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KIRKLANDPEN
Private Equity Newsletter

May 20, 2015

Recent Decision Increases Risks of Using a Shareholder Loan to Finance German Portfolio Companies

PENpoints

A recent German Supreme Court decision will change structure of shareholder loans to German company.

A private equity sponsor with a direct or indirect investment in a German company should take note of a recent German Supreme Court decision affecting the treatment of shareholder loans in German insolvency proceedings. This decision upends previously common methods for subordinating a shareholder loan to comply with German insolvency law.

Background

Under German insolvency law, when (1) a company becomes "overindebted," or balance sheet insolvent,[1] and (2) company management (ideally, as advised by third-party accountants) repudiates their assumption that the company is a "going concern," the company's directors must, as soon as possible but in any event within 21 days, discontinue all unnecessary trading and file for insolvency or face civil and criminal fines, sanctions, and potentially incarceration. A shareholder loan is counted as debt for purposes of determining whether the company is balance sheet insolvent unless the shareholder has agreed in advance to subordinate its loan to a level just above equity.

When making a loan to a German company, a shareholder has often entered into a subordination agreement to help keep its loan from triggering an unwanted insolvency and while allowing the shareholder to receive principal and interest payments on a current basis until the company commenced insolvency proceedings. Prior to the recent German Supreme Court decision, that agreement would subordinate the loan and block all loan payments *only if* the German company became subject to a later insolvency proceeding and *only for the purposes of* that later insolvency proceeding.

In the recent case, however, the court limited the ability of an equity sponsor to receive payment of principal and interest on its shareholder loans *even before* an insolvency proceeding has been filed, effectively requiring, *from the outset*, agreed-upon, deep subordination of shareholder debt.

Consequences

In order to comply with the German Supreme Court decision, a shareholder making a new loan to a German company should continue to enter into a subordination agreement at the outset, but to preserve its ability to receive payments on the loan, such agreement should (1) permit payment of principal and interest *only* from an "asset surplus," (2) condition subordination and payment blockage on repudiation of the company's going concern assumption, and (3) if the going concern assumption has been repudiated, subordinate only an amount of the shareholder loan necessary to avoid balance sheet insolvency.

An existing shareholder loan subordination agreement that does not satisfy these conditions should be amended accordingly, with one very important caveat: such an agreement should not be changed if the company is already balance sheet insolvent. Under German insolvency law, a subordination agreement is a contract for the benefit of a third party, so that once the debtor is balance sheet insolvent, its terms generally cannot be amended without consent of *all* of the company's other creditors.

The German Supreme Court's opinion demonstrates the legal minefield that an equity sponsor with a German company in its portfolio must navigate when it comes to insolvency. The decision does not make it impossible to balance a sponsor's interest in seeing a shareholder loan repaid against the interest of the company and its directors to avoid insolvency, but it does create a new, and more difficult, regime for achieving such balance.

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1 Under German law, balance sheet insolvency is determined using the liquidation value of the company's assets and liabilities (including contingent liabilities).

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

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PLI Delaware Law Developments 2015: What All Business Lawyers Need to Know
New York, NY
June 4, 2015

The top Delaware corporate law experts from the Delaware judiciary, leading law firms and corporations, and academia will examine the latest case law and practical trends and share their real-world experiences, insights and advice on the issues of greatest concern to the corporate/securities legal community. Kirkland partner Yosef Riemer will discuss key issues in appraisal cases. Click here for more information.

Deal Dynamics
Chicago, IL
June 23, 2015

Kirkland & Ellis and Major, Lindsey & Africa are hosting a breakfast CLE discussion for general counsel and M&A and securities counsel from the greater-Chicagoland area to highlight certain challenges and opportunities in the acquisition and integration of private targets by public companies. Kirkland partners Kevin Morris and John Lausch will participate in the panel discussion. Click here for more information.

Structuring and Negotiating LBOs
San Francisco, CA
September 10, 2015
New York, NY
September 24, 2015
Chicago, IL
October 1, 2015

This biennial event, chaired by Kirkland partner Jack Levin, focuses on the legal, tax, structuring and practical negotiating aspects of buyouts and other complex private equity deal-doing. More information to follow.

PLI Hot Topics in Mergers & Acquisitions 2015
Chicago, IL
September 16, 2015
New York, NY
October 2, 2015

An expert faculty of lawyers, general counsel, regulators and investment bankers will explore the state of M&A and trends for the year ahead. Kirkland partners Scott Falk and Sarkis Jebejian are co-chairs of the event. Click here for more information.

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Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012, 2013 and 2014 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. Kirkland was named "Law Firm of the Year in Mergers and Acquisitions Law" by U.S. News Media Group and Best Lawyers in its 2014 "Best Law Firms" rankings. The Firm was named "Best M&A Firm" at *World Finance*'s 2014 Legal Awards, "North American Law Firm of the Year: Fund Formation" and "North American Law Firm of the Year: Transactions" at *Private Equity International*'s 2014 Private Equity International Awards and "Private Equity Deal of the Year" at the 2014 IFLR Americas Awards.

In 2012, 2013 and 2014, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011, 2012, 2013* and *2014*, and has consistently received top rankings among law firms in Private Equity by The Legal 500 and IFLR, among others.

The Lawyer has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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