

Limitation Language applicable when security grantor becomes insolvent?

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Introduction

Pursuant to section 30 paragraph 1 sentence 1 of the German Limited Liability Companies Act (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung*; "GmbHG"), the assets required for maintaining the registered share capital of a limited liability company (*Gesellschaft mit beschränkter Haftung*; "GmbH") must not be distributed to shareholders. Pursuant to section 43 paragraphs 2 and 3 sentence 1 GmbHG, the managing director is personally liable for payments that are made in violation of this capital maintenance rule.

Prevailing legal opinion holds that providing security in order to secure liabilities of a shareholder (so-called upstream security) or affiliated companies (so-called cross-stream security) can constitute a distribution within the meaning of section 30 paragraph 1 sentence 1 GmbHG. The classic circumstances for such security are group financings where the parent company takes out the loan as borrower and the group companies provide security.

Limitation language

The liability risk of the managing director of a GmbH in providing the upstream or cross-stream security described above can be mitigated by including enforcement limitations into the security agreement, in particular for circumstances where the enforcement of the security would result in a violation of section 30 of the GmbHG (so-called limitation language).

Many details with respect to the necessity, scope and exemptions of limitation language are disputed and are regularly subject of negotiations between the grantor and beneficiary of security.

However, until – in particular – the key question of whether limitation language is necessary at all has been decided upon by the Federal Court of Justice, it has to be noted that the inclusion of limitation language is absolutely market standard where a GmbH is asked to provide upstream or cross-stream security. This is also accepted by banks, although limitation language can significantly reduce the actual economic value of the security.

Judgment of the Higher Regional Court of Frankfurt/Main

To date, the judgment of the Higher Regional Court (*Oberlandesgericht*) of Frankfurt/Main dated 8 November 2013 (case no. 24 U 80/13) appears to be the first decision of a Higher Regional Court on some questions in the context of limitation language.

The decision is generally lender-friendly:

From a practice perspective, probably the most interesting affirmation of the Higher Regional Court of Frankfurt/Main is that limitation language does not apply where the subsidiary which granted the security has become insolvent. The court argues that due to the commencement of insolvency proceedings, the reason for the inclusion of limitation language, namely the protection of the managing director against liability for prohibited payments to shareholders, has ceased to exist. Accordingly, no legitimate reason for limitation language existed any more. The Higher Regional Court of Frankfurt/Main therefore apparently assumes that a managing director cannot be held liable for the enforcement of security after the commencement of insolvency proceedings. At least some legal commentators take a different view (see Redeker, CFL 2011, p. 289 *et seq.*).

The second interesting affirmation relates to section 30 paragraph 1 sentence 2 GmbHG. According to that provision, payments do not violate capital maintenance rules and are therefore not subject to enforcement limitations if these payments are (i) made while a domination or profit and loss transfer agreement is in place or (ii) covered by fully-valued (*vollwertig*) consideration or recourse claim against the shareholder. In legal commentary it is disputed whether alternative (i) additionally requires that a possible loss compensation claim of the subsidiary under the domination or profit and loss transfer agreement is fully-valued. The Higher Regional Court of Frankfurt/Main rejected this.

Finally, a comment by the court relating to another exemption within limitation language is notable: It is market standard to agree that limitation language does not apply to the extent that the proceeds of the loan are passed on by the parent borrower to the subsidiary which granted the security. The Higher Regional Court

of Frankfurt/Main did not discuss and therefore seems to agree with the prevailing opinion that such exemption is permissible. In addition, in the case decided upon, the court held that due to the agreed wording, the exemption would not only apply if the funds passed to the subsidiary stem from the proceeds of the loan secured by the subsidiary, but also from other funds of the parent. This seems to be quite far-reaching and has to be kept in mind when negotiating limitation language.

Summary

In cases where upstream or cross-stream security is granted by a GmbH, the inclusion of limitation language is market standard. In its judgment dated 8 November 2013, the Higher Regional Court of Frankfurt/Main decided for the first time upon some questions in connection with limitation language. Leave to appeal to the Federal Court of Justice was unfortunately not granted, meaning that the questions discussed above – and several others – will remain disputed in practice until these are ultimately decided upon at the highest court level.

Note

This overview is solely intended for general information purposes and may not replace legal advice on individual cases. Please contact the respective person in charge with GÖRG or the author himself: Dr. Thomas Lange on +49 221 33660-603 or by e-mail to tlange@goerg.de. For further information about the author visit our website www.goerg.com.

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