

4th P+P White Paper

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THE CRISIS OF A PORTFOLIO COMPANY FROM THE SPONSOR'S PERSPECTIVE

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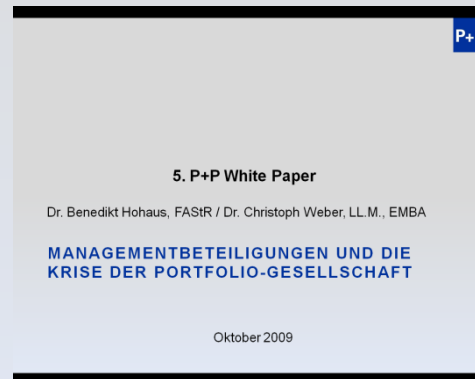
Objective of P+P White Paper

Investors require a great variety of information regarding current legal and tax developments in order to take optimal decisions for their investments. This information is quite often not purposefully prepared for the investors' demands. For this reason, P+P has started its new line of P+P White Paper.

The P+P White Paper is primarily intended for internal use and shall present important legal and tax issues in the areas of M&A and Private Equity – from funds structuring to the acquisition of an enterprise to restructuring issues – ordinarily structured and with a practical focus.

The authors of P+P White Paper are lawyers and/or tax advisors of P+P Pöllath + Partners who are experts in the respective areas.

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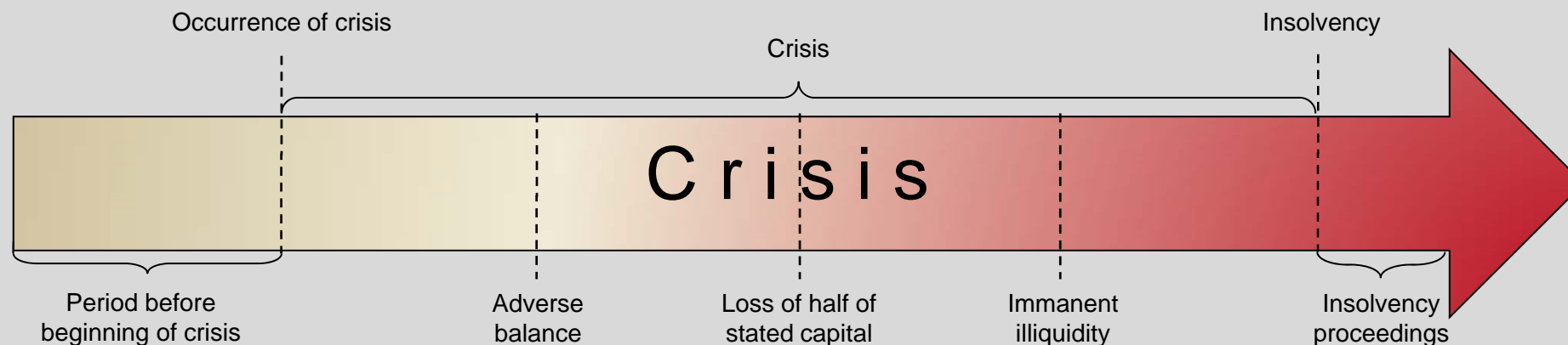
Executive Summary

- ▶ Following the loss of half of the stated equity of the portfolio company, management must call for a shareholders' meeting and must inform the shareholders accordingly.
- ▶ If a portfolio GmbH has an adverse balance (*Unterbilanz*), the capital preservation rules of the GmbH prohibit all payments to the shareholders of the GmbH (with only very limited exceptions): for an AG the prohibition of all returns of contributions applies even without an adverse balance (with only very limited exceptions).
- ▶ Even in a crisis scenario, management of a portfolio GmbH is generally bound by entrepreneurial decisions of the sponsors.
- ▶ Management is only obliged to file for insolvency proceedings upon illiquidity or over-indebtedness of the portfolio company; imminent illiquidity (*drohende Zahlungsunfähigkeit*) only entitles management to file for insolvency.
- ▶ If a portfolio company is without management, the shareholders of a GmbH as well as the supervisory board of an AG must comply with the above insolvency rules; in case of violation of such rules, they may be liable for a delayed filing for insolvency proceedings.
- ▶ The risk of any liability of sponsors as shareholders in a portfolio company specifically occurs in connection with the insolvency of a portfolio company.
- ▶ Upon an application for insolvency of a portfolio company, a shareholder must return all payments received on shareholder loans in the last year prior to such application.

Statutory Stages of Crisis

The crisis of a portfolio company from the sponsor's perspective

In a crisis of a portfolio company, GmbH Act, Stock Corporation Act and Insolvency Order are linked to various circumstances.



Prior to crisis	Occurrence of crisis	Adverse balance	Loss of half of stated capital	Imminent illiquidity	Insolvency proceedings
Prior to any crisis, management is bound by customary obligations for executive care, for example the implementation of an early warning system.	The parliamentary bodies just recently eliminated the criterion of "crisis" from the GmbH Act; accordingly, no legal consequences follow from that criterion any more.	Regarding a GmbH, the occurrence of an adverse balance results in the principle prohibition of payments to shareholders (so called capital preservation rules).	Upon loss of at least half of the stated capital, management of an AG and a GmbH must call for a shareholders' meeting.	Imminent illiquidity is a valid reason for insolvency; it does not, however, oblige management to file for insolvency proceedings.	Upon illiquidity or over-indebtedness there is an obligation to file for insolvency. All payments on shareholder loans within the last year prior to the application to insolvency are contestable.

— Reporting Requirements of Management —

Reporting requirements of management vis-à-vis the shareholders or the supervisory board may, inter alia, result from law, articles of association, standing orders or employment agreements.

Reporting requirements of management vis-à-vis bodies of company		
Statutory Reporting requirements	Loss of half of stated capital	<ul style="list-style-type: none"> • If a company loses half of its stated capital, management must immediately call for a shareholders' meeting and must inform the shareholders accordingly. • The prudent exercise of discretion is sufficient for calling the shareholders' meeting ("balance sheet in head"); an interim balance sheet is not required. • In calculating the loss, the general accounting rules regarding the annual balance sheet apply, so that any subordination to avoid insolvency for over-indebtedness must be disregarded. • If management violates the obligation to call for a shareholders' meeting, it may be liable both under corporate and criminal law.
	Only GmbH	<ul style="list-style-type: none"> • If it is necessary in the best interests of the company, management must call for a shareholders' meeting and report to shareholders. Specifically, such an obligation exists if extraordinary measures shall be taken or if management intends to execute a measure with which shareholders are likely to disagree. • In principal, the GmbH Act (except such scenarios as described above) does not require automatic information of management to the shareholders. However, upon request of the shareholders (and the supervisory board, if applicable) management must inform about the matters of the company and allow the review of the commercial books.
	Only AG	<ul style="list-style-type: none"> • Management of an AG is specifically required to inform the supervisory board on the intended policy/principles of the entrepreneurial planning (once a year), the profitability of the company (upon discussion of annual accounts), on the current business affairs (turnover of the company at least quarterly) as well as on all other transactions of significant importance (§ 90 Stock Corporation Act). Upon request of the supervisory board, management must report on the affairs of AG at any time.
Reporting requirements under articles of association or standing orders	<ul style="list-style-type: none"> • Reporting requirements under articles of association or standing orders have usually to be met in case of transactions exceeding the ordinary course of business and with regard to information necessary to evaluate the economic situation of the company. • If a standing order validly exists, certain reporting requirements for management follow directly from such standing orders and rarely from the articles of association. 	
Further reporting requirements	It must be established on a case-by-case basis if any additional reporting requirements vis-à-vis any body of the company result from employment agreements or from decisions validly passed by other bodies of the company.	

Additional reporting requirements for management can result from contractual obligations, specifically from loan agreements or cash pool agreements.

Typical reporting requirements of management vis-à-vis contractual partners		
Loan Agreement (following LMA standard)	Reporting requirements	<ul style="list-style-type: none"> • Usually there is an obligation to immediately notify the creditors upon a default (meaning any breach of an obligation resulting from the documents underlying the loan agreements); specifically in case of a (reasonably likely) breach of financial covenants. • If shareholders or certain creditors receive information from the borrower, such information must also be passed to the lenders under the loan agreement. • A lender must be informed of any court or administrative proceedings which might have a so called material adverse effect. • In addition to annual accounts and management accounts, management must submit to creditors any further information upon reasonable request.
	Compliance Certificate	<ul style="list-style-type: none"> • Facility agreements usually require that management must submit a compliance certificate upon a draw-down of any credit facility, upon a choice of an interest period and/or upon the submission of financial statements. • With this compliance certificate, management usually repeats certain representations and warranties contained in the facility agreement and confirms the non-existence of a default. • Submitting an incorrect compliance certificate may result in civil law and criminal law liability of management.
Cash Pooling Agreement	<ul style="list-style-type: none"> • Cash pooling agreements usually require that each participant in the cash pool must immediately notify the other parties of any event which might be detrimental to the financial condition of such participant. • The financial condition is specifically negatively affected, if the value of claims under the cash pooling is decreasing or no longer secured. 	
Other Agreements	Any other agreements shall be reviewed for further reporting requirements.	

Capital Preservation Rules

Management of a portfolio company is bound by the capital preservation rules whenever payments to the sponsor in its capacity as shareholder are made.

Capital preservation rules (§ 30 et seq. GmbH Act, §§ 57, 62 Stock Corporation Act)	
General rule	GmbH <ul style="list-style-type: none"> • The capital preservation rules of a GmbH prevent management from making any payments to its shareholders if and as far this results in or increases an adverse balance, unless such payment is exceptionally permitted by law. • An adverse balance is given if the net assets of GmbH (meaning assets minus liabilities and minus provisions, but without reserves) falls below the stated capital. • Relevant for the calculation of an adverse balance are the general accounting principles applying to the annual balance sheet, i.e. subordination under insolvency rules is to be disregarded and goodwill must not be activated.
	AG <p>An AG must not return any of the contributions made by the shareholders. Accordingly, AG must not undertake any kind of transaction vis-à-vis a shareholder, unless such transaction is at arm's length, the AG distributes profits shown on the balance sheet or unless the transaction is – as an exception – permitted by statutory law.</p>
What is a qualifying payment or repayment of contributions?	Payments or repayments of contributions are transactions of any kind including, inter alia, cash payments, transfer of assets, transfer of claims, payment on any liability of a shareholder, netting out of claims as well as granting of collateral in favor of a shareholder.
Who is a prohibited recipient of a payment or repayment?	<ul style="list-style-type: none"> • Individuals and entities being shareholders at the date of payment/repayment. • Third parties if the payment/repayment settles an obligation of a shareholder or if the company makes such payment/repayment upon instructions by a shareholder. • Third parties that are affiliated with a shareholder.
Are there exceptions from the capital preservation rules?	<ul style="list-style-type: none"> • No prohibition if the payment is compensated by a fully valid claim against the shareholder or if contractual arrangements meet an arm's-length test (see page 11). • No prohibition if there is a domination or profit and loss transfer agreement between company and shareholder. • No prohibition if shareholder loans are repaid or if a payment is made on a claim resulting from transactions which are economically comparable to a shareholder loan.
Which consequences result from violation of the capital preservation rules?	<ul style="list-style-type: none"> • The recipient of a prohibited payment/repayment (the shareholder or affiliated third party) must reimburse the amount received; if the recipient does not have sufficient means, other shareholders of a GmbH (not AG) are liable. • If management acted intentionally or negligently, the management is liable (in addition to the shareholders) for damages. The same applies to the supervisory board of an AG. Contractual arrangements between a sponsor as shareholder and the portfolio company do not violate capital preservation rules if the arrangements meet the arm's-length test.

Exchange agreements between a sponsor as shareholder and the portfolio company do not violate the capital preservation rules if the contractual arrangement meet the arm's-length test.

Exchange agreements	
In general	<ul style="list-style-type: none"> • Exchange agreements between a portfolio company and its shareholders do not violate capital preservation rules if the contractual arrangements meet the arm's-length test. • Agreements not meeting this test always violate the capital preservation rules applying to an AG and violate the capital preservation rules applying to a GmbH if there is an adverse balance. The arm's-length test requires that any claim against the shareholder must be fully valid and must reflect the respective market value (i.e. shareholder must pay all hidden reserves of an asset delivered to such shareholder by the company).
Specifically: Service agreements	<ul style="list-style-type: none"> • Services of a shareholder to the company (for example advising, monitoring) cannot be activated in the balance sheet and accordingly, might only pass the arm's-length test if the company cannot exist without such services – i.e. such services are not only useful but imperatively required (for example services of a shareholder-manager (see KG Berlin as of 30 April 2000)). • Accordingly there is a risk that under the capital preservation rules payments for services provided by a private equity fund or an affiliate to a portfolio company may only be paid if (in case of a GmbH) such portfolio company does not show an adverse balance and, with regard to a portfolio AG, such payment may principally violate the capital preservation rules.
Specifically: Loan agreements	<ul style="list-style-type: none"> • Loans of a portfolio company to a shareholder do not violate the capital preservation rules if the claim for repayment of the loan is fully valid at the time of payment and if the interest rates are adequate. • It is still unclear if (specifically with regard to an AG) the loan must be sufficiently secured to meet the arm's-length test.

— Instruction Right of Sponsor —

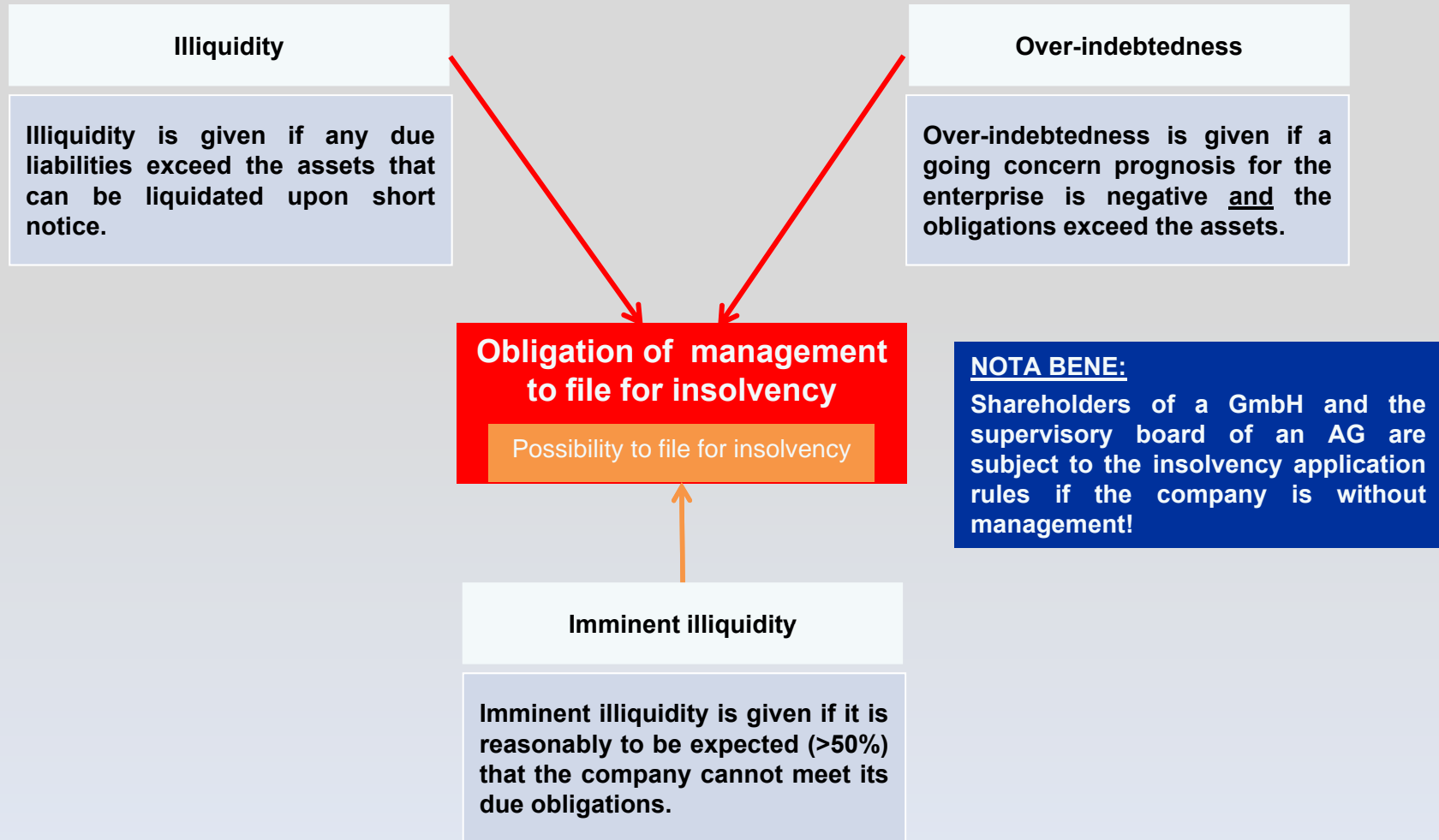
Even in a crisis scenario, the management of a portfolio GmbH is principally bound by entrepreneurial instructions by the sponsor in its capacity as shareholder.

Duties of GmbH management resulting from instructions	
Legal basis	The GmbH Act provides an instruction right of GmbH shareholder towards GmbH management; accordingly, the shareholders may give entrepreneurial instructions to the portfolio company. The Stock Corporation Act does not provide a shareholder or the supervisory board with a right of instruction vis-à-vis the executive board of an AG; accordingly, the subsequent discussions do not apply to an AG.
Instruction right	Who may give instructions? <ul style="list-style-type: none"> • The shareholders' meeting of a GmbH • Other bodies of a GmbH (for example a non-mandatory supervisory board), if these bodies have such rights according to the articles of association. • <u>But not</u> a mandatory supervisory board (§ 111 sec. 2 clause 1 Stock Corporation Act).
	Types of instruction <ul style="list-style-type: none"> • Positive-imperious instructions and negative-prohibiting instructions possible. • General instructions possible (for example no contracts with defaulting debtors). • Specific instructions possible (for example offer X must be accepted).
	Effect of instructions <ul style="list-style-type: none"> • Instruction is only binding upon an effective shareholder resolution. • Instruction given by an individual shareholder or by a minority shareholder without shareholder resolution is not binding. • But: a sole shareholder may give instructions without formal shareholder resolution.
Limits of instruction right	<ul style="list-style-type: none"> • Instructions based on an invalid shareholder resolution (for example due to formal deficiencies) or instructions violating public policy/good morals are not binding. • No obligation to comply with instructions violating statutory obligations (for example violation of capital preservation rules or violation of duty to file for insolvency). • In addition, instructions violating the articles of association or instructions which can reasonably be expected to be challenged are usually not binding.
Consequences of valid instructions	<ul style="list-style-type: none"> • Management is obliged to execute instructions validly given. If such an instruction is not executed, management is liable for damages vis-à-vis the company. • The execution of valid instructions can never be seen as a violation of an obligation of management so that such execution cannot result in any liability of management.

Insolvency

The crisis of a portfolio company from the sponsor's perspective

Only illiquidity and over-indebtedness of an enterprise result in an obligation to file for insolvency; imminent illiquidity only results in the possibility to file for insolvency.



Illiquidity must be distinguished from a principally irrelevant delay in payments as well as from imminent illiquidity.

Illiquidity (§ 17 InsO)		
When is illiquidity given?	Illiquidity	Illiquidity is given if the company is no longer able to meet its due obligations, i.e. if the due obligations are no longer covered by the available liquid means.
	Mere deferral of payments	<ul style="list-style-type: none"> • Illiquidity is to be distinguished from a mere deferral of payment, i.e. a temporary (<3 weeks) shortfall of liquidity. • A mere deferral of payment does not result in an obligation to file for insolvency, nor does it justify such an application.
	Imminent illiquidity	<ul style="list-style-type: none"> • Imminent illiquidity (§ 18 InsO) is given if it is to be expected (>50%) that the company will not be able to meet its existing payment obligations when due. • Imminent illiquidity justifies the application for insolvency proceedings but does not require such an application; the consequences of a failure to file for insolvency do in general not apply.
How to measure illiquidity?	<ul style="list-style-type: none"> • Generally, illiquidity is measured on a basis of a liquidity balance: all liquid assets and all assets that can be liquidated within three weeks are set against all liabilities due on that date. • Illiquidity as well as an obligation to file for insolvency is given if the liquidity balance shows a gap in liquidity. • In general, a minor liquidity gap (<10% of all due obligations) does not necessarily result in illiquidity unless additional circumstances apply. A minor liquidity gap must not be closed within three weeks; however, it must be closed in “a foreseeable time period”. If the liquidity gap is not just minor (>10%), then illiquidity is refutably assumed. • Illiquidity is in general to be assumed if a payment stop occurs. 	

Currently, the main factor to establish over-indebtedness is a negative going concern prognosis!

Over-indebtedness (§ 19 InsO)		
When is over-indebtedness given?	Conditions until 31 December 2013	Over-indebtedness is only given if the subsequent conditions are met cumulatively: - There is no positive going concern prognosis <u>and</u> - the assets of the company do not cover the existing liabilities.
	Conditions as of 1 January 2014	<ul style="list-style-type: none"> • Over-indebtedness is given if the obligations of the company exceed its assets. • If the going concern prognosis of the enterprise is positive, then this does not exclude over-indebtedness; however, in an over-indebtedness balance, the assets of the enterprise are reflected with going concern values instead of liquidation values.
Which principles apply to the going concern prognosis?	<p>In addition to the intention to continue the enterprise, a positive going concern prognosis requires that the successful continuation of the enterprise can objectively be expected, i.e. that a prudent businessman would decide in favor of continuation of the enterprise:</p> <ul style="list-style-type: none"> • The continuation of the enterprise promises to be successful if the given circumstances (ex ante) allow the conclusion that the enterprise will most likely (>50%) fulfill its due obligations during the prognosis period (so called "liquidity to pay prognosis"). • The prognosis period generally covers the current and the following business year. • The continuation prognosis must be based on a valid enterprise concept and on a financial and business plan documented in detail (i.e. understandable for a third party). • Discretion is granted if and when the continuation prognosis is made; accordingly, the prognosis is only wrong if such prognosis is – from the perspective of a prudent businessman – simply no longer maintainable. 	
What is an over-indebtedness balance?	<ul style="list-style-type: none"> • The over-indebtedness balance is a special sort of balance to be distinguished from both accounting balance and tax balance. • The over-indebtedness balance covers all assets (unclear, if this includes goodwill) and all existing liabilities in order to give the truest realistic view of the financial situation possible. 	

The application to file for insolvency proceedings can easily trigger liabilities: such application must not be filed too early or too late.

Application for opening of insolvency proceedings

Upon illiquidity or over-indebtedness, management must file insolvency proceedings immediately if any efforts to save the enterprise are obviously without success, in other scenarios at least within three weeks (if there is no management then such application must be filed by a GmbH shareholder or by a member of the supervisory board of an AG (§ 15 a InsO)).



(Too) early application

- Early application is given if an insolvency filing is made without the existence of a reason for insolvency or if out of court restructuring was not reviewed sufficiently.
- If the application was filed too early, management is generally liable vis-à-vis the company for all damages resulting from the early application: for example, costs of insolvency proceeding and the resulting negative publicity.
- In addition, management may be liable for damages vis-à-vis the (co-)shareholders.
- In case of imminent illiquidity, the application is valid but too early, if such application is made without the approval of the shareholders' meeting. In this case, liability vis-à-vis the company can also arise.



(Too) late application

- Late application is given if an application is not filed or – in case of restructuring efforts – not filed within three weeks or – in case of obviously unsuccessful restructuring efforts – not filed immediately, so called procrastination of insolvency.
- Negligent or intentional procrastination of insolvency results in criminal liability (with a maximum prison sentence of three years). This applies specifically to management, but – if there is no management – just as well to GmbH shareholders or members of the supervisory board of an AG.
- If the obligation to file for insolvency proceedings is violated due to negligence or intent, liability for damages arises vis-à-vis the creditors of the company as well as vis-à-vis the company itself.
- Intentional procrastination of insolvency results in a statutory prohibition to act as GmbH manager for a period of five years.

Shareholder Liability

The risk of GmbH shareholders to become liable specifically occurs in connection with the insolvency of a portfolio company!

Main risks of shareholder liability during a crisis	
Liability as factual manager (“ <i>faktischer Geschäftsführer</i> ”)	<ul style="list-style-type: none"> • GmbH shareholders act as factual managers if – in view of all circumstances – they run the affairs of the company vis-à-vis third parties to an extent usually associated with a manager. • In principle, the factual manager is liable like a regular manager: <ul style="list-style-type: none"> - Liability for procrastination of insolvency. - Liability for causing insolvency and reducing assets. - Liability for violation of capital preservation rules. • In principle, factual management does not occur in the context of an AG as the management of an AG is not bound by any instructions of shareholders or the supervisory board.
Liability for procrastination of insolvency	<ul style="list-style-type: none"> • GmbH shareholders and members of the supervisory board of an AG must timely file for the application of insolvency proceedings, if the company has no management (see page 15 above). If such shareholders/members of supervisory board intentionally or negligently violate such obligation they are liable on the criminal law for procrastination of insolvency (with a maximum prison sentence of three years) and are liable for damages of the company.
Liability for interference (“ <i>existenzvernichtender Eingriff</i> ”)	<ul style="list-style-type: none"> • A shareholder may be liable for destruction of the portfolio company if the shareholder deprives the company of assets (without compensation) and thereby intentionally causes the insolvency of the company. • In this case, the shareholder must compensate the assets withdrawn and is liable for any collateral damages (for example damages resulting from the liquidation following insolvency). Such liability is very extensive!
Obligation to compensate according to § 31 GmbH Act and § 62 Stock Corporation Act	If a shareholder receives payments from its company under violation of the capital preservation rules then such shareholder must repay the company the received amount.

A shareholder must reimburse the company for all payments received in the last year prior to the application for opening of insolvency proceedings.

Defeasibility of repayment of shareholder loans under insolvency law	
Reason for defeasibility	Upon an insolvency, all shareholder loans are treated as subordinated. In order to prevent a circumvention of such subordination immediately prior to insolvency, all repayments of shareholder loan within in the last year prior to insolvency are defeasible.
Recipient of notice of defeasibility	<ul style="list-style-type: none"> • Shareholders and persons equivalent to a shareholder (for example fiduciaries, indirect shareholders, affiliates of shareholders). • Former shareholders, if the loan was granted while such former shareholder held an interest in the company. • In specific cases providers of mezzanine finance who participate in entrepreneurial risks and chances (for example silent partners, providers of participating loans or holders of jouissance rights).
Scope of defeasibility	Each payment on a shareholder loan or an equivalent claim (including interest) made in the last year prior to the application for insolvency is defeasible.
Consequence of exercise of defeasibility	<ul style="list-style-type: none"> • Any amount which the portfolio company transferred on the basis of the defeasible transaction must be repaid by the sponsor into the insolvency assets of the company. • The amount the company gave away is relevant, not the amount the sponsor received.
Exceptions	Minimal participation privilege <ul style="list-style-type: none"> • If a shareholder holds less than 10% in the portfolio company and does not participate in the management of such company, then shareholder loans granted by such shareholder are not subordinated in an insolvency and, accordingly, are not subject to defeasibility. • To calculate the 10% threshold, the shareholder's participation in the liable capital is relevant (§ 39 sec. 5 InsO).
	Restructuring privilege <ul style="list-style-type: none"> • If a sponsor who formerly did not hold a participation acquires shares in a company upon (imminent) illiquidity or over-indebtedness for restructuring purposes, then loans provided by such shareholders are not subordinated in an insolvency and are not subject to defeasibility.

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