Overindebtedness ……

…….. **in accountancy terms of a limited liability company**

Short info - legal measures to avoid balance sheet deficit“

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Overindebtedness in accountancy terms of a limited liability company

If the company's equitiy in the statutory accounts shows a deficit at the balance sheet date, the company is overindebted in accountancy terms. Thereof, special statutory obligations and responsibilities are resulting for the management board. For your information, please find a summary of those obligations below.

1. Obligation to file for insolvency according to § 15a InsO

The managing director has to file an application for insolvency without undue delay, however, at the latest, three weeks after the occurence of overindebtedness or insolvency. The managing director is personally liable for any damage resulting from the delayed filing of the application for insolvency.

Overindebtedness in accountancy terms does not imply automatically that the company is overindebted in terms of InsO (German Insolvency Code). Based on the current legislation there is overindebtedness in terms of InsO if the existing liabilities exceed the assets - evaluated with the current fair of value - and at the same time going concern is predominantly not likely based on the current situation of the company.

Thus, a favorable going concern forecast for the company excludes overindebtedness. The forecast has to be verified based on a business and financial plan and a feasible corporate concept. If going concern is not likely for the company, in a second step it has to be analyzed, if - based on a liquidation

scenario - the assets of the company cover the liabilities respectively evaluated at the current fair value.

The management board is able to avoid overindebtedness with measures as e.g. subordination agreements or letter of comfort. However in case of overindebtedness in accountancy terms the management board has to control continuously a potential overindebtedness in terms of InsO.

2. Measures to remedy over-indebtedness

a) Increase in share capital

The capital increase only becomes valid by registration in the commercial register. The management of the GmbH has to apply for such registration. A Notary Public is mandatory.

b) Increase of free reserves

This is a capital injection from the shareholders guided by an shareholders resolution. A Notary Public is not necessary.

c) Subordination of (shareholder) loans to the company

A common measure to redress the liquidity of a company is through shareholder loans. Further, in order to avoid over-indebtedness (balance-sheet insolvency), shareholders may additionally declare a subordination of their loans to the company. However, such subordination must be worded carefully in order to avoid undesired fiscal effects, as it may otherwise cause extraordinary profits and thereby trigger taxes.

d) Letters of comfort

As an alternative to loans, shareholders may provide a letter of comfort.

A parent company may address a letter of comfort to its subsidiary or to creditors of such subsidiary. Depending on the wording, it may:

- produce a legal obligation against its issuer (ie, a binding letter of comfort); or
- contain only a non-binding and therefore unenforceable statement of some moral value – if any (ie, a non-binding letter of comfort).

In order to prevent over-indebtedness and insolvency of the beneficiary, the letter of comfort must be binding. In a binding letter of comfort, a shareholder

typically declares to its subsidiary that it will provide – at any time – the necessary financial means required by the subsidiary to fulfil its financial obligations and cover any adverse balance.

Such a letter of comfort is traditionally seen as suitable to relieve the subsidiary's directors from the duty to file for insolvency proceedings – provided that the parent company is in sufficient financial standing to fulfil its financing obligation.

e) Loss transfer agreement

A similar effect with respect to possible losses has a domination, and profit and loss transfer agreement

Such an inter-company agreement provides that all losses – but also all profits – be transferred from the subsidiary to its parent company. As to the losses, it means that the parent company will be obliged towards its subsidiary to pay an amount equal to such losses at the end of the financial year.

It is often used to create tax unity between a subsidiary and a parent company, whereby the losses of one company diminish any taxable profits of the other. In order to create the desired fiscal effect, such agreement must be entered into for at least five years. Further differences with respect to a binding letter of comfort are that the shareholders must decide on such agreement and the agreement must be registered and made public.

f) Cost plus agreement

Cost plus pricing is a cost-based method for setting the prices of goods and services. Under this approach, you add together the direct material cost, direct labor cost, and overhead costs for a product, and add to it a markup percentage (to create a profit margin) in order to derive the price of the product.

The cost plus method begins with the costs incurred by the supplier of property or services in a controlled transaction for property transferred or services provided to an associated enterprise. An appropriate mark-up, determined by reference to the mark-up earned by suppliers in comparable uncontrolled transactions, is then added to these costs, to make an appropriate profit in light of the functions performed and the market conditions.

A cost plus agreement will avoid losses in advance.

3. Comments to provisions for preservation of capital

The managing director is obliged to call a shareholder's meeting without delay, if - based on financial statements for the fiscal year or based on preliminary financial statements - half of the share capital is lost (§49 (3) GmbH (Limited Liability Companies Act))

Additionally, the managing directors have to ensure that the assets required for the preservation of the share capital may not be paid out neither for the grant of loans to managing directors or e.g. persons authorized with general power of representation (Prokuristen) (§ 43a GmbHG), nor for payments to shareholders.

Please consider the following provisions in particular: § 43a GmbHG, § 49 GmbHG und § 84 GmbHG.

a) Payments to shareholders

The assets required for the preservation of the share capital may not be used for payments to shareholders. This is not applicable if there is a recoverable claim for the refund of the payments. Otherwise, the shareholders have to pay back the prohibited repayments (§§ 30, 31 GmbHG). Under certain conditions the claim can also be demanded from the managing director personally.

In case of a tense liquidity situation it is not allowed to authorize payments to shareholders if these payments cause insolvency. Additionally, if the company is insolvent or overindebted, in order to safeguard the assets under liquidation, the managing director may not make any payments on behalf of the company - except for a few exemptions. (§ 64 GmbHG).

Please consider the following provisions in particular: § 30 GmbHG, § 31 GmbHG and § 64 GmbHG.

b) Particularities concerning a limited liability company, which is a general partner of a limited partnership

Payments effected by a limited partnership to a person who is shareholder of this partnership and its general partner in the form of a limited liability company may in certain cases also be prohibited payments. One precondition is that this payment leads indirectly to a reduction of the share capital of the general partner.

4. Final short info: The German Law:

Please consider the following provisions in particular:
§ 15a InsO, § 17 InsO, § 19 InsO und § 135 InsO; for instance:

Section 19 InsO - **Insolvency law** - Overindebtedness

(1) Overindebtedness shall also be a reason to open insolvency proceedings for a legal person.

(2) Overindebtedness shall exist if the debtor's assets no longer cover his existing obligations to pay, unless it is highly likely, considering the circumstances, that the enterprise will continue to exist. As regards claims in respect of the restitution of shareholder loans or claims deriving from legal transactions corresponding in economic terms to such a loan, for which the creditors and the debtor have agreed, in accordance with section 39 subsection (2), that they shall rank lower behind the claims set out in section 39 subsection (1), nos. 1 to 5 in the insolvency proceedings, consideration shall not be given to the obligations under the first sentence.

(3) If none of the general partners of a company without legal personality is a natural person, subsections (1) and (2) shall apply mutatis mutandis. This shall not apply if the general partners include another company with a natural person as general partner.

Die Innova Steuerberatungsgesellschaft mbH steht Ihnen gerne für weitere Fragen zur Verfügung. Bitte sprechen Sie uns an!

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