INSOLVENCY & RESTRUCTURING - GERMANY

Equitable subordination of leased assets – the end of the story?

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Introduction

The concept of 'equitable subordination' – essentially, the rules regarding the treatment of shareholder loans – is deeply rooted in German law and foresees that shareholder loans rank below (unsecured) third-party creditor claims. This concept also extends to transactions which were initially considered as commercially comparable to granting a loan – for example, the lease of an asset from a shareholder to its subsidiary. For that reason, the leasing of assets by shareholders to subsidiaries used to be a sub-category of the principle of equitable subordination of shareholder loans. Properties let by shareholders to subsidiaries in a financial crisis had to be rented free of charge during insolvency proceedings (subject to contractual termination rights). In cases where shareholders deprived the insolvent company of such use, they were held liable for payment of an appropriate consideration. The insolvency administrator had the right to claw back any rental payments made to the shareholders in the year preceding the opening of insolvency proceedings, as well as any payment causing a short balance of the subsidiary.

Law

The principles were developed on the basis of the former stipulations of Sections 32a and 32b of the Limited Liability Companies Act and various layers of jurisdiction which evolved over more than 30 years. Although these provisions were completely removed by the introduction of the Law Modernising the Limited Liability Company Law and Combating Abuse in 2009, most legal literature was in favour of continuing to apply the principles regardless of drastic changes to the applicable laws. The reason was the conceptual similarity of a shareholder lease to a shareholder loan: both may be seen as shareholder contributions in a financial crisis that may not necessarily have been granted by third parties at comparable terms. For shareholder loans, the Insolvency Code contains unequivocal provisions which result in a clear subordination of such loans in an insolvency situation under insolvency law combined with the possibility to claw back any payments made to the shareholder in the year before filing for insolvency. Similar stipulations have not been introduced regarding the lease of assets or other commercial valuables. The existing rules deal with another topic regarding the use of assets leased by the shareholder to the insolvent company. This is unfortunate, as it leaves room for different interpretations of the law, which in turn leads to legal uncertainty – just as under the previous rules which were abolished in 2009.

Decision

In a long-awaited ruling, the Federal Court of Justice stated that the lease of assets by shareholders to their subsidiaries no longer triggers the application of the principle of equitable subordination (January 29 2015, IX ZR 279/13). The court clearly stated that shareholders are no longer considered subordinated creditors in this respect. Therefore, rental payments made in the year preceding the opening of insolvency proceedings cannot be clawed back on the basis of the rules applying to the repayment of a shareholder loan. However, such payments may be still be clawed back from the shareholder on the basis of the general avoidance rules. Further, the court has finally confirmed that a lease contract is not economically comparable to a shareholder loan and therefore does not fall under the scope of the rules on the treatment of shareholder loans and comparable transactions.

Notwithstanding this positive ruling, which had been considered long overdue, the Insolvency Code upholds the previous idea of the limitation of the property repossession for the benefit of a shareholder in a modified manner. Under the current regime, the insolvency administrator still has the right to continue using such assets for one year following the opening of insolvency proceedings against payment of compensation, if and to the extent that use of the relevant asset is considered significant for the continuation of the business (Section 135(3) of the Insolvency Code).

The amount of compensation to be paid by the insolvency administrator depends on whether the lease contract has been terminated before the opening of insolvency proceedings:

- If the contract has not been terminated before the opening of insolvency proceedings, the insolvency administrator must pay the contractual rent to the lessor (ie, the shareholder). The rental payment qualifies as preferential claim against the estate.
- If the contract has been cancelled by either party before the opening of insolvency proceedings, the insolvency administrator of the subsidiary can continue the use against payment of consideration qualifying as a preferential claim against the estate. The amount of the payment will be determined on the basis of the average lease paid in the year preceding the insolvency filing. The calculation can be reduced by various factors – for example, if and to the extent that rental payments have been deferred in order to preserve liquidity or as a consequence of the exercise of general avoidance rights by the insolvency administrator regarding payments rendered in the past.
- The court has once again opened the door to equitable subordination with a view to the payment of rent which has been deferred over 30 days or more. The court held that such deferred claims will be subordinated in analogous application of the rules governing shareholder loans due to the financial aspect of such deferral. This is in line with the general concept of equitable subordination. From the shareholder's perspective, it is understandable, as the non-demand of outstanding rental payments is comparabel to a loan.
- The above principles apply to all shareholders holding more than 10% of the shares in the insolvent company, but can also be applied to third-party lessors which qualify as quasi-shareholders, depending on the amount of influence they exert on the lessee.

Comment

Notwithstanding the positive clarifications made by the court – which are welcome – the ruling is likely to trigger other negative effects. It may, for example, set negative incentives for hostile behaviour of shareholders, which may impede the restructuring of a crisis-shaken company. Shareholders may be tempted not to defer or reduce the rental payments during a crisis in order to ensure that appropriate compensation is paid for use of the asset by the insolvency administrator during insolvency proceedings. This may turn out to be a stumbling block when it comes to agreeing appropriate restructuring contributions among stakeholders.

Moreover, shareholders may also be inclined to terminate the lease contract at a premature stage in order to allow for expedited repossession of their asset before the opening of insolvency proceedings, to avoid lengthy discussions with an insolvency administrator regarding adequate compensation for future use of the asset. Insolvency itself is not considered a valid reason for exercising the termination right. Further, the premature and unjustified termination of a lease contract can be clawed back by the insolvency administrator. The same applies to an amicable termination of the lease contract.

Alternatively, shareholders may consider continuing the lease contract despite commercial indications. This may be of interest in cases where the basis for compensation is considered to be low as a consequence of the claw-back of rental payments, payment deferrals or other reasons. In this context, shareholders must consider their fiduciary duties towards the company and should refrain from putting themselves at risk of violating these duties, because they could be held liable for damages. Therefore, it is worthwhile to consider carefully the merits and downsides of any counteraction in advance.

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