen as overly complicated and cumbersome by foreign investors. As a result, many German entrepreneurs make use of the possibility, after the European Court of Justice (ECJ) judgment regarding Inspire Art, to use alternative corporate forms, such as an English Limited (Private Company Limited by Shares).

This has been viewed with some suspicion by the German Government. On 25 May 2007 the Government presented its draft Act (MoMiG) on the modernisation of the German GmbH Act. The aim of the reform is twofold; to regulate the use of foreign companies in Germany and to make German companies more attractive.

The draft Act also addresses issues that have arisen in cross-border restructurings involving Germany recently. The MoMiG is expected to come into effect in the first half of 2008. It could still undergo extensive changes.

The draft Act's importance has already been recognised by the German legal community, where it is the subject of intense debate. The most significant of the envisaged changes are:

Duty for non-German companies to file for insolvency in Germany

There is a duty to file a petition for the opening of insolvency proceedings if the company is unable to pay its debt when due, or is balance sheet insolvent, in other words when liabilities exceed assets. Failure to comply with this is a criminal offence. The maximum penalty is three years of imprisonment.

Presently this is only imposed on directors of German corporations. Under the draft Act this will be extended to any kind of corporations and partnerships, as long as they don't have an individual as a general partner.

This expressly includes non-German companies, including an English plc, a US corporation or a Dutch BV.

An estimated 30,000 German businesses in recent years have opted for non-German corporate forms because of the strict three-week deadline for filing for insolvency covering German GmbHs and AGs. Many critics believed this was far too short a period in which to come up with a rescue plan and negotiate it with creditors.

That was one of the reasons why migrations became popular. Also, foreign companies which clearly had their centre of main interest (COMI) in Germany enjoyed this privilege, for instance Hans Brochier. The draft Act aims, according to its reasoning, to set aside this preference for these 'pseudo-foreign' companies.

The wording of the Act is not confined to this kind of company. This raises a further question; whether a director of a non-German company will also have to file for insolvency in Germany even in a case where a German insolvency court would most likely not open insolvency proceedings because the company has no COMI, or even assets, in Germany.

> The new rule makes migrations like Deutsche Nickel, Schefenacker and Hans Brochier more difficult. The mere 'conversion' to an English Limited may no longer set aside the duty to file for insolvency in Germany.

The new rule gives rise to a serious conflict of law issue. The continuation of trading by an over-indebted company may be legal in the jurisdiction of its incorporation, but illegal in Germany.

From the wording of the draft Act alone, a director would have to file even if a German insolvency court would most likely reject such a petition on grounds that no COMI exists in Germany.

A mere establishment in Germany will not suffice, as a debtor cannot file for secondary proceedings under German international insolvency law, except for cases to which the European Insolvency Regulation would apply.

This leaves the director to decide whether to file, in which case the company would also have to bear the court fees if the filing is rejected; or not to file, thereby facing possible litigation from creditors, or even criminal investigations by the public prosecutor.

Significantly, since the duty to file is now set out in the Insolvency Code (InsO), it would not apply if a company was already subject to main proceedings under the European Insolvency Regulation in another member state.

The duty to file for opening of insolvency proceedings will in future also rest with shareholders of a GmbH and members of the supervisory board of a stock corporation (Aktiengesellschaft, or AG) if the company has no managing director.

General equitable subordination of shareholder loans

The law of equitable subordination has long been a favourite playing ground for German lawyers. Foreign creditors have often looked with dismay at the overly complicated, unclear and cumbersone rules.

The MoMiG seeks to simplify these rules.

In future, shareholder loans shall generally be subordinated to claims of other creditors in German insolvency proceedings. This will also apply in German insolvency proceedings over a non-German company, such as an English Limited. Repayments on the principal of the loan will be subject to claw-back for a period of one year from the insolvency filing.

The existing exceptions for minority shareholders remain in place; however, the minority will be 10 per cent or less for all kinds of companies, whereas for an AG, the exception currently already applies if the shareholding is 25 per cent or less.

The so-called restructuring privilege, which exempts a shareholder loan from subordination if the shares are acquired in an attempt to restructure the company, shall in future only apply to share acquisitions during insolvency or imminent insolvency.

This will be a formidable disincentive for investors who seek to obtain shares when the company is already in financial trouble, but not yet insolvent.

It also clarifies that the subordination rule is an insolvency law. This sets aside the dispute that has arisen in European group insolvencies under the European Regulation, such as Collins & Aikman, whether secondary proceedings have to be commenced to make use of equitable subordination.

> The new rules disadvantage shareholders because their loans will in future be subordinated even without any reproachable behaviour.

The rules may also encourage forum shopping by creditors where large inter-company debts are concerned; in Germany they would be subordinated, whereas in the UK for instance they would not be subordinated. The one year claw-back period may even result in delays of insolvency filings.

In COMI filings over German GmbHs in the future, it will be required to file, if possible, for secondary proceedings in Germany in order to make use of these rules.

Increased liability for GmbH directors for payments that cause insolvency

One of the other new rules that is regarded as highly detrimental to restructurings is that managing directors will be liable for payments to shareholders which "directly" cause the insolvency of the GmbH.
The draft Act states that this new rule shall be an "approach to the solvency test", without giving further details how such a solvency test will have to be performed. As this new rule is in addition to other rules limiting upstream benefits, managing directors may face new conflicts of interests between the instruction from a shareholder, for instance to pay out a dividend, and their duty to refrain from payments that can cause insolvency.

Upstream benefits

The new draft Act addresses upstream benefits, in particular upstream loans, that can lead to the GmbH’s assets falling below the value of its registered share capital. Whereas recent case law was prone to the assumption that any upstream benefit could lead to a reduction of the assets if a recourse (in case of upstream security) or repayment (in case of upstream loans) claim existed, the draft Act emphasises that a recourse or repayment claim can be set-off against the upstream benefit if it is fully recoverable under applicable accounting principles.

This shall also apply to an AG, which under current law would not be permitted to make any upstream benefits at all. This made LBOs very difficult where the target was an AG.

> There is a poison pill in the comments of the draft that says that claims against a company which is a mere acquisition vehicle can not be regarded as fully recoverable.

One might be able to take this as a hint that upstream security in LBO structures might still be problematic. The draft also clarifies that upstream benefits by a GmbH to the other party of a profit and loss pooling agreement, usually the shareholder, will not be considered as unlawful distributions.

Good faith acquisition of GmbH shares

Under the current law it is not possible for a prospective buyer of GmbH shares to rely on the commercial register or other documents to ensure that he acquires title in the shares from the real shareholder, and there is no good faith acquisition of shares from the registered owner.

In an acquisition of a distressed company this often led to significant due diligence efforts to verify the title chain, as the seller either was not willing to give a title warranty or such warranty would have been worthless due to the distressed state of the seller.

Under the draft Act, shares can be acquired in good faith if the seller has been registered in the shareholders’ list filed with the commercial register for more than three years without an objection. However, there are exceptions which will render the good faith acquisition possibility virtually useless. In addition, there is still no public registry for security interest in shares of companies. As a result, there will still be significant uncertainty if the acquired shares are owned by the seller and free of security interests.

GmbH can have COMI outside of Germany

The new law expressly allows for a GmbH to have its COMI outside Germany. Its registered office must still be in Germany. This means that in a COMI filing, following the ECJ’s Eurofood ruling, the presumption that a GmbH's COMI is where its registered offices are, will still have to be rebutted.

Minimum share capital slashed; The ‘One Euro GmbH’

If you want to form a GmbH in Germany there is a minimum capital requirement of 25,000 euro. In England by contrast you only need a symbolic UK£1.00 (1.49 euro) to set up a ‘limited’.

The Act proposes cutting the German minimum share capital requirement from 25,000 euro to 10,000 euro.

Further, it will be possible to incorporate a limited company with a lower share capital, down to a minimum 1 euro. The name of such a limited will not be "GmbH" but "Unternehmergesellschaft (haftungsbeschränkt)", translated literally as business corporation (limited).

Unfortunately there is no agreed abbreviation of this new corporate form yet.

Other than its share capital requirement, it will have the same legal features as a GmbH, in particular the far-reaching competencies of its shareholders meeting.

As compensation for the waiver of the minimum capital requirement, the new corporate form will be obliged to accrue at least one quarter of its annual profits in its reserves on its balance sheets until the 10,000 euro minimum share capital has been reached.

Conclusion

The new law, if it is enacted in the form of the draft, will certainly have an impact on the restructuring and LBO world in Germany.

In particular, the extension of the insolvency filing duty to non-German companies may make migrations more difficult. It raises as many questions as it answers. For instance, will directors of a foreign company have to file for insolvency in Germany even if they are permitted to continue trading under their domestic laws?

The new duty on managing directors to refrain from payments to shareholders that cause insolvency will encourage German managing directors to be even more cautious.

On the other hand, LBOs involving upstream security might become easier. The provisions found in financing documents limiting the enforceability of upstream or cross-collateral will therefore probably change as soon as the draft Act has become effective.