Cash Pooling Under the Revised German Private Limited Companies Act (*GmbHG*)

By Jochen Vetter and Christian Schwandtner[*]

A. Introduction

Following the 24 November 2003 decision of the *Bundesgerichtshof* (BGH - Federal Court of Justice)[1] the legal framework for upstream loans granted by companies in the legal form of a *Gesellschaft mit beschränkter Haftung* (GmbH - Private Limited Company), i.e., loans by the GmbH to its direct and indirect shareholders or to an affiliate of such shareholder, has remained uncertain. The ruling of the BGH led to a broad spectrum of interpretations by legal scholars and practitioners – some even predicted the end of cash pooling arrangements for German corporations – which made it difficult for managers of a GmbH to continue existing cash pooling arrangements without changes to their original scope and conditions.

The uncertainty caused the German legislature to clarify the legal framework of upstream loans. Because the rules on downstream loans, i.e., loans granted to the GmbH by an indirect or direct shareholder of the GmbH or by an affiliate of such shareholder which is not a direct or indirect subsidiary of the GmbH, were not only clarified, but significantly modified, the entire legal framework for cash pooling arrangements has changed. After initial proposals for a revision were brought forward in 2006, the German government introduced a first draft of the *Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (*MoMiG - Act on the modernization of the GmbH law and on the prevention of abuses*)* in May 2007, a bill which provides for the most fundamental reform of the law on the GmbH since its introduction in Germany in 1892. The German *Bundestag* (lower house of the German Parliament) accepted the MoMiG on 26 June 2008. It is to be expected that the new law will come into effect in October/November 2008.

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1 BGHZ 157, 52.

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This article presents, after a brief description of the technical implementation of cash pooling systems and the legal relevance thereof, an overview of the changes in the *Gesetz betreffend die Gesellschaft mit beschränkter Haftung*) (GmbHG - Private Limited Companies Act) relevant for cash pooling systems with a focus on the rules on downstream loans.

B. Description of Cash Pooling and its Legal Relevance

I. Technical Implementation of a Cash Pooling System

"Cash Pooling" is a popular instrument for optimizing the liquidity reserves within a group of companies and thereby reducing external borrowings (primarily from banks) as well as the associated interest costs. The reduction of interest payable can be achieved by concentrating and allocating the liquidity that is available within a group of companies. This makes it possible to avoid situations where certain companies within the group have a cash surplus deposited on their bank accounts (so-called "cash positive" entities) at significantly lower rates than the interest rates to be paid by other members of the group that may otherwise need to borrow from a bank (so-called "cash negative" entities). Instead, by implementing a cash pooling system, cash held by cash positive companies is made available under the cash pooling system for group companies that are cash negative and only the excess amount required by the group is financed externally through banks.

There are two main ways to implement a cash pooling system: The so-called "notional" or "virtual" cash pooling does not result in a physical transfer of funds held by cash positive entities to the accounts of cash negative entities. However, a reduction of interest costs can be achieved by involving the banks in the cash pooling and having them calculate interest only on the amount of net indebtedness incurred by all members of the group (i.e., after deduction of cash deposits of the group members with the banks involved).

The so-called "zero balancing" results in a physical transfer of all amounts standing to the credit of the accounts of the members of the group (e.g., at the end of each business day) to a central account which is held by such member of the group that manages the cash pooling system (the cash pool leader). This means that the accounts of all entities of the group participating in the cash pooling system will be balanced to zero (0) at the end of each business day by cash transfers to, or from, the cash pool leader. The amount that remains with the cash pool leader after balancing all accounts participating in the cash pool will either be deposited with a bank (in case of an overall positive cash balance) or will be loaned from banks (in case of a negative cash balance). Each company participating in the cash pooling

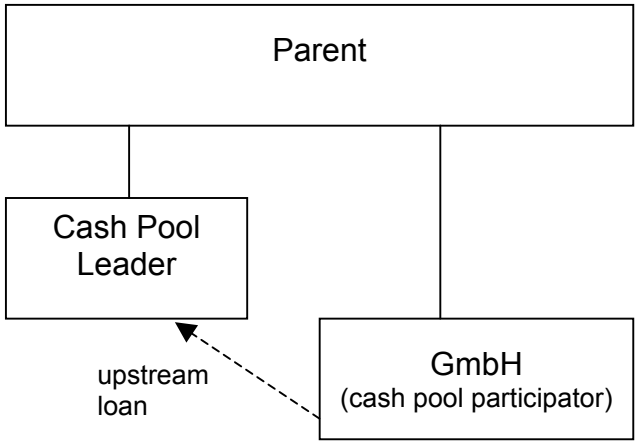
notifies its cash needs in advance so that the cash pool leader can plan and manage the appropriate allocation of available, and the procurement of additional cash.

II. Legal Relevance of the Technical Implementation

Since the notional or virtual cash pooling does not result in a physical transfer of funds between the group members, the legal relevance of notional and virtual cash pooling is rather low from the point of view of each entity participating in the cash pool. Therefore, the notional cash pooling shall not be considered further hereinafter.

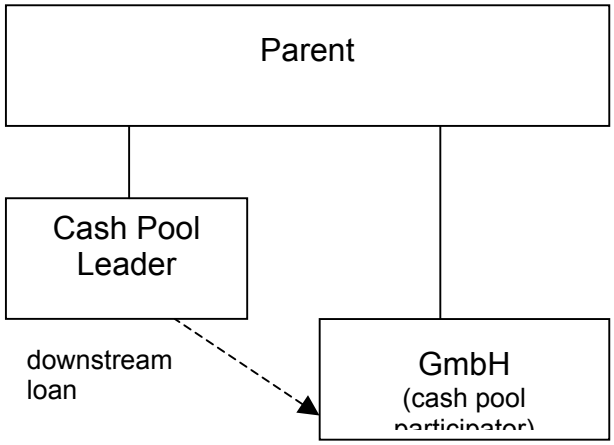
In contrast, the zero balancing cash pooling results in a transfer of cash between different members of the group via the cash pool leader. From a legal point of view, the relevant payment is made on the basis of a loan agreement between the two members of the group among which the payment under the cash pooling is made, i.e., the cash pool leader of the group on the one hand and the entity participating in the cash pool on the other hand. The cash pool leader typically is the parent or group head company or a special financing vehicle set up by the group head for such purpose. The following discussion will assume that the cash pool leader is a direct or indirect shareholder of the cash pool participating entity or an affiliate of such shareholder, but not a subsidiary of the entity participating in the cash pooling.

Depending on the direction of the flow of funds, cash pooling can raise various legal concerns. On the one hand, the flow of funds can be upstream, i.e., the cash pool leader is an indirect or direct shareholder of the cash pool participating entity or an affiliate of such shareholder and the cash pool participating entity transfers a positive cash balance to the cash pool leader.



Note:
The GmbH is cash positive and transfers funds under the cash pooling system to the cash pool leader
→ upstream loan

On the other hand, the funds can flow downstream, i.e., the cash pool leader is an indirect or direct shareholder of the cash pool participating entity or an affiliate of such shareholder and it transfers cash to the cash pool participating entity.



Note:
The GmbH is cash negative and therefore the cash pool leader transfers funds under the cash pooling system to the GmbH
→ downstream loan

With a view to the participation of entities in the legal form of a GmbH in a cash pooling system, upstream loans may, in particular, raise concerns in view of the capital maintenance rules (Section 30 GmbHG, see C.I. below). Downstream loans, on the other hand, may raise concerns in view of the rules on equity replacing loans

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as set out in Sections 32a and 32b GmbHG, and of the rules set by the jurisprudence of the BGH[2] (see C.II. below). In addition, the transfer of funds to a direct or indirect shareholder (or an affiliate thereof), whether by way of upstream loan or repayment of a downstream loan, may conflict with the rules and principles on the so-called "*existenzvernichtender Eingriff*" (acts causing the insolvency), i.e., the prohibition to transfer assets to a shareholder, if such transfer could deprive the GmbH of its ability to properly fulfill its obligations towards creditors when due (see C.III. below). The following discussion will focus on capital maintenance rules and only briefly address the other questions raised.

C. Legal Framework of Cash Pooling under German Corporate Law

I. Upstream Loans – Restrictions resulting from Capital Maintenance Rules

While it is in the interest of the group to reduce external interest costs by concentrating liquidity within the group, there are certain risks connected with upstream loans under cash pooling systems. In particular, external creditors may face the risk that the entity participating in the cash pooling is stripped of the cash required to meet its external liabilities. A company which transfers readily available cash to the cash pool leader but receives a less liquid claim against the cash pool leader in turn is subject to an increased insolvency risk. This risk might not be offset by the contractual right of the company participating in the cash pooling to be provided with the liquidity required for its business up to a certain maximum amount, as this claim, again, is subject to the cash pool leader's ability to provide such financing when needed. In order to reduce the risks resulting from upstream loans, Section 30 (1) GmbHG sets out restrictions for upstream loans granted by entities in the legal form of a GmbH.

1. Capital Maintenance Rules -- Former Law

a) Basic Principles of Section 30 (1) GmbHG

Section 30 (1) GmbHG sets forth strict capital maintenance rules for companies in the legal form of a GmbH. Section 30 (1) GmbHG states: "Company assets required to preserve the stated *Stammkapital* (share capital) may not be distributed to the shareholders."

Pursuant to Section 30 GmbHG, any payment or other financial advantage by a GmbH to its direct or indirect shareholders as well as to affiliates of such

2 *See* BGHZ 90, 381, 388.

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shareholders which are not subsidiaries of the GmbH is prohibited if such payment results in the company's net assets falling short of the amount of its stated share capital. Any payment or other financial advantage by a GmbH to its direct or indirect shareholders (or to affiliated companies) exceeding the amount of its net "free" assets is considered unlawful. The rationale of the introduction of the capital maintenance rules is that a limitation of liability of the shareholders of a GmbH shall only be granted if and to the extent the equity contribution promised by the shareholders has been validly contributed to the GmbH and not been repaid to the shareholders.[3]

The prohibition of a repayment of share capital under the capital maintenance rules is interpreted broadly. It applies not only to payments but to all kinds of benefits with a financial or commercial value, including upstream guarantees and the granting of other security charges.[4] Therefore, any financial assistance by a GmbH to its direct or indirect shareholder (or affiliates thereof) must be limited to the amount by which the net assets exceed the registered share capital of the company.

Relevant for the test if a payment or other financial advantage by a GmbH results in a breach of Section 30 (1) GmbHG is the equity of the company as reported in its balance sheet established pursuant to German Generally Accepted Accounting Principles (GAAP) (not International Financial Reporting Standards (IFRS)). Such equity consists of the line items (i) stated share capital, (ii) capital and profit reserves and (iii) a profit/loss carried forward, and therefore is equal to the balance of the assets minus real liabilities (liabilities, accruals and deferred income) as shown in the balance sheet of the company.

Once the equity as recorded in the balance sheet of the company falls short of the amount of the stated share capital, the GmbH is in the status of an *Unterbilanz* (underbalance). As long as this is the case, any payment or other financial advantage by the GmbH to its shareholder is forbidden even if such payment or financial advantage has no impact on the balance sheet and the equity, e.g., the sale

3 *See* Christoph Teichmann, *Reform des Gläubigerschutzes im Kapitalgesellschaftsrecht*, NEUE JURISTISCHE WOCHENSCHRIFT, 2444, 2445 (2006); Christoph Schmelz, *Cash-Management, quo vadis?*, NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT, 456, 457 (2007).

4 Peter Dampf, *Die Gewährung von Upstream-Sicherheiten im Konzern*, DER KONZERN, 157 (2007); Goetz Hueck & Lorenz Fastrich, *Section 30 GmbHG*, *in* GMBH-GESETZ (Adolf Baumbach & Alfred Hueck ed., 18th ed., 2006), margin number 27; Tobias Tillmann, *Upstream-Sicherheiten der GmbH im Lichte der Kapitalerhaltung – Ausblick auf das MoMiG*, NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT, 401 (2008); Michael Winter, *Upstream-Finanzierung nach dem MoMiG-Regierungsentwurf*, DAS DEUTSCHE STEUERRECHT, 1484, 1488 (2007); Gerald Spindler, *Konzernfinanzierung*, 171 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT, 245, 278 (2007).

of an asset which has a fair market value of EUR 1,000 at its book value of EUR 1 to the shareholder.[5]

b) Legal Consequences of a Violation of Section 30 (1) GmbHG

Violations of Section 30 (1) GmbHG can have a broad range of legal consequences. First of all, the shareholder is obliged to return the payment or financial advantage received (Section 31 (1) GmbHG). If the shareholder who has received the payment does not fulfill his return obligation, a corresponding liability of the co-shareholders arises (Section 31 (3) GmbHG).[6]

Moreover, the managing directors of the GmbH may be held liable for the breach of Section 30 (1) GmbHG and may be obliged to compensate the damage caused to the GmbH (Section 43 GmbHG). A violation of the capital maintenance rules (Section 30 (1) GmbHG) may also constitute a criminal offence by the managing directors of the company (Section 266 of the *Strafgesetzbuch* (German Penal Code)) and by the managers of the shareholder who initiated the forbidden distribution.

Finally, a violation of Section 30(1) GmbHG may cause problems in the course of the statutory audit of the company's annual accounts. The auditor may, in particular, point to a serious violation of the law in the statutory audit report. For tax purposes, a violation of Section 30 (1) GmbHG may be regarded as a *verdeckte Gewinnausschüttung* (hidden distribution of profits) within the meaning of Section 8 (3) *Körperschaftsteuergesetz* (Corporate Income Tax Act) so that taxes may be imposed upon the payment to the shareholder.

c) Upstream Loans under the Former Law

The transfer of a positive cash balance by a GmbH under a cash pooling system to the cash pool leader constitutes an upstream loan by the GmbH to the cash pool leader.

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5 *See* Jochen Vetter & Christoph Stadler, HAFTUNGSRISIKEN BEIM KONZERNWEITEN CASH POOLING 35 (2003); Wolfgang Schön, *Kreditbesicherung durch abhängige Kapitalgesellschaft*, 159 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT, 351; Winter, *supra* note 4, at 1486.

6 For further details regarding legal consequences of a violation of Section 30 (1) GmbHG please refer to Vetter & Stadler, *supra* note 5, at 40.

i) Prevailing Opinion until the Ruling of 24 November 2003

Following a decision of the *Reichsgericht* (Supreme Court of the German Reich) in 1935,[7] it was the prevailing opinion of constant jurisdiction and legal scholars that a loan granted by a GmbH to its shareholder complied with Section 30 (1) GmbHG provided that the respective repayment claim of the GmbH (as lender) against its shareholder (as borrower) was valuable and *vollwertig* (fully realizable) and that the loan was granted on an arm's length basis. This view was based on the assumption that a loan granted by the GmbH to its shareholder would not affect the net asset position of the company to the extent it is fully valuable because it, in turn, could be accounted for on the balance sheet of the GmbH at face value of the loan. In such a case, the granting of the upstream loan would result in a mere exchange of asset positions on the company's balance sheet, i.e., the respective reduction of the line item "cash" would be offset by an equivalent increase of the line item "accounts receivable" so that the equity shown on the balance sheet would remain unaffected.[8]

ii) 24 November 2003 Ruling of the Federal Court of Justice

Severe legal uncertainty was caused by the ruling of the BGH of 24 November 2003.[9] With respect to an upstream loan in a significant amount granted by a distressed GmbH to its shareholder the court ruled:

> "Upstream loans by a GmbH to its shareholder which are not paid out of capital/profit reserves or profit carried forward, but are paid to the detriment of the stated share capital do violate Section 30 (1) GmbHG even if the claim for repayment of the loan against the shareholder should be fully realizable."

However, the BGH indicated that an upstream loan may, as an exception to the above mentioned general rule, not have violated Section 30 (1) GmbHG if (i) the granting of the loan was in the interest of the GmbH, (ii) the terms of the loan corresponded to market conditions (arm's length basis) and (iii) the shareholder's financial standing was beyond any doubt or, alternatively, the loan was adequately

7 Reichsgericht, II 113/25, RGZ 150, 28, 34/35 (Dec. 20, 1935).

8 *See* Winter, *supra* note 4, at 1485; VETTER & STADLER, *supra* note 5, at 35 with further references.

9 BGHZ 157, 52.

secured so that there was no doubt as to the realizability of the repayment claim of the GmbH against the borrower.

Pursuant to the prevailing opinion of legal scholars, the limitation on upstream loans set by the above ruling of the BGH also applies to a transfer of positive cash balances under a cash pooling system as this results in an upstream loan as well.

iii) Interpretation of the Ruling of 24 November 2003

The key statements of the ruling as well as the underlying reasoning given by the BGH are ambiguous and therefore led to a considerable uncertainty in the application of the capital maintenance rules. The major alternative interpretations were as follows:

Interpretation 1: Upstream loans granted by a GmbH to its shareholder are only permitted if the capital reserves and accumulated profits exceed the loan amount irrespective of the expected realizability of the loan. Given that the BGH has not clearly declared an exception in case the three specific conditions mentioned above (loan in the interest of the GmbH, terms at arm's length, financial standing of the borrower beyond any doubt or adequate security provided) are met, the strictest view leaves it at that, i.e., upstream loans can only be granted if and to the extent the GmbH has adequate free distributable reserves. In other words, the repayment claim relating to the loan granted by the GmbH to its shareholder has to be accounted for at a value of zero (0) for the purposes of the balance sheet orientated test with respect to a possible violation of Section 30 (1) GmbHG.[10]

Interpretation 2: Others share the basic view of the BGH but make an exception in case the three preconditions for an exception for upstream loans set by the court (see above) are fulfilled.[11]

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10 Oberlandesgericht München (OLG - Higher Regional Court), 23 U 3480/05, ZIP 2006, 25, 26 (Nov. 24, 2005); Joachim Blöse, *Zur Frage der Zulässigkeit eines Finanzierungs- und Liquiditätsausgleichs zwischen verbundenen Unternehmen*, GMBH RUNDSCHAU, 146 (2006); Walter Bayer & Jan Lieder, *Darlehen der GmbH an Gesellschafter und Sicherheiten aus dem GmbH-Vermögen für die Gesellschaftsverbindlichkeiten*, ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT, 133, 141 (2005); Detlev Joost, *Cash Pool Systeme, International Financial Reporting Standards, Solvency Test*, *in* DIE GMBH-REFORM IN DER DISKUSSION, 31, 34 (Gesellschaftsrechtliche Vereinigung ed., 2006); Markus C. Kerber, *Die Beurteilung von Cash-Pool-Verträgen im Lichte höchstrichterlicher Rechtsprechung*, ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT, 437 (2005); Hartwig Henze, Konzernfinanzierung und Besicherung, ZEITSCHRIFT FÜR WIRTSCHAFTS- UND BANKRECHT, 717 (2005); Andreas Engert, *Kreditgewährung an GmbH-Gesellschafter und bilanzorientierter Kapitalschutz*, BETRIEBS-BERATER, 1951, 1954 (2005).

11 Hueck & Fastrich, *supra* note 4, at margin number 26.

Interpretation 3: A third group of legal scholars and practitioners is of the opinion that the strict rules and the exception set by the BGH only apply if (1) the GmbH is already in the status of underbalance (as it was apparently the case in the decision of the BGH given that the GmbH was distressed) or (2) enters into such status due to the granting of the loan (which is only conceivable if the repayment claim does not appear to be fully realizable or if the interest is below market condition so that the face amount must be impaired for accounting purposes).[12]

For upstream loans created by a transfer of cash under a cash pooling system, the strict interpretation of the ruling of the BGH of 24 November 2003 as outlined above (interpretation 1) would have meant that such a loan would not have violated Section 30 (1) GmbHG in case the freely available capital reserves and accumulated profits of the GmbH would have exceeded the amount owed by the cash pool leader to the GmbH at any time. However, such a test is very strict and it was not unusual that it was not satisfied by a GmbH even if the company was far from any financial crisis.

Against this background and in view of the severe legal consequences of a breach of Section 30 (1) GmbHG (see C.I.1.b) above), a significant uncertainty was caused by the 24 November 2003 ruling of the BGH. Although the wider interpretation 3 of the ruling of the BGH seemed to be predominant among legal commentators and practitioners given that the other alternatives would have treated the granting of an upstream loan like a definite distribution of the corresponding amount and would, in testing whether the company was in the status of underbalance, have supposed that the claim for repayment of the loan had no positive value at all, irrespective of the creditworthiness of the borrower or the security granted,[13] many GmbH managers have obeyed the strictest interpretation of the ruling to avoid personal liability. In consequence of the ruling of the BGH, many cash pooling arrangements were amended for precautionary reasons and the amount of upstream loans was limited to the amount of freely distributable reserves of the GmbH even if the GmbH had much higher cash reserves available.

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12 Jochen Vetter, *Darlehen der GmbH an ihre Gesellschafter und Erhaltung des Stammkapitals*, BETRIEBS-BERATER, 1509 (2004); Wulf Goette, *Cash-Pool und Kapitalerhaltung*, DAS DEUTSCHE STEUERRECHT, 767, 768 (2006); Carsten Schäfer, *Probleme des Cash-Poolings bei Kapitalaufbringung und -erhaltung – Welche Lösung bringt das MoMiG?*, BETRIEBS-BERATER, 5, 6 (2006); Matthias Hentzen, *Konzerninnenfinanzierung nach BGHZ 157, 72* ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT, 480, 488 (2005); Mathias Habersack & Jan Schürbrand, BETRIEBS-BERATER, 288, 289 (2006); Ulrich Haas & Jürgen Oechsler, *Missbrauch, Cash Pool und gutgläubiger Erwerb nach dem MoMiG*, NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT, 806, 811 (2006).

13 *See* Ulrich Seibert, *GmbH-Reform: Der Referentenentwurf eines Gesetzes zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen – MoMiG*, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT, 1157, 1163 (2006).

iv) Safe Haven for Cash Pooling Systems

aa) Exception set by the Federal Court of Justice in the Ruling of 24 November 2003

For practical purposes, the exceptions set by the BGH (see C.I.1.c) ii) above) did not significantly lower the uncertainty caused by the ruling of the BGH because the BGH had neither clearly accepted an exception to its strict rules nor explained in detail under what circumstances it considered such conditions to be met. Therefore many managers abstained from widening the scope of cash pooling arrangements to be on the safe side. The exceptions mentioned by the BGH therefore did not create a true safe haven in practice.

bb) Implementation of a Domination Agreement

A more reliable means of reducing the risk of a violation of Section 30 (1) GmbHG under the ruling of 24 November 2003 was to enter into a *Beherrschungsvertrag* (control or domination agreement) concluded between the GmbH as cash pool participating entity and its shareholder (which would not necessarily have to be the cash pool leader). Pursuant to a domination agreement, the *herrschende Gesellschaft* (controlling entity) is, in principle, entitled to instruct the *beherrschte Gesellschaft* (controlled entity) to effectuate certain acts even if they have a negative impact on the controlled entity (cf. Section 308 *Aktiengesetz (*AktG - Stock Corporation Act)).

With respect to domination agreements entered into with an *Aktiengesellschaft (*AG - stock corporation) as a controlled entity, Section 291 (3) AktG expressly stated that the relevant capital maintenance rules (in particular Section 57 (1) AktG) did not apply to payments made upon a valid instruction under the domination agreement. The reason was that the controlled company and its creditors are protected by different means, in particular by the obligation of the controlling company to compensate any annual net loss of the controlled entity occurring during the term of the domination agreement (Section 302 AktG). The obligation to compensate for any loss incurred by the controlled entity significantly reduces the insolvency risk of the controlled entity which justifies a relaxation of the otherwise strict capital maintenance rules.

Domination agreements can also be entered into with a GmbH as the controlled entity. However, the GmbHG has not expressly excluded the strict capital maintenance rule of Section 30 (1) GmbHG for payments made based on a valid instruction under a domination agreement until the implementation of the MoMiG. Therefore, it was highly disputed among legal commentators whether Section 30 (1)

GmbHG was nevertheless precluded under the regime of a domination agreement.[14]

2. Impact of the MoMiG on Cash Pooling

The legal uncertainty caused by the 24 November 2003 ruling of the BGH with respect to upstream loans led the German legislature to clarify the legal regime of upstream loans of a GmbH by implementing the MoMiG. Among other rules, the MoMiG provides for a revision of the capital maintenance rules set forth in Section 30 (1) GmbHG (and similarly in Section 57 (1) AktG for stock corporations). While the wording of Section 30 (1) sentence 1 GmbHG will remain unchanged, the MoMiG will implement more relaxed standards of capital maintenance by adding a new sentence 2 to Section 30 (1) GmbHG which states: "Sentence 1 does not apply to benefits which are granted while a domination or profit-and-loss transfer agreement (Section 291 AktG) is in place or which are covered by a fully valuable counterclaim or retransfer claim against the shareholder."

Section 30 (1) sentence 2 GmbHG therefore will clarify the existing legal uncertainty in two aspects:

a) Reconstitution of the Balance Sheet orientated Test of Upstream Loans

Under the new capital maintenance rules, the management of a GmbH will be allowed to transfer assets of the company to direct or indirect shareholders of the company if a fully valuable counterclaim for their return exists.

The new law therefore will reconstitute the strictly balance sheet oriented interpretation of Section 30 (1) GmbHG with respect to upstream loans as it was widespread before the 24 November 2003 ruling of the BGH:[15] An upstream loan will not violate Section 30 (1) sentence 1 GmbHG if the repayment claim against the borrower appears to be fully realizable. The legislature therefore expressly confirms that the test as to whether a payment or other benefit granted by the GmbH to its direct or indirect shareholder violates Section 30 (1) GmbHG shall be based on a review of the balance sheet of the GmbH only. Upstream loans are no longer limited by the amount of the capital and profit reserves and a profit/loss carried

14 See Matthias Hentzen, *supra* note 12, at 517; Boris Schilmar, *Kapitalschutz beim Cash Management*, DAS DEUTSCHE STEUERRECHT, 568, 573 (2006); Spindler, *supra* note 4, at 258; Harm Peter Westermann, *Section 30 GmbHG*, in SCHOLZ - KOMMENTAR ZUM GMBH-GESETZ, margin number 51 (10th ed., 2006).

15 *See* Winter, *supra* note 4,at 1486.

forward. Also, the further conditions set by the BGH for an exception to its strict rule (loan in the interest of the GmbH, conditions at arm's length) are abolished by the legislature.

On the other hand, the approach supported by some legal commentators to replace or complement the balance sheet orientated test by a solvency test will not be implemented in Section 30 (1) GmbHG.[16] Rather, Section 64 sentence 3 GmbHG (as amended, see III. below) will expressly provide for an obligation of the managing directors of the GmbH to indemnify the company for payments to shareholders which result in a *Zahlungsunfähigkeit* (illiquidity) of the company. Consequently, a solvency test in relation to payments to shareholders, and therefore also in relation to upstream loans, will form part of the fiduciary duties of the managers of a GmbH.

The explanatory statements of the legislature, which are not legally binding, state that the violation of the capital maintenance rules has to be tested only at the time of the drawdown of the upstream loan. Any negative development of the realizability of the repayment claim against the shareholder which may result in an impairment of the claim shown on the balance sheet will not retroactively incriminate the drawdown of the loan.[17] However, such impairment of the realizability may oblige the management of the GmbH under its fiduciary duties to terminate the upstream loan early and to enforce the repayment claim against the shareholder. Therefore a prudent manager should abstain from entering into long-term upstream loan agreements with the shareholder without an adequate possibility to react by early termination if the financial situation of its debtor deteriorates. That means that under the new law it will still be advisable to implement an early warning system that allows the management of the GmbH to receive adequate information about the financial standing of the borrower and to include early termination rights in case the financial standing of the shareholder would deteriorate after drawdown of the upstream loan.

With respect to cash pooling systems, the new law will mean that any transfer of cash by a GmbH to the cash pool leader under the cash pooling system which

16 With respect to the proposed introduction of a solvency test please refer to Joachim Hennrichs, *Zur Zukunft der Kapitalerhaltung: Bilanztest – Solvenztest – oder beides?*, DER KONZERN, 42 (2008); Tim Drygala & Thomas Kremer, *Alles neu macht der Mai – Zur Neuregelung der Kapitalerhaltungsvorschriften im Regierungsentwurf zum MoMiG*, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT, 1289, 1292 (2007); Horst Eidenmüller, *Die GmbH im Wettbewerb der Rechtsformen*, ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT, 168, 190 (2007).

17 BTDrucks 16/6140, 94.

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creates an upstream loan will not violate Section 30 (1) sentence 1 GmbHG if the repayment claim of the GmbH against the cash pool leader appears to be fully realizable at the time of the transfer of cash to the cash pool leader.[18]

If the repayment claim does not appear to be fully realizable, the transfer of cash under the cash pooling system will not violate the capital maintenance rules if the payment is covered by freely distributable reserves of the GmbH. In this regard, the wording of the new law is unclear in respect of the question whether the loan amount needs to be fully covered by freely distributable reserves of the company or if it is sufficient that it is so covered only to the extent the amount of the upstream loan appears not to be fully realizable. Based on the balance sheet orientated test of a breach of the capital maintenance rules and the general approach to relax the capital maintenance rules, the latter interpretation seems to be favorable.

Even if the GmbH is already in the status of underbalance, the new Section 30 (1) sentence 2 GmbHG does apply (i.e., no violation of the capital maintenance rules occurs) as long as the repayment claim is fully realizable and the interest has been set at arm's length.[19] The new law thereby accepts, in principle, that the GmbH transfers readily available cash to shareholders thereby creating a less liquid claim against the borrower.

Should the interest be below market conditions however, this would lead to a violation of Section 30 (1) sentence 1 GmbHG if the GmbH was already in the status of an underbalance or if such unfavorable interest arrangement would result in an underbalance due to an impairment of the repayment claim based on German GAAP.

b) Clarification in Respect of Domination Agreements

The second remarkable revision of Section 30 (1) sentence 2 GmbHG refers to the express clarification that Section 30 (1) sentence 1 GmbHG shall not apply in case of payments effectuated while a domination and/or profit-and-loss transfer agreement is in place. The new law therefore clarifies the uncertainty existing under the former law on the applicability of the capital maintenance rules under a

18 Drygala & Kremer, *supra* note 16, at 1292.

19 Deutscher Anwalt Verein, *Stellungnahme des Deutschen Anwaltsvereins zum Referentenentwurf eines Gesetzes zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG)*, No. 6/07, 16 (February 2007), *available at* http://www.anwaltverein.de/downloads/stellungnahmen/2007-06.pdf; Drygala & Kremer, *supra* note 16, at 1295; Winter, *supra* note 4, at 1487.

domination agreement in line with the predominant opinion among the legal commentators.[20]

In addition, the new law also makes clear that the suspension of the capital maintenance rules will not require that the relevant act, which may otherwise violate the capital maintenance rules, is based on a valid instruction of the controlling entity under the domination agreement. Rather, the mere existence of a domination agreement or profit-and-loss transfer agreement will suffice to preclude a breach of Section 30 (1) sentence 1 GmbHG.[21] The MoMiG thereby goes beyond the relief from the strict capital maintenance rules provided for in Section 291 (3) AktG (before its amendment by the MoMiG) for stock corporations. This provision (as well as Section 57 (1) AktG) has consequently been revised by the MoMiG as well.

For cash pooling systems this means that upstream loans granted by a GmbH will not violate the capital maintenance rules while the GmbH is party to a domination agreement as controlled entity even if the repayment claim does not appear to be fully realizable.

However, it should be noted that if a repayment claim against the cash pool leader does not appear to be fully realizable, a claim against the controlling entity to compensate for any potential loss of the GmbH will often not be fully realizable either, at least if the cash pool leader is also the controlling entity under the domination agreement. In such an instance, the managing directors of the GmbH are not entitled to carry out instructions by the controlling entity[22] and may therefore not grant any loan upon request of, or on behalf of, the controlling shareholder. Therefore the managing directors of the GmbH have to make sure that the GmbH can terminate or at least suspend its participation in the cash pooling if a potential claim against the controlling entity to compensate for any loss no longer appears to be fully realizable in the course of time. In order to facilitate such assessment, the cash pooling system should provide for an early warning system in respect of the financial stability of the cash pool leader as well as the controlling

20 *See* Drygala & Kremer, *supra* note 16, at 1295.

21 The wording of the Act is thereby implementing a proposal made in Deutscher Anwalt Verein, *Stellungnahme des Deutschen Anwaltsvereins zum Regierungsentwurf eines Gesetzes zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG)*, No. 43/07, 20 (Sept. 5, 2007), *available at* http://www.anwaltverein.de/downloads/stellungnahmen/2007-43.pdf.

22 Holger Altmeppen, *Section 308 AktG*, *in* MÜNCHNER KOMMENTAR ZUM AKTIENGESETZ, margin number 122 (Bruno Kropff & Johannes Semler ed., 2nd ed., 2000); Volker Emmerich, *Section 308 AktG*, *in* AKTIEN- UND GMBH-KONZERNRECHT, margin number 64 (Volker Emmerich & Mathias Habersack ed., 5th ed., 2008).

entity and corresponding suspension and termination rights with regard to the participation in the cash pooling system.

II. Equity Replacing Loans

1. Former Status

While upstream loans in principle are a matter of restrictions specified in the capital maintenance rules (Section 30 (1) GmbH), downstream loans, i.e., loans granted by a direct or indirect shareholder of a GmbH or an affiliate of such shareholder which is not a direct or indirect subsidiary of the GmbH, mainly had to be considered in view of the rules on *eigenkaptalersetzende Darlehen* (equity replacing loans).

Without going into details,[23] under the old law loans which were granted by a shareholder of a GmbH to the GmbH while the GmbH was in the status of a crisis were treated as equity of the GmbH and could therefore not be repaid (in full) until the GmbH resolved its crisis. In this regard, a crisis of the GmbH was mainly defined as a situation in which the GmbH was not in the position to borrow funds from third parties at market conditions or if it was in the status of *Überschuldung* (over-indebtedness) or illiquidity.[24]

A repayment of equity replacing loans in violation of the rules on equity replacing loans primarily resulted in an obligation of the shareholder as lender to re-contribute the funds received from the GmbH as repayment of the loan.[25]

In connection with cash pooling systems, the law on equity replacing loans bore the risk that loans created by the transfer of funds to a GmbH which was cash negative, and which therefore incurred indebtedness under the cash pooling system vis-à-vis the cash pool leader, were to be regarded as equity replacing loans if the GmbH was in the status of a crisis.

To avoid such risk, the participation of a GmbH in a cash pooling system was often suspended when a crisis of the GmbH occurred. Instead, liquid funds required by

23 For details on the revision of the law on equity replacing loans please refer to the article of Dirk Verse, *Shareholder Loans in Corporate Insolvency – A New Approach to an Old Problem* [in this issue of the GERMAN LAW JOURNAL].

24 *See* Hueck & Fastrich, *supra* note 4, at margin number 48; Andreas Heidinger, *Sections 32a, 32b GmbHG*, *in* KOMMENTAR ZUM GMBH-GESETZ, 44 (Lutz Michalski ed, 2002).

25 Karsten Schmidt, *Sections 32a, 32b GmbHG*, *in* SCHOLZ – KOMMENTAR ZUM GMBH-GESETZ, margin numbers 78, 83 (10th ed., 2006).

the GmbH were made available on the basis of individual loan agreements. Such suspension was advisable in view of the legal uncertainty with respect to the calculation of the amount of the equity replacing loan created under a cash pooling system. Given that the amount of the loan drawn by the GmbH may increase and decrease continuously in the day to day business, one could theoretically argue that the aggregate amount of all decreases during a crisis could be regarded as a prohibited repayment of equity replacing loans. However, while the maximum amount that may be drawn under the cash pooling system at any time by each participating entity is typically limited, it is conceivable that the aggregation of all decreases of the loan during a crisis may exceed the amount of such limit. This would have created an obligation to re-contribute funds to the GmbH in an amount which may significantly exceed the amount which the shareholder/cash pool leader was prepared to provide to the GmbH on the basis of loans under the cash pooling system. Therefore it seemed to be more convincing that the amount of the relevant repayment of an equity replacing loan under a cash pooling system needed to be determined by the highest amount drawn by the GmbH during the crisis and such amount should be compared to the amount outstanding at the time the unlawful repayment of the equity replacing loan was raised. Only the difference between the highest amount and the actual loan outstanding at that time needed to be re-contributed by the shareholder/cash pool leader.[26]

Again, in light of the legal uncertainty in this regard, it was advisable for the managing directors and shareholders to suspend the participation in a cash pooling system during a crisis of a GmbH and to provide the GmbH with funds required, if at all, on the basis of individual loan agreements only.

2. Modifications to the Law on Equity Replacing Loans by the MoMiG

a) Introduction of a "Shareholder Loan" concept

The MoMoG will significantly change the rules on downstream loans. The new law (Sections 39 (1) no. 5 and 135 InsO) will no longer require that the loan is granted to the GmbH while it is in the status of a crisis. Instead, any loan granted by a direct or indirect shareholder to the GmbH, i.e., a downstream loan will, in its capacity as shareholder loan, be subject to the new rules.

Under the new law any payment by the GmbH to the lender as repayment of a shareholder loan will have to be returned to the GmbH if such repayment by the GmbH occurred within the last year before the filing of an application for the

26 *See* Vetter & Stadler, *supra* note 5, at 27.

opening of insolvency proceedings over the assets of the GmbH (Section 135 (1) InsO). On the other hand, the GmbH no longer has the right to decline the repayment of a shareholder loan based on the argument that the GmbH is still in the status of a crisis at the time of the repayment. Under the new law a repayment of a shareholder loan may only be declined by the management of the GmbH if the repayment would result in an illiquidity of the GmbH (cf. Section 64 sentence 3 GmbHG (as amended)).[27]

b) Repercussions for Cash Pooling Systems

For downstream loans created under a cash pooling system, the new law means that the management in general will not breach its fiduciary duties by repaying loans incurred under the cash pooling system. However, in case the repayment of the loan would result in an illiquidity of the GmbH, the managers must decline the repayment in order to avoid personal liability in accordance with Section 64 sentence 3 GmbHG (as amended).

Against this background, and given the fact that the legal uncertainty on the calculation of the amount of an equity replacing loan incurred under a cash pooling system (see above C.II.1) will not be resolved by the MoMiG, it may still be advisable to provide for constant control of the status of the cash pool participating subsidiary and to suspend the participation of such subsidiary once a crisis becomes apparent.

While under the old law, the preconditions for a crisis and therefore the definition of the right point in time to suspend the participation in the cash pooling system could be more or less well-defined in the cash pooling arrangements, the setup of a cash pooling system will become more difficult under the new law as the right point in time for a suspension can no longer be defined unambiguously because it is determined by an event in the future, i.e., the application for the opening of the insolvency proceedings.

27 Heribert Hirte, *Die Neuregelung des Rechts der (früher: kapitalersetzenden) Gesellschafterdarlehen durch das MoMiG*, ZEITSCHRIFT FÜR WIRTSCHAFTS- UND BANKRECHT, 1429, 1430 (2008); Markus Gehrlein, *Die Behandlung von Gesellschafterdarlehen durch das MoMiG*, BETRIEBS-BERATER, 846, 848 (2008); Michael Burg & Stefan Westerheide, *Praktische Auswirkungen des MoMiG auf die Finanzierung von Konzernen*, BETRIEBS-BERATER, 62 (2008); Mathias Habersack, *Gesellschafterdarlehen nach MoMiG: Anwendungsbereich, Tatbestand und Rechtsfolgen der Neuregelung*, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT, 2145 (2007); for details please refer to the article of Dirk Verse, *Shareholder Loans in Corporate Insolvency – A New Approach to an Old Problem* [in this issue of the GERMAN LAW JOURNAL].

III. The Prohibition to Cause the Company's Insolvency

In relation to cash pooling systems, it should also be noted that the shareholders of a GmbH must not withdraw cash or other assets from the GmbH if this results in the GmbH not being able to properly fulfill its obligations vis-à-vis its creditors when due. A violation of such prohibition entitles the GmbH to claim damages from the shareholder based on a provision of tort law (Section 826 BGB (*Bürgerliches Gesetzbuch* (Civil Code)) pursuant to recent court rulings of the BGH[28].

A related obligation of the managing directors has been codified by the MoMiG by the insertion of a new Section 64 sentence 3 GmbHG: The managing directors must not make any payment (or transfer any other asset) to a shareholder if this leads to the illiquidity/insolvency of the GmbH, unless the managing directors could not predict such result. While the shareholders have to indemnify the company's damage resulting from a forbidden transfer of assets, a violation of Section 64 sentence 3 GmbHG results in the managing directors' obligation to repay to the company an amount equal to the forbidden payment.

With respect to cash pooling arrangements, the above rules may become relevant with respect to both (i) the granting of an upstream loan and (ii) the repayment of a downstream loan.

IV. Capital Increases under Cash Pooling Systems

Cash pooling systems can also bear risks in relation to capital increases against contribution of cash made during the operation of such system. In particular, the preconditions for a valid contribution of cash in relation to capital increases via a cash pooling system were highly disputed under the former law.[29] In this regard the MoMiG will provide for some relief: A cash contribution to an entity which is cash positive, i.e., an upstream loan has been granted to the cash pool leader under the cash pooling system, and is repaid to the shareholder under the cash pooling system so that the amount of the upstream loan increases will, in principle, not hinder the validity of the capital increase provided that the repayment claim against the shareholder under the cash pooling system appears fully realizable and

28 BGHZ 173, 246; BGH, II ZR 264/06, DB 2008, 1423.

29 BGHZ 166, 8; Walter Bayer & Jan Lieder, *Kapitalaufbringung im Cash-Pool*, GMBH RUNDSCHAU, 449 (2006); Matthias Hentzen, *Die Abgrenzung von Kapitalaufbringung und Kapitalerhaltung im Cash-Pool*, DAS DEUTSCHE STEUERRECHT, 948 (2006); Jochen Vetter & Christian Schwandtner, *Kapitalerhöhung im Cash-Pool*, DER KONZERN, 407 (2006); Schäfer, *supra* note 12, at 7; Spindler, *supra* note 4, at 273; Walter Bayer, *Moderner Kapitalschutz*, ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT, 220, 230 (2007).

is *fällig* (payable) at any time (cf. Section 19 (5) GmbHG (as amended)). In practice this will, at least to some extent, reduce the uncertainty existing in relation to capital increases under cash pooling systems under the former law.[30]

D. Summary – Concluding Thesis

Under the old law the operation of a cash pooling system was mainly restricted by the uncertainty of the 24 November 2003 ruling of the BGH.[31] The limits applicable to upstream loans in particular remained unclear. This has led the legislature to clarify the legitimacy of upstream loans in the MoMiG.

The new law will reconstitute the strict balance sheet orientated test for violations of the capital maintenance rules set out in Section 30 (1) GmbHG. Under the new law upstream loans will not violate Section 30 (1) GmbHG if the repayment claim against the borrower can be accounted for at its face value. If and to the extent the repayment claim does not appear to be fully realizable, an upstream loan will still be permissible if the negative balance between the face value of the repayment claim and the amount at which the repayment claim can be accounted for on the balance sheet of the GmbH does not exceed the capital and profit reserves -- including a profit/loss carried forward of the GmbH at the time of the draw down of the upstream loan if such loan is fully realizable (and bears interest at market conditions).

A significant revision implemented by the MoMiG concerns upstream loans granted while the GmbH is in the status of an underbalance. While the permissibility of such loans was highly disputed under the old law, it will no longer be necessary to differentiate between the granting of upstream loans during and outside the status of underbalance.

While the regime for upstream loans will be relaxed, the rules for downstream loans will be revised to the detriment of practical application. This mainly results from the fact that in future the application of the rules on downstream loans will no longer depend on whether the loan has been granted or repaid while the GmbH is in the status of a crisis. Instead, any loan granted by a direct or indirect shareholder

30 *See* Christine Oppenhoff, *Die GmbH-Reform durch das MoMiG – ein Überblick*, BETRIEBS-BERATER, 1630 (2008); Georg Maier-Reimer & Axel Wenzel, *Kapitalaufbringung in der GmbH nach dem MoMig*, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT, 1449, 1454 (2008); Rüdiger Veil, *Die Reform des Rechts der Kapitalaufbringung durch den RegE MoMiG*, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT, 1241, 1247 (2007).

31 BGHZ 157, 52.

to a GmbH will be regarded as a "shareholder loan." While the management of the GmbH then can no longer decline the repayment of a shareholder loan based on the argument that the GmbH is in the status of a crisis, the lending shareholder is obliged to re-contribute the funds received as a repayment of a shareholder loan if the GmbH has to apply for insolvency proceedings within one year after the repayment of the loan. For cash pooling systems this entails the risk that the point in time for a suspension of the participation of a GmbH in a cash pooling system (in the past this was the occurrence of a “crisis”) cannot be adequately determined in advance.