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13.07.2015

German Tax and Legal News

Legal requirements for qualified subordination agreements

In its decision dated 5 March 2015 (case IX ZR 133/144) the German Federal High Curt (Bundesgerichtshof - BGH) ruled on the legal nature of qualified subordination agreements as well as to the legal requirements. The ruling, referring to a highly disputed restructuring instrument, will have significant consequences for the practice.

Facts of the case
In order to avoid over-indebtedness for insolvency law purposes, subordination declarations or more precise subordination agreements are often mentioned as solutions.

The consequence of a subordination agreement is in essence, that the liabilities covered by the subordination do not need to be recognized as a liability in an insolvency status (a specific balance sheet drawn up for insolvency law purposes) and thus - provided that the subordination is far enough - over-indebtedness for insolvency law purposes is excluded.

The German Insolvency Act refers to subordination agreements. However, it does prescribe the precise requirements relating to the content of subordination agreements.

The German Federal High Curt (Bundesgerichtshof - BGH) now ruled on the legal nature and the legal requirements of a qualified subordination agreement. The ruling has significant consequences for the practice.

The insolvency receiver of the debtor, a German limited liability company, has lodged a legal action and requests reimbursement of payments made by the debtor to the defendant while the debtor was already over-indebted. The payments were interest payments in the amount of approx. EUR 342,000 resulting from a mezzanine loan.

In 2006 and 2007, the debtor entered into a profit participation agreement and a loan agreement with the legal predecessors of the defendant. Neither the defendant nor its predecessors are or were shareholders of the debtor. The agreements were assigned to the defendant who received interest payments during the period January to March 2008.

The filing for the opening of insolvency proceedings over the assets of the debtor was submitted in June 2008 and the proceedings were opened in October 2008.

The previous instances rejected the claim of the plaintiff.

Decision
In its ruling, the BGH clarifies that the stipulations of the German Insolvency Code (InsO) dealing with subordination agreements are also applicable in case the subordination is not granted by a shareholder of the debtor but by a third party creditor such as mezzanine creditors as in the present case.

Following, the BGH sets out the legal requirements that have to be fulfilled by a qualified subordination agreement to avoid over-indebtedness of a legal entity. The court confirms that the legal requirements applicable until 1 November 2008, the date on which the modernized law of obligations (MoMiG) came into effect, also apply to subordination agreements entered into according to the new legal stipulations. As a result, the subordination agreement has to cover both, the period prior as well as the one after the opening of the insolvency proceedings. In addition, it has to be clearly stated that the claims of the subordinated creditors may only be paid as follows: outside the insolvency proceedings only out of any free assets, during the insolvency proceedings only after the claims of creditors that have not agreed on a subordination of their claims. With respect to the so-called “depth” of the subordination, the BGH now considers it as sufficient that the creditor declares to be paid after the claims according to section 39 sub-section 1 no. 5 InsO. It is no longer required to declare that the claims have the same rank as claims for repayment of capital contributions of the shareholders of the debtor. If the subordination agreement shall avoid an over-indebtedness of the debtor, it is required to enter into such agreement for an unlimited period. The court also confirms that the subordination not only affects to the main claim but also interest payments and other ancillary claims.

The question with respect to the legal nature of the subordination is answered by the BGH to the effect that it is a debt modification agreement, however not modifying the existence of the claim itself but of its rank. The agreement between the parties is modified in a way that the creditor can only request payment of its claim should enough free assets of the debtor be available. If, however, the debtor is obliged to file for the opening of insolvency proceedings, there is no right of the creditor to request payment.

This legal qualification results in the fact, that payments to subordinated debtors during a period in which an obligation to file for opening of insolvency procedures exists, are made without legal cause and can be reclaimed according to the stipulations of unjust enrichment (sections 812 et seq. German Civil Code – BGB). Such reclaim can be unjustified if the paying entity knows that there is no legal cause. It is however required that such payment is made intentionally and voluntarily.

Further, the BGH states that payments that are made during the term of the subordination agreement can be reclaimed as consideration free of charge in accordance with section 134 InsO. The term “free of charge” in the context of the InsO has to be understood in a broad sense and can be confirmed if the reduction of the assets is not compensated with a respective increase of the assets of the creditor. The BGH confirms this in the case of a payment without legal cause. The possible rescission extends to any payments made during a period of four years prior to the opening of insolvency proceedings and is also possible if claims for unjust enrichment are excluded.

The question whether a subordination agreement can be canceled subsequently is answered by the BGH to the effect that the subordination agreement constitutes an agreement also protecting third parties (Vertrag mit Schutzwirkung zugunsten Dritter), namely present and future creditors of the debtor. Therefore, it is not possible to cancel or terminate the subordination agreement without involving such third parties, unless there is no insolvency scenario present or has overcome with respect to the debtor.

The BGH refers the case back to the court of appeal as the facts have to be investigated further. The court of appeal has to determine, whether the debtor was obliged to file for the opening of insolvency proceedings at the time the interest payments were made.

Practical Advice
The decision of the BGH contains clarifications with respect to important and so far often disputed issues of subordination agreements, in particular the period to be covered, the „depth“ of the subordination, its term and legal nature. This now provides legal security for the drafting of new subordination agreements.

With respect to existing subordination agreement it is advisable to review such agreements taking into account the current decision. This is in particular important if the debtor is in financial difficulties.

For third party creditors that have entered into subordination agreements, the present decision will be of particular interest, mainly regarding the legal qualification as agreement also protecting third parties. As set out above, this qualification results in restrictions regarding the cancellation and termination of such agreements. The relationship of third party creditors with their debtor is usually limited in time, as opposed to the relationship of a shareholder to its subsidiary. Should the debtor have financial difficulties at the point in time when the relationship shall be terminated, it may not be possible for the creditor to terminate the subordination agreement and to get repayment of its claims. That was already the case prior to the current decision, but has now been explicitly confirmed by the BGH. Third party creditors should therefore consider carefully whether it is really required to enter into qualified subordination agreements with respect to all other creditors or whether it is sufficient to only declare the claims subordinated vis-à-vis certain creditors. In the present case of a mezzanine lender this could be the senior lender only.

One important issue is also the tax treatment of subordinated claims, meaning that such claim is not written off resulting in a taxable income. It is therefore desirable that the Federal Tax Court follows the decision of the BGH and accepts the legal requirements for qualified subordination agreements to result in the respective tax effects.

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