Closed for business, but not for paying up: German courts have ruled that capital maintenance provisions in upstream guarantees do not apply to German limited liability companies undergoing insolvency proceedings.

Quo vadis capital maintenance?

Courts set aside limitation language for upstream guarantees in insolvency

By Dr. Birgit Friedl and Dr. Marcus Geiss

The Higher District Court of Frankfurt recently upheld a ruling of the District Court of Darmstadt restricting the scope of protection against capital impairment accorded to German limited liability companies (GmbHs): The courts argued that the prohibition to repay registered share capital to shareholders does not apply in situations when insolvency proceedings have been opened over the assets of a German limited liability company.

While the decision has not yet become fully effective as further remedies are still being pursued by the guarantor in the case, the ruling will likely impact negotiations between financing banks, borrowers and the managing directors of German limited liability companies in financing transactions in which German subsidiaries grant upstream collateral for shareholder debt.

The principle of capital maintenance

In financing transactions it has long been customary to restrict the enforcement of upstream guarantees or collateral to the detriment of financing banks. This is due to one of the peculiarities of German corporate law and its strong emphasis on the principle of capital maintenance *(Kapitalerhaltung)* pursuant to Sections 30 and 31 of the German Limited Liability Companies Act. These provisions prohibit the repayment of registered →

share capital by the respective GmbH to its shareholders. As the amount of registered share capital is recorded in the publicly accessible commercial register, creditors of German GmbHs can in principle rely on the fact that any GmbH will, based on a balance sheet assessment, have assets to cover such registered share capital figures or, if assets have been used up in the course of an entity's business activities, they at least have not been repaid or upstreamed to shareholders.

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The German principle of capital maintenance can lead to frictions, particularly in the context of larger international financings

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In order to sanction any undue repayment of share capital, the managing directors of German corporations face personal liability when they effect or authorize the repayment of registered share capital in contravention of these strict principles.

In particular in the context of larger international financings, these principles can lead to frictions. The interests of the financing banks and the borrowing parent shareholders, on the one hand, collide with the legal obligations of the management of the German subsidiaries, on the other hand, who are regularly being asked to support the parent loan by providing upstream guarantees and/or other forms of upstream securities like global assignments, pledges or real estate securities. The fact that the subsidiary might be asked to repay or secure the parent's debt directly vis-à-vis the bank when the parent itself defaults on its repayment obligations is structurally the economic equivalent of upstreaming funds to the parent, who then repays the bank. This can also result in a prohibited repayment of the registered share capital. In order to mitigate the risk of personal liability, German management therefore has to insist on certain contractual safeguards, so-called limitation language, in German security agreements before granting any form of upstream security. In essence, this language provides that any future enforcement of upstream guarantees or security is restricted to those assets that can be used without infringing against due maintenance of the registered share capital figure. In addition, such clauses often include the specifics of how the free assets available for enforcement →

are calculated and which balance sheet position can be disregarded, particularly in cases in which the securing German subsidiary directly benefits from the loan granted to the parent. From the bank's perspective, such limitation language may considerably reduce the value of the guarantee or collateral.

The ruling

The District Court of Darmstadt (*Landgericht* Darmstadt, AZ 16 O 195/12) and, on appeal, the Higher District Court of Frankfurt (*Oberlandesgericht* Frankfurt am Main, AZ 24 U 80/13) have recently become the first German courts to deal with the effects and effectiveness of such limitation language clauses. In this particular case, the borrower defaulted under the loan and the bank in turn proceeded against the subsidiary under an upstream guarantee that contained limitation language to protect the registered share capital of the guarantor. The specific question the courts were faced with was whether such limitation language still applied and protected the registered share capital against the bank's enforcement claims even after both the borrowing parent and the guaranteeing subsidiary had fallen into insolvency.

When dealing with the effectiveness of limitation language at the stage of the guarantor's insolvency, both courts approached the issue by determining the purpose of such limitation language first. Rather than basing their analysis predominantly on the interests of the company's creditors at large in preserving the registered share capital figure as a liability fund for all creditors, the courts held that the main purpose of such limitation language is to protect the managing director against the risk of personal liability inherent in granting security for a debt of the parent and shareholder. The courts then decided that this protective purpose no longer applies in insolvency proceedings because at this stage the managing directors have already been replaced by the insolvency administrator. In other words, the limitation language served its initial purpose of protecting the managing directors of the guarantor for as long as they were in office. As soon as they are replaced due to the initiation of insolvency, the courts concluded, the limitation language is no longer necessary to protect them. It thus no longer applies in insolvency. The bank's claim for the guaranteed sum is no longer limited to free assets only but now covers all of the debtor's assets (including those previously required and blocked to cover the sum of the registered share capital under a balance-sheet-based assessment).

This interpretation is reinforced by the courts' additional auxiliary argument that the registered share capital is regularly used up in insolvency, anyway. Therefore, the protective layer for creditors accorded by the principle of capital maintenance no longer exists.

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This decision means that the scope of the assets available to the bank for satisfaction of its claims is—from a legal perspective—more extensive in insolvency than it was while the guarantor was still trading. While guarantees in insolvency only give the banks an unsecured claim that has no structural priority over other third-party creditors and is settled from the regular insolvency quota alongside other third-party creditors, outside insolvency, the claim under the guarantee would be restricted to the amount by which the net assets of the GmbH exceed the registered share capital.

While the facts of the decided case only concerned an upstream guarantee, meaning they did not deal with *in rem* or other genuine upstream securities, it is notable that the reasons of the courts appear to be deliberately abstract and broad enough to cover any type of upstream collateral. The effect of this judgment is even more far-reaching when applied to genuine upstream securities such as global assignments or land charges. Such *in rem* securities give the beneficiary bank a secured priority claim and right to preferred satisfaction in insolvency. If they are indeed untouched by the limitation language in insolvency, this would result in a situation in which the lending banks will be entitled to enforce and satisfy their claims without any regard to capital maintenance rules in preference to other third-party creditors.

Practical implications for lenders and grantors of subsidiary security

Until further guidance by future court decisions or by the Federal Supreme Court (if this decision is successfully revisited on further appeal), it can be expected that banks will revise the wording of the limitation language they are willing to accept from borrowers or their subsidiaries in such a way as to expressly state that the limitations under capital maintenance rules only apply and limit the pre-insolvency enforcement by the –>

lenders, but exclude their applicability in insolvency both for guarantees and all other types of upstream security.

The courts further ruled that the limitation language also does not apply as long as the subsidiary has received any unrepaid loan from the parent rather than just and specifically (part of) the bank loan in question because such loans serve as compensation for the granting of securities. In the case at hand, the borrower-shareholder and the guaranteeing subsidiary were engaged in extensive intercompany lending. The shareholder had initially passed on a tranche of the specific bank loan to the guarantor. In the intervening years, however, the subsidiary had likely repaid this specific tranche to the shareholder but reborrowed unrelated funds under a cash-pool system. In practical terms, this will either result in a further qualitative narrowing of the scope of applicability for the limitation language as many groups of undertakings will operate downstream loans in the context of cash-pool systems even if the secured loan as such is reserved exclusively for the parent-borrower level and not on-lent, or will result in the borrower having to reformulate the limitation language in the negotiations with banks to only exempt specifically on-lent funds from the limitation.

From a bank's perspective, the court's view will be a very welcome one. For years, banks have reluctantly accepted limitation language as an inevitable, but bothersome restriction necessary to allow managing directors to safely enter into upstream securities. On the other hand, they have always argued that such language often bites hardest in the very scenario for which such security is granted, the financial breakdown of the borrowing shareholder that leaves the lending bank looking for alternative payers. If the decision of the Higher District Court of Frankfurt becomes unappealable, this argument at least no longer applies once such financial distress reaches the stage at which the guarantor/security grantor itself has entered insolvency because banks are then freed from the shackles of capital maintenance and the corresponding limitation language.

For managing directors, the decision means that the scope of the limitation language may need to be revised in future negotiations to reflect the key conclusions of the judgment.

Outlook

The legal community as such will be left to assess whether some of the more general points in the judgment really have the broad applicability the courts have seemed to have given them. Without going into the finer details, it is, for instance, not true that managing directors are generally replaced in insolvency proceedings. There are insolvency proceedings where the management stays in charge of the debtor during insolvency, for example in protective shields proceedings (*Schutzschirmverfahren*) and own administration proceedings (*Eigenverwaltung*). It is debatable whether the court's reasoning justifies that the limitation language would also automatically cease to apply in such proceedings. Similarly, the argument that the registered share capital is regularly used up in insolvency anyway, thus removing most of the purpose of the limitation language, is not always and automatically sound if insolvency proceedings are initiated not based on over-indebtedness but rather purely due to illiquidity where significant illiquid assets may exist from a balance-sheet perspective. As such, it will be interesting to see how this judgment will affect future negotiations between lenders and borrowers in this sensitive area between general German corporate law and international financing law and legal principles. <–

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