Substantial Changes with Respect to German Corporate Law Imminent

BY DR. CHRISTOPHER WOLFF AND DR. CHRISTIAN HALASZ

The German legislature intends to enact the statute for the modernization of the limited liability company law and for the combat of misuse ("MoMIG") coming into effect presumably as of November 1, 2008. MoMIG was passed by the Bundestag on June 26, 2008 but is still waiting final approval by the Bundesrat. It contains changes to the German Liability Company Act ("GmbHG") and the German Insolvency Code ("InsO").

MoMIG is meant to modernize and deregulate the German Limited Liability Company Law, provide protection against misuse, especially regarding liquidation and insolvency of the GmbH, and promote the GmbH as an internationally competitive legal form. Additionally, MoMIG applies to certain German Federal Supreme Court decisions that have been the subject of extensive discussions in recent years. One of the most prominent changes in German corporate law regarding MoMIG will be the abolition of all regulations with respect to equity replacing loans and services. MoMIG will primarily affect entities that may become subject to German insolvency proceedings (i.e., entities with centre of main interest in Germany, including UK LLPs or Ltds).

The major expected changes in German corporate law resulting from MoMIG are the following:

1) Cash Pooling and Upstream/ Sidestream Loans/Securities

The extensive interpretation of the capital maintenance rules by the German Federal Supreme Court in the recent past caused fierce discussions concerning the legitimacy of upstream/sidestream loans/securities. Especially in connection with LBO-financings and cash pooling, within a group this extensive interpretation caused a lot of uncertainty and clear guidance was a scarce resource. MoMIG appears to ease these concerns by clarifying that (i) an upstream intercompany loan granted by a German GmbH is permitted (no breach of Section 30 para. 1 GmbHG-E) if the repayment claim against the intercompany borrower covers the amount granted under the loan and can be valued at par (voll werthaltig) at the time of the granting of the loan and (ii) the relevant capital maintenance rules do not apply to the extent that a valid domination agreement (Beherrschungsvertrag) and/or profit and loss transfer agreement (Gewinnabfuhrungsvertrag) exists.

2) Deregulation of the Rules Concerning Equity Replacing Loans

Abolition of Equity Replacement Rule

The current principles and provisions with respect to equity replacing loans and services (Eigenkapitalersetzende Leistungen) shall be
abolished. A mandatory subordination of all shareholder loans shall apply exclusively in connection with insolvency proceedings (irrespective of whether the shareholder loan was granted in times of a financial crisis of the company or existing termination rights with respect to the shareholder loan have been waived). Loans granted by third parties behaving like shareholders will also be treated as shareholder loans (Section 39 para. 1 no. 5 InsO-E). Any repayment of a shareholder loan during the last year prior to a filing for insolvency is subject to revocation by the insolvency administrator (i.e. the shareholder has to pay back the amount received from the company to the insolvency administrator). However, contrary to the outdated concept of equity replacement, a repayment of a shareholder loan does not constitute a breach of German corporate law (Section 135 para. 1 no. 2 InsO-E and Section 30 para. 1 GmbH-E).

No Statutory Subordination of Loans in Over Indebtedness Balance Sheet (Überschuldungsbilanz)

An initially proposed change that calls for an automatic subordination of shareholder loans in connection with the over indebtedness balance sheet was not incorporated in the latest draft of the law. By contrast, the new regime does require a qualified subordination declaration (qualifizierte Rangrücktritt) of the shareholder if the loan shall not be taken into account in the assessment of the company’s over indebtedness status (Section 19 para. 2 InsO-E and Section 30 para. 1 GmbH-E).

Exemptions from Equity Replacement Rules Survived

Former exemptions from the equity replacement rules have survived and are now available for the non-qualification as shareholder loans, i.e., (i) loans granted by shareholders holding less than a 10% interest in shares of the respective company shall be exempt from the aforementioned revocation provisions and (ii) the restructuring privilege has been retained as exemption, with the logical consistent change that the exemption ends upon the occurrence of a sustainable and successful restructuring (Section 39 para. 4 InsO-E). The new legislation specifies that these exemptions apply to any legal form (Section 39 para. 3 InsO-E).

Duty of Creditor to Primarily Enforce Shareholder Collateral

The creditor who has been granted a security by a shareholder is required to enforce the respective security first, i.e., the creditor cannot choose between claiming repayment from the company as debtor and enforcing the security granted by the shareholder. Only if the creditor is not satisfied upon the sale of the collateral granted by the shareholder, he would be entitled to seek payment from the debtor in the insolvency proceedings (Section 44a InsO-E). Such a claim, however, would be subordinated (Section 39 para. 1 no. 5 InsO-E). Internally (this remains unchanged under MoMIG), the security granting shareholder has to reimburse the insolvent company for any amount paid by the company to the creditor (Section 143 InsO-E).

3) Deregulation of the Rules Concerning Hidden Contributions in Kind (verdeckte Sacheinlagen)

The current principles concerning hidden contributions in kind (i.e., cash contributions which under certain circumstances have to be qualified as contributions in kind) will be deregulated. In the future, a hidden contribution in kind can be set off (after the share capital increase is registered) against the existing cash contribution obligation of the shareholder in such an amount which corresponds to the value of the contributed asset (Section 19 para. 4 GmbHG-E). The burden of proof for the value of the asset lies with the shareholder and hence the shareholder will be liable (only) for the remaining amount. Contrary to the current applicable principles for hidden contributions in
kind, the shareholder does not bear the risk of paying his contribution twice.

4) Possibility of Bona Fide Acquisition of Shares in German Limited Liability Companies

Bona Fide Acquisition

MoMIG provides for the possibility of a bona fide acquisition of shares in a German GmbH (Section 16 para. 3 GmbHG-E). The basis for such bona fide acquisition (i.e., the acquisition of shares from a person/entity having no valid title to such shares) will be the shareholder list filed with the commercial register. A bona fide acquisition of shares in a German GmbH requires that the assignor of the shares has been listed in the shareholder list for a period of three years and the commercial register contains no objection to such listing. Furthermore, a bona fide acquisition shall also be possible if assignor/seller has been listed in the shareholder list for less than three years and if such inaccuracy is attributable to an action or omission of the entitled legal owner of the transferred shares.

Voting Rights/Dividends

A further substantial change will be that exclusive persons listed in the shareholder list will be entitled to (i) exercise voting rights and (ii) receive dividend payments.

5) Liability of Managing Directors and Shareholders of a GmbH/Supervisory Board Members of a Stock Corporation (AG)

Managing Director Liability

According to Section 64 sent. 3 GmbHG-E, a managing director completing payments from the GmbH to its shareholders could (in addition to his remaining other liability) be held personally liable if such payments cause the illiquidity of the GmbH.

Shareholders'/Members' of Supervisory Board Liability

In cases where a GmbH/AG has to apply for insolvency proceedings and is without legal representation (führungslos), i.e., has no managing director (GmbH) or management board member (AG), each shareholder (GmbH) or each supervisory board member (AG), as the case may be, who has knowledge of both facts, has the duty to file for insolvency proceedings.

6) "GmbH light" – No Minimum Registered Share Capital

GmbH light

MoMIG introduces "Section 5 GmbHG-E" a new type of GmbH, the so-called "Entrepreneur's Company" (Unternehmergeellschaft) (haftungsbeschränkt). Such "Entrepreneur's Company" is not a new legal form, but rather a GmbH without the minimum registered share capital of € 25,000. This easement in terms of the registered share capital stands vis-à-vis certain limitations concerning the profit distribution in an "Entrepreneur's Company" only 75% of the annual profits can be distributed and at least 25% of the annual profits are to be retained and booked as statutory reserve. The limitation of the distribution of profits applies until a registered share capital of € 25,000 has been created.

Authorized Capital

In Section 55a GmbHG-E, MoMiG also created the possibility for the GmbH to register an authorized capital (similar to the provisions for the AG) which can be used by the managing directors without any further shareholders' resolution.

7) Administrative Seat Outside Germany

Pursuant to MoMIG, the registered and the administrative seat of a GmbH may be based in different locations. Consequently, a GmbH is now able to maintain its administrative seat outside Germany.
If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Frankfurt am Main

Dr. Christopher Wolff
49.69.90.748.5113
christopherwolff@paulhastings.com

Dr. Christian Halasz
49.69.90.748.5118
christianhalasz@paulhastings.com