Cash Pooling after the Reform of the German Act on Limited Liability Companies (GmbHG)

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On 1st November 2008 the "Law to Modernise the Law Governing Private Limited Companies [GmbH] and to Combat Abuse" (MoMiG) entered into force. The new law has brought about considerable changes, especially in the area of raising and maintenance of capital for German private limited companies, thereby making German corporate law currently undergo the most significant changes for decades. The MoMiG has also changed provisions of the German Insolvency Act considerably.

This article aims at providing an outline of the implications of the new law on cash pooling systems providing for a transfer of cash from the various bank accounts involved (zero balancing cash pooling). The alterations of the law outlined below do not have an impact on cash pooling systems that do not provide for a zero balancing of accounts involved (notional cash pooling). Section I. will provide a cursory overview of the changes to the rules on capital raising of the GmbH and on the increase in share capital. Section II outlines the new legal framework under the revised German Corporate Law with particular attention to the new rules on capital maintenance as imposed by the MoMiG. Section III. subsequently outlines the legal framework concerning downstream loans in a cash pool under the revised German Insolvency Law.

I.
Raising and Increase of the Company's Share Capital and Cash Pooling

Capital raising as well as the increase of share capital – if conducted in a limited company that was intended to join a cash pooling system or that was already member in a cash pool – was seriously problematic under the old rules.

<u>Legal Situation in Germany before the MoMiG</u>
So far, German rules of capitalisation and capital maintenance have been exceptionally strict, the reason for this being, that German Law intended to guarantee that the company actually and finally obtained its capital, having whatever was owed at its disposal. The rules of German company law allowed to capitalise a GmbH both by providing the company's share capital in cash or in kind by placing "real assets" at the company's disposal, the latter including receivables against third parties or against a shareholder.

However, if a shareholder wanted to provide his company with real assets rather than cash, German law required him to obey to strict rules in order to assure that the assets left to the company actually met their declared value. The fact that assets rather than cash were contributed had to be expressly declared *(Sachgründungsbericht)* and the shareholder had to make available to the commercial register a valuation report proving that the assets met their declared value. In case of an incorporation by asset contribution, the assets transferred to the GmbH had to be described in the articles of association. These requirements were perceived as being too costly and time-consuming and as sometimes directly interfering with the company's secrecy and confidentiality interests. Furthermore, capital paid to the company could not later be repaid as a loan granted to the shareholder.

However, the obvious reaction to capitalise the company with cash first and to subsequently buy the assets from the shareholder did not present an option, because German courts considered this to be an avoidance of the rules on the raising of capital (hidden contribution in kind – *verdeckte Sacheinlage*) and severely punished such arrangements. The cash payment of the shareholder did not discharge him of his initial obligation, the claim of the company still continued to exist. In case of a subsequent purchase transaction between company and shareholder concerning the assets that were initially meant to be brought into the company, this latter contract, was held to be null and void, leading to enormous problems in unwinding the contract and restoring the parties to the positions they had before. Similar results occurred where the cash provided by the shareholder was later repaid, thus leaving the company with a claim against the shareholder rather than with the money itself.

In the context of cash pooling systems, the implications outlined above gave rise to particular problems. If the parent company established a new subsidiary in the legal form of a GmbH and if that company became a member to an intra-group cash pooling arrangement (or in case of a capital increase of a company that was already a member of a cash pool), the evening-up of the account could lead to a repayment of the capital to the parent company. As the parent was the subsidiary's shareholder, the regular mode of operation of the cash pool resulted in the shareholder (parent company) not discharging its capital contribution obligations. In the event of an insolvency of the subsidiary, the parent was under the obligation to pay its capital contribution in full again. The German Federal Court of Justice (BGH) had affirmed in a number of decisions that no exception is to be made for cash pooling systems (*cf*. BGH, 16.01.2006 – II ZR 76/04).

State of the law after the Reform

The coming into force of the MoMiG has brought about some considerable changes. According to a new sec. 19 subsection 4 Act on Liability Companies (GmbHG), the contribution of a shareholder to a capital increase which is made in cash, still, does not discharge the shareholder of his obligation to pay his capital contribution if it is made in connection with an agreement to later acquire assets from the shareholder. However, the contracts made between company and shareholder concerning the purchase of the assets are deemed valid under the revised rules. Furthermore (and more importantly in the context of cash pooling systems), according to sec. 19 subsection 5 of the new GmbHG, in case of a the rising or increase of share capital, a contribution made in cash that – due to an agreement between shareholder and company – is subject to a later repayment, now releases the shareholder of his obligation to contribute to the share capital, if (and so long as) the repayment is covered by a valuable claim for repayment due at any time or if the loan to the shareholder can be terminated at any time without prior notice.

This means that under the new German Company Law, a newly founded subsidiary (or a subsidiary that has recently undergone a capital increase) may take part in (or continue to be part of) a cash pooling system without the parent incurring liability in case of the subsidiary's insolvency, provided always that the loans granted to the parent in the framework of the cash pooling agreements are of value and realisable at any time.

II.

Upstream Loans / Restrictions of Corporate Law

Even if cash pooling accounts are not used to pay in capital as part of the incorporation of a subsidiary GmbH or in a capital increase, the German capital rules on capital maintenance impose restrictions to be observed. Whenever there is balance in favour of the subsidiary, the evening-up of the accounts and the transfer of the funds to the parent company results into a loan being granted by the subsidiary to its parent.

Legal Situation in Germany before the MoMiG

Under the rules in force until November 2008, it was prohibited for a company to make payments to its direct or indirect shareholders, if – as a result of such payment – its net assets fell short of the registered share capital. Court precedents have enlarged the scope of application of these rules over the years and according to the judgements of the German Federal Court of Justice (Bundesgerichtshof), the restrictions imposed by the rules of capital maintenance also applied to the granting of loans by a company to its direct or indirect shareholders. Thus, any zero-balancing in the context of a cash pooling arrangement was prohibited, as long as this led to an upstream loan which impaired the company's share capital. Initially it was, however, a commonly shared view that such an impairment did not occur, where a loan granted to a shareholder was given at market conditions and where the claim for repayment was valuable and could be realised.

A great deal of uncertainty and a controversial discussion has been caused by the judgement of the *Bundesgerichtshof* of 24 November 2003 – II ZR 171/01. In this decision, the court held:

> *Loans granted by a GmbH to one of its shareholders which are not paid out of capital reserves or profit carried forward, but rather to the detriment of the registered share capital are in principle to be considered as an illicit payback of corporate property [thereby violating sec. 30 subsection 1 GmbHG] even if the claim for repayment of the loan against the shareholder may in individual cases be fully realisable.*

Although, from the facts of the case, the decision did not expressly touch a situation in which loans were granted in the framework of a cash pooling agreement, according to the prevailing opinion amongst legal scholars, the decision applies to cash pool loans as well. However, the court – without establishing a clear rule – indicated, that there may be an exception to this rule and an upstream loan might be regarded as not infringing the rules of capital maintenance as long as the following requirements were met:

- The upstream loan is in the interest of the GmbH,
- The terms and conditions of the loan are at arm's length, and
- The creditworthiness of the receiving shareholder is beyond any doubt even when applying the strongest standards or where the repayment of the loan to the company is beyond any doubt realisable, because valuable and adequate security is provided.

However, on the facts of the case decided by the *Bundesgerichtshof*, such an exception was out of question, so the court refrained from taking a clear position on whether or not such exception exists, thereby leaving those affected by the decision without a practical guideline.

The main issue concerning the accession to a cash pooling system under the old law was the ambiguity of the court's decision and the resulting uncertainty. Especially the aforementioned exception and the lack of clear-cut rules have led to some controversy amongst legal scholars. The strictest interpretation of the quoted decision concluded that, as the BGH had not clearly established an exception, one could not assume that such an exception existed and the granting of a loan was therefore only admissible, if the company was able to raise the credit value from its freely distributable reserves alone. Thus the granting of an upstream loan was considered not to be in breach of section 30 subsection 1 GmbHG if the freely available capital reserves together with the accumulated profits of the company exceeded the amount owed for repayment by the parent company at any given time. Others applied the aforementioned exception even though the *Bundesgerichtshof* has refrained from taking a clear position on the issue. Finally, some commentators argued that not only the exception, but also the principle of the decision had to be regarded in the light of the circumstances of the individual case decided by the *Bundesgerichtshof*. As the facts of the case showed that the company concerned had a negative equity, the decision (and the exception) only applied where the GmbH in question already showed an adverse balance or where this condition was brought about by the granting of the loan (*cf.* VETTER/SCHWANDTNER, German Law Review [2008] 1155, 1163 et seq.)

In case of a violation of section 30 GmbHG, the impending legal consequences were tremendous: Among others, the shareholder was under an obligation to repay the amount received (section 31 subsection 1 GmbHG). Furthermore, according to section 31 subsection 3 GmbHG in case the amount could not be recovered from the shareholder, the other shareholders – although they did not themselves profit from the initial payment – were under an equivalent obligation. The managing directors of the GmbH could incur personal liability for the company's breach of section 30 GmbHG (section 43 GmbHG). Moreover, the granting of a loan in breach of section 30 GmbHG could also be punished as a criminal offence. To avoid these implications and in the absence of clear-cut rules, most directors – thereby applying the strictest interpretation – amended cash pool agreements in such a way as to limit the aggregate amount of loans that could be granted to parent companies (and affiliates) under the agreement to the amount of the freely distributable reserves of the company.

Changes to the existing legal situation established by the MoMiG
The MoMiG has brought quite a few changes in relation to upstream loans.

Capital Maintenance
The MoMiG adds a new (second) clause to the rule in sec. 30 GmbHG, stating:

> *" 1) The capital necessary to maintain the company's registered share capital must not be repaid to the company's shareholders. 2) Sentence 1 does not apply to payments that are granted while a domination or profit transfer agreement (sec. 291 AktG) is in existence or which are covered by a fully valuable counterclaim or claim for repayment against the shareholder…"*

The rather strict approach on capital maintenance taken by German law has to some extent become alleviated by the introduction of this addendum. Sec. 30 subsection 1 clause 2 GmbHG now expressly provides that the repayment requirement of clause 1 will not apply, if the GmbH is controlled by the parent company due to a domination agreement or where a profit-and-loss-transfer agreement is in place. Furthermore, upstream loans are no longer limited to the amount of capital, profit reserves and a potential profit or loss carried forward, but may be granted by the company, if repayment is secured. Although the revised rules provide no clear answer to the question as to when the claim for repayment must be fully realisable, the official comments in the legislation process suggest that the claim must be collectible at the time of the drawdown of the loan, any later impairment of the claim does not affect the legitimacy of the initial payment (*cf.* Explanatory Statement of the German *Bundesregierung* (Federal Government) BT-Drucks. 16/6140, p. 41).

Risks of liability of managing directors

Although the legitimacy of upstream loans is now no longer directly linked to the "free capital" of a company, there still exists the risk of personal liability of the managing directors, if granting of the loans triggers the illiquidity of the GmbH (sec. 64 clause 3 GmbHG). According to this new provision payments to shareholders resulting in the company's illiquidity must not be executed. Liability can only be avoided, if it has not been recognisable to a reasonable businessman that the payment would lead to the company's illiquidity. Moreover, even though claim for repayment of the loan must be fully valuable only at the time the loan is granted, a subsequent impairment may give rise to a liability of the company's management, if they refrain from terminating the upstream loan forthwith and from effectively enforcing any claims for repayment in such a situation (*cf.* Explanatory Statement of the German *Bundesregierung* (Federal Government) BT-Drucks. 16/6140, p. 41).

Therefore, there remains a risk of personal liability of the managers. Even under the revised rules of capital maintenance, managers should be aware of the need to uphold a system of regular checks on the shareholder's (i.e. the parent company) solvency. Furthermore, it may be necessary to amend the cash pool agreement to ensure that the GmbH may only enter into short-term loans, and to provide for a possibility to cancel the loan on short notice. While this alone will not reliably avoid the personal liability of the managing directors of the GmbH, it will at least offer the possibility of reacting to an upcoming illiquidity (*cf.* VETTER/SCHWANDTNER, German Law Review [2008] 1155, 1167).

III.
Downstream Loans / Restrictions of Equity-replacing Loans and Insolvency Law

Under the old law, a shareholder (or one of its affiliates) who granted a loan to its company in the company's crisis rather than providing further equity was forced to treat this loan – according to its true economic nature – as equity; the loan was deemed equity. The term "crisis" was defined as a situation where the company was unable to obtain capital from private financiers at market conditions or where the company was in a state of over-indebtedness ("*Überschuldung*"), and therefore a reasonable shareholder would have provided extra equity instead.

In the company's insolvency the claim for repayment of such a loan was treated as a subordinate debt, meaning that the shareholder would more often than not receive no repayment at all. If the company had already repaid such loans, the respective funds were subject to repayment to the company. The same rules applied in a situation, where the shareholder had granted the loan at a time where the company was still commercially profitable (i.e. not in a crisis), but refrained from immediately drawing off the credit in the advent of the crisis.

Concerning cash pooling operations, the risk incurred by the parent company in granting loans to its subsidiary within the framework of the cash pooling agreement was assessable. As long as such loans were cancelled and recalled in time before the occurrence of the crisis, these loans were not necessarily deemed equity.

Implications of the MoMiG

This has radically changed under the new rules. Under the revised rules of the MoMiG, shareholder-loans are placed on an entirely different foundation. It is no longer the qualification as "equity capital" that leads to the consequences described above. Rather will the fact that a loan has been granted to the GmbH by one of its shareholders be in itself sufficient to convert the claim for repayment into a subordinate claim and – where repayment has already been effected within a certain period prior to insolvency – to enable the company to challenge this repayment and to entitle it to reimbursement of the amount already repaid. In this context, the revised sec. 135 Insolvency Act ("InsO") qualifies any repayment of a loan (or a coequal receivable) granted by a shareholder as an action that may subsequently be challenged by the insolvency administrator, if the payback has been effected up to one year in advance of the filing for insolvency. The granting of a security for a shareholder's loan may even be challenged if the security has been granted up to ten years in advance of the filing for insolvency.

Concerning cash pool operations, this new approach taken by German law will most likely cause considerable problems, because any downstream loans granted by the parent company to a subsidiary which is a member of the cash pool will be granted by a shareholder and will be subject to the new rules irrespective of its qualification as equity capital (exceptions only apply to those loans privileged by sec. 135 subsection 5 in connection with sec. 39 subsections 4 and 5 Insolvency Act, i.e. loans granted by non-executive shareholders only marginally participating in the company's share capital and by new shareholders who acquired their shares in order to allow a financial restructuring of the company and who subsequently granted a loan to the company). Thus, in principle any repayment of downstream loans within the last year before the filing for insolvency will be affected.

The avoidance strategy practised under the old rules, i.e. the termination of the company's participation in the cash pool and the forthwith reclaim of any outstanding loans, will no longer be a viable concept. As the sole trigger under the new rules is the time of the granting of the loan, it is now impossible to react to an economic downturn of the company at a later stage. Thus, to avoid the legal consequences described above, it will be necessary to assess at the time of the granting of the loan, whether or not the GmbH may become insolvent within the upcoming year. While it was possible under the old rules to react and withdraw outstanding loans in time before they were entangled in the rules of equity-replacing loans, it is rather impossible to foresee at the time of the granting of the loan, whether or not the economic situation of the subsidiary will develop in such a way as to make the commencement of insolvency proceedings inevitable. It will, therefore, not be possible to avoid the liability of sec. 135 InsO by just keeping an eye on the economic situation of the subsidiary. This new concept bears potential for serious conflicts between shareholders and management of the company, because according to sec. 15 a Insolvency Act, the managers of a GmbH are under a duty to file for bankruptcy without delay and at the latest within three weeks after the company becomes insolvent or over-indebted. As failure to comply with this duty results in criminal and civil liability, a manager will be in a serious dilemma, given a situation in which the company becomes insolvent while the one-year period for challenging repayment of a loan runs out shortly after the manager's deadline for filing for insolvency,

To make matters worse, during the academic debate on the new set of rules, it has been suggested by several legal scholars that under the rules of the MoMiG netting of loans in a cash pool will not qualify as *re-payment* of the loan, but rather as *granting of a security* (*cf. KLINCK / GÄRTNER*, NZI 2008, 457 et seq.; *BURG / WESTERHEIDE*, BB 2008, 62 et seq.). Such qualification would result in the parent's obligation to repay all positive balances cleared and transferred over the past ten years to the affiliated subsidiary in case of the latter's insolvency. Although, the suggested <u>result</u> appears to be indefensible in practice and has already been rebutted by other authors (*cf. HAMANN*, NZI 2008, 667 et seq.), the way, in which said authors arrive at their conclusion, does not seem completely indefensible.

It is too early in the process of academic debate to assess the risk arising from the suggestions described above. Due to the recent introduction of the new rules, there are – of course – no precedent cases available on the issue. It will probably take some time until the German Federal Court of Justice (BGH) will have to decide on the issue. The discussion may even prompt legislation to pass an amendment to the act. Until either of these possibilities occurs, there will inevitably be a state of legal uncertainty.

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This article is intended to provide a first overview of the topic covered. Please bear in mind that as such it cannot cover every detail of the subject matter. It neither intends to, nor can it reasonably replace profound legal advice on an individual basis. Although all due effort has been exerted in compiling the information contained herein, we assume no liability whatsoever for the contents of this article.