# "Coordinated financing" by a group of (minority) shareholders during a crisis

## - Important decision of the German Federal Civil Court and need for action for investors -

**Shareholder loans are generally subordinated in the insolvency of the borrower/debtor. As a consequence, shareholders normally do not receive an insolvency quota, and are also subject to increased risks of insolvency claw-back. However, none of this generally applies if the shareholder in question does not hold more than 10% of the debtor's capital (so-called „minority participation privilege" – „*Kleinbeteiligtenprivileg*").**

**In practice, it could often be observed in the past - in the absence of clear case law - that majority shareholdings (of more than 50%) have been split between several companies often based in non-German jurisdictions, formally not belonging to the same company group, but factually or legally connected e.g. via the same management vehicle, in order to benefit from the minority participation privilege.**

**With its ruling of January 26, 2023 (Case IX ZR 85/21), which was published at the end of March 2023, the German Federal Civil Court („*Bundesgerichtshof*") has now decided for the first time that in the case of a "coordinated financing" decision by several shareholders, which do not belong to the same corporate structure, the participation quotas can possibly be added together. In the following, we briefly present the ruling, its considerable significance for practice and finally the resulting need for action.**

**Principle:**
**Subordination of shareholder loans according to German insolvency law**

**Exception:**
**„Minority participation privilege"(„*Kleinbeteiligtenprivileg*")**

**Background: Ranking of Claims in German Insolvency Proceedings**

For insolvency proceedings in Germany, the German Insolvency Code ("***Insolvenzordnung***" - "**InsO**") provides that creditors' claims are satisfied in a specific order of priority at the end of the proceedings. The lower ranking creditors only receive payments from the insolvency estate if all higher ranking creditors have been satisfied to 100%. In general, the German Insolvency Code provides for the following ranking classes (no. 1 being the highest and no. 4 being the lowest rank):

1. **Preferential liabilities** („*Masseverbindlichkeiten*“) pursuant to Sec. 53 et seq. InsO (in particular court costs, remuneration of the insolvency administrator/custodian, liabilities after the opening of proceedings)

2. **Insolvency claims** pursuant to Sec. 38 InsO (esp. claims of suppliers, financing partners, employees)

3. **Subordinated insolvency claims** pursuant to Sec. 39 InsO (in particular shareholder loans pursuant to Sec. 39 (1) no. 5 InsO)

4. **Surplus on final distribution** according to Sec. 199 InsO (to be distributed to the debtor / shareholder)

**Principle: Subordination of shareholder loans and increased risk of insolvency claw-back**

Often, financiers are only willing to continue financing in a crisis if they acquire shares in the debtor company and thus participate in the future development beyond the interests. If the financier acquires shares in the debtor, however, his ranking deteriorates:

- Without a shareholding in the debtor, the financier‘s claims are usually normal insolvency claims (see rank 2 above).

- By becoming shareholder, his claims generally become lower-ranking subordinated insolvency claims (pursuant to section 39 (1) no. 5 InsO, see rank 3 above).

This deterioration in rank not only means that the financier usually no longer receives an insolvency quota at the end of the insolvency proceedings (in contrast to the claims of normal-ranking insolvency creditors as per rank 2, who can often expect quotas of between 5-10% of their respective claims). Moreover, repayments of shareholder loans and the provision of collateral in favor of the shareholder/financier are then easily subject to insolvency claw-back:

- Pursuant to Section 135 (1) No. 2 InsO, for example, repayments of shareholder loans in the last year before the filing for insolvency are subject to claw-back.

- Pursuant to Sec. 135 (1) No. 1 InsO, the provision of collateral to a shareholder in the 10 years (!) preceding the filing for insolvency is also subject to claw-back.

**Exception: Minority participation privilege („*Kleinbeteiligtenprivileg*“)**

The German Insolvency Code provides for exceptions with regard to subordination. As one of these exceptions, section 39 (5) of the German Insolvency Code provides that a non-managing shareholder’s

(e.g. loan repayment) claim who holds a maximum 10% interest in the debtor's capital is not subordinated (so-called "minority participation privilege"). In this case, the very strict rules on claw-back in insolvency (see above) also do not apply (pursuant to Sec. 135 (4) InsO).

In practice, we see that shareholdings of the same financier group are often split between several companies, often based in non-German jurisdictions and formally not being part of the same company group, but factually or legally connected e.g. by the same management company, and based on coordinated financing decisions. The objective of benefiting from the minority participation privilege was and is insofar often crowned with success, also due to the fact that there was no clear guidance from the German Federal Civil Court („*Bundesgerichtshof*") on the requirements for the aggregation of such shareholdings.

**German Federal Civil Court:**

**„Coordinated financing" by a group of minority shareholders**

In its decision of January 26, 2023, the German Federal Civil Court has now ruled that minority shareholdings can already be aggregated if the shareholders have undertaken a

**"coordinated financing".**

In the view of the German Federal Civil Court, the following circumstances indicate such coordinated financing:

1. The decision to make the necessary financial contributions has been made jointly by the shareholders. According to the Court, the coordinated decision to finance could have even be taken before the crisis started.

2. Joint collateral has been provided for the shareholders.

3. The shareholders have linked their loans via a syndicated loan agreement and agreed on internal compensation rules.

The German Federal Civil Court's ruling is intended to prevent circumvention. Thus, the "coordinated financing" can lead to the aggregation of shareholdings if it shows that the shareholders "assume entrepreneurial responsibility" together. The term "coordinated financing" is not limited to the three aforementioned points but depends on "an assessment of all relevant facts" according to the Court. Therefore, even in the absence of a syndicated loan agreement between the shareholders with regard to their shareholder loans, the existence of coordination could already be in question if the shares in the company are acquired at the same time and after jointly conducted negotiations.

The ruling of the German Federal Civil Court will have to be considered in all comparable open matters and litigations, and has considerable practical significance. Affected financiers should take the ruling as an opportunity to swiftly assess the risks to their own legal position and - where possible - observe the requirements of the ruling when negotiating with the debtor regarding the acquisition of shares in coordination with other creditors.

**Conclusion:**

**Need for action: Risks of subordination should be assessed**

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