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ARTICLE

Reversal of Value Extraction Schemes: The German Perspective

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Synopsis

Value extraction schemes, used by shareholders who buy a company in financial distress in order to strip it of its assets, are intensively discussed in the UK. Under German law – and the same holds true for many other European jurisdictions – such schemes can be tackled in various ways. Remedies can be found in transactions avoidance law, particularly through rules on transactions on an undervalue and on intentionally fraudulent transactions. Alongside, instruments of company law – e.g. directors' or shareholders' liability or rules on share capital protection – can be activated. In recent case law, the German *Bundesgerichtshof* has also applied tort law, developing the legal figure of 'existence-crushing intrusion'. In all, German law addresses the problem of value extraction schemes sufficiently.

I. Introduction

Insolvencies are sometimes caused by shareholders sucking the last valuable assets from their company. It can frequently be observed that investors buy a company in financial distress via share deal and, while feigning a rescue attempt, strip it of its assets and eventually send it into insolvency proceedings. The company is then no longer salvageable, is subject to liquidation proceedings and creditors will then receive only a small (if any) return of the proceeds.

Such value extraction schemes appear in various shapes: shareholders (or closely related persons) are granted a contract as directors and receive an unusually high salary; the company pays a 'management fee' to the shareholder without them being official directors; shareholders grant a short term loan with unusually high interest rates which is paid back in the vicinity of the application for, or opening of, insolvency proceedings; shareholders receive charges over company property for securing such loans; shareholders buy assets for an unusually low price or lease them back for excessive remuneration; etc. After the opening of insolvency proceedings, insolvency practitioners (if necessary by approaching a court) will try to reverse the value extraction scheme by recollecting unfair advantages from the shareholders, be it by means of transactions avoidance, be it by means of company or general civil law.

In the UK, the government launched a consultation on Insolvency and Corporate Governance on 20 March 2018[1] which, among other things, has explicitly addressed value extraction schemes. The consultation (p. 15) describes the following example:

> 'A company in financial trouble is bought by a new investor. The new investor injects £20m as a loan into the company, to support its working capital. The company pays interest on the loan at considerably more than a commercial rate and the loan is secured over the company's property. In addition, the company pays a 'management fee' to the investor. The company subsequently enters formal insolvency. The investor has benefited from interest payments and management fees prior to the insolvency and, at insolvency, benefits from its charge over the assets (...).'

On 26 August 2018, the UK government published a response to this consultation[2] and has announced that it intends to tackle the problem of unfair transactions in the lead up to insolvency (p. 36 et seq.), albeit without making concrete proposals.

Many participants in the consultation have expressed their concern that current powers of insolvency practitioners (or courts) under English law are not sufficient to undo such transactions. It is most likely that this is also a problem in many other jurisdictions. Against this background, it might be interesting to learn about the legal situation in Germany which I will deal with in the first part of this paper. The second part will report on a project of a working party of CERIL, the Conference on European Restructuring and Insolvency Law, which has started a new survey on the reversal of value

Notes

1 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/691857/Condoc_-_Insolvency_and_Corporate_Governance_FINAL_.pdf (last accessed 9 January 2019), p. 13 et seq.

2 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/736163/ICG_-_Government_response_doc_-_24_Aug_clean_version__with_Minister_s_photo_and_signature__AC.pdf (last accessed 9 January 2019).

extraction schemes in the EU member states and evaluates the results.

II. Value extraction schemes under German law

Value extraction schemes have been discussed in Germany since the 1990s, originally exclusively in the context of company law (and here of the law of groups of companies). Since 2007, the German Federal Court of Justice (Bundesgerichtshof, BGH) applies general tort law (§ 826 Buergerliches Gesetzbuch, BGB) and recently also transactions avoidance law (§ 133 Insolvenzordnung, InsO).[3]

1. Transactions avoidance law

Let me start with transactions avoidance law.[4]

a) Preferences

All payments (whether excessive or not) can be clawed back as preferences when made within the suspect period of three months prior to the application for insolvency proceedings (or after such application but before the opening of proceedings). As long as the payments meet the terms of the (loan etc.) agreement between shareholder and company, they are treated as 'congruent coverage' within the meaning of § 130 InsO. If so, they are only voidable if the debtor company was insolvent (unable to pay their debts when they fall due – cash flow insolvency) at the point in time when the payment was made which is mostly the case in the context of value extraction schemes. A further (subjective) prerequisite is the knowledge of the shareholder of the debtor's inability to pay debts. This typically has to be proven by the Insolvency Practitioner (IP) who challenges the payment. However, since the shareholder normally is a closely related person[5] their knowledge is rebuttably presumed (§ 130(3) InsO). Shareholders engaged in value extraction schemes typically know of the debtor company's insolvency. Hence, the rebuttal will not succeed.

Where the shareholder receives payments which are not due or for other reasons not covered by the agreement between shareholder and company the payments are challengeable as incongruent coverages under § 131 InsO. The suspect period is also three months (as in § 130 InsO), but there are no subjective requirements (mental elements). The only additional prerequisite is the cash flow insolvency (inability to pay debts) of the debtor. If the payment has been made during the last month before (or after) the application for insolvency proceedings even this is not necessary.

However, in all cases (congruent as well as incongruent coverages, but also transactions at an undervalue and transactions defrauding creditors) transactions avoidance is not possible if the shareholder is sufficiently secured, because in this case the payment is not detrimental to the general body of creditors which is required by § 129 InsO. The grant of the charge is the detrimental aspect, and it is for this reason that challenging the charge is predominant to challenging the payment. In other words, payments on secured credit are only voidable if the security is voidable itself. This means that incidentally transaction avoidance of the charge has to be examined. Here, the same rules apply as for payments: charges can be challenged as congruent or incongruent coverages, transactions at an undervalue and transactions defrauding creditors under the same prerequisites as payments. There is one exception, which is very important in the present context: under § 135(1)No.1 InsO securities granted to shareholders within the last ten years prior to (or after) the application for insolvency proceedings can be challenged if they secure a loan granted by the shareholder.

Another question is whether the underlying disadvantageous contracts rather than the payments on such contracts can be challenged. The answer can be found in § 132 InsO which allows the challenge of such contracts under the same prerequisites as § 130 InsO, provided that the contract caused an immediate disadvantage to the general body of creditors which is the case in most value extraction schemes if the counter-performance of the shareholder is unusually low.

b) Transactions at an undervalue

Payments covered by a value extraction scheme can also be challengeable under § 134 InsO which deals with transactions at an undervalue. The only substantive prerequisite is that the performance of the debtor was gratuitous, i.e. without adequate and balancing counter-performance of the shareholder. This covers (for example) unusually high salaries, interest rates or remunerations or sales for unusually low prices. According to judgments of the BGH, it is necessary that – which has to be proven by the IP – both parties (company and shareholder) are aware of the inequality

Notes

3 Statutes can be found in English on the internet. See for the BGB http://www.gesetze-im-internet.de/englisch_bgb/index.html; for the GmbHG http://www.gesetze-im-internet.de/englisch_gmbhg/index.html; for the InsO http://www.gesetze-im-internet.de/englisch_inso/index.html (all last accessed 9 January 2019).

4 Useful hints by Markus Gehrlein, *Verbindungslinien zwischen Eigenkapitalersatz, Insolvenzanfechtung und Deliktshaftung*, NZI 2015, 577-583.xxx

5 Cf. below at e.

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of the performances.[6] Special mental elements are not required. The suspect period is four years prior to the application for insolvency proceedings and the burden of proof lies with the IP as far as the gratuitousness is concerned.

However, it should be emphasised that the effect of tackling value extraction schemes as a transaction at an undervalue is limited to the excessive part of the performance.[7] If, for example, a fee of 100 is usual and the parties have agreed to pay 140, only 40 can be clawed back under § 134 InsO.

c) Intentionally fraudulent transactions

Under § 133 InsO, the German version of the *actio pauliana*, all acts of the debtor detrimental to the general body of creditors and granted within ten years prior to (or after) the application for insolvency can be challenged if the debtor company acted in bad faith (i.e. with the intent to disadvantage the general body of creditors) and the opponent knew of this intention. This rule is dominantly characterised by mental elements which are difficult to prove. However, the BGH has found a wide range of circumstantial evidence. Especially, if the parties knew that the debtor company was (at least imminent) insolvent, the subjective requirements are indicated and it is for the opponent to prove that the debtor acted in good faith or that the debtor's intent was unknown to him.[8] In the context of value extraction schemes, the shareholder is either a director himself or the directors are in close contact with the shareholder. Hence, proving the mental elements should not be too difficult.[9]

§ 133 InsO is a remedy not only against disadvantageous payments but also against disadvantageous contracts. This is proven by § 133(4) InsO which presumes the mental elements for closely related parties[10] if an exchange contract causes an immediate disadvantage to the general body of creditors. § 133(4) InsO covers not only disadvantageous contracts but also payments. In the case of payments, the disadvantage is immediate if the shareholder's claim was unenforceable, be it for legal reasons (shareholder loans are subordinated retrospectively once insolvency proceedings have been opened), be it for economic reasons (shareholder claims are worthless if the debtor company is substantively insolvent).[11]

d) Shareholder loans

According to § 135 InsO, payments and securities granted to shareholders can be clawed back under alleviated conditions. All payments which have been made during the last year – and all charges granted during the last ten years – prior to (or after) the application for insolvency proceedings are voidable. There are no further prerequisites, especially no mental elements.

Addressees of this rule are – by reference to § 39 InsO – all shareholders who

(1) hold shares of a company without a natural person with personal liability for the company's debts,

(2) hold more than 10% of the shares or are acting as director (including shadow director)

(3) have not acquired the shares for restructuring purposes while the company was at least imminently insolvent. Subordinated by §§ 39, 135 InsO are loans and comparable claims of the shareholder, e.g. claims for remuneration which have not been enforced for more than 30 days.

e) Connected parties

There are also rules which amend the general norms of transactions avoidance laws for closely related parties, especially by transferring the burden of proof to the opponent (§§ 130(3), 132(3), 133(4) InsO). Closely related parties are defined in § 138 InsO. According to § 138(2) InsO,

> 'if the debtor is a legal person or a company without legal personality, the persons with a close relationship to the debtor shall be:
>
> 1. the members of the body representing or supervising the debtor, as well as his general partners and persons holding more than one quarter of the debtor's capital;
> 2. a person or a company having on the basis of a comparable association with the debtor under company law or under a service contract the opportunity to become aware of the debtor's financial circumstances;
> 3. (...).'

Notes

6 BGH, 15.9.2016 – IX ZR 250/15 = NZI 2017, 68. Critical remarks by Reinhard Bork, *Die Anfechtung unentgeltlicher Leistungen nach § 134 InsO*, NZI 2018, 1-9.

7 BGH, 25.6.1992 – IX ZR 4/91 = NJW 1992, 2421.

8 BGH, 14.6.2018 – IX ZR 22/15 = ZIP 2018, 1794; 18.1.2018 – IX ZR 144/16 = NZI 2018, 264; 14.9.2017 – IX ZR 3/16 = NZI 2018, 114; 6.7.2017 – IX ZR 178/16 = NZI 2017, 850; 5.3.2009 – IX ZR 85/07 = BGHZ 180, 98 = NJW 2009, 1601 Rdnr. 10; 29.11.2007 – IX ZR 121/06 = BGHZ 174, 314 = NJW 2008, 1067; 13.4.2006 – IX ZR 158/05 = BGHZ 167, 190 = NJW 2006, 2701.

9 Cf. BGH, 21.2.2013 – IX ZR 52/10 = NJW-RR 2013, 1321.

10 Cf. below at e.

11 BGH, 9.6.2018 – IX ZR 153/15 = NZI 2016, 773; 20.12.2012 – IX ZR 130/10 = NJW-RR 2013, 880.

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It follows from this text that § 138 InsO is an insider rule which justifies the (rebuttable) presumption that these persons have the detrimental knowledge required by §§ 130, 132, 133 InsO. As regards the personal scope, the norm covers directors, members of the board and shareholders with significant influence (personal liability or more than 25% of the company's share capital) or knowledge (No. 2). Regarding the factual scope, § 138 InsO covers all transactions, whereas §135 InsO covers repayments of and securities for loans and comparable claims.[12]

2. Company law

Leaving insolvency law and turning to company law, a preliminary remark is due. Since most debtor companies in Germany are organised as a GmbH (Gesellschaft mit beschraenkter Haftung, limited company), I will restrict the following text to the GmbHG (Gesetz betreffend die Gesellschaften mit beschraenkter Haftung, Limited Liability Companies Act). This statute does not contain any special rules on value extraction schemes, but there are some general rules which are applicable to our subject.

a) Directors' liability

Starting with directors' liability, the GmbHG provides for such a liability in a twofold manner. First, there is the general liability rule in § 43 GmbHG according to which the directors shall conduct the company's affairs with the due care of a prudent businessman and directors who breach these duties shall be jointly and severally liable to the company for any damage arising. In the context of value extraction schemes, this means that directors who (e.g.) conclude detrimental contracts and pay excessive remunerations to shareholders and thereby cause damage to the company can be held liable in person. However, § 43 GmbHG is not applicable where a shareholders' meeting has approved of or even directed the conclusion of such contracts or the making of payments, since directors of a GmbH are bound to directions of the shareholders' meeting (§ 37 GmbHG).

Second, according to § 64 GmbHG, the directors are obligated to compensate the company for payments made after the company has become illiquid or after it is deemed to be over-indebted. This shall not apply to payments which, after this point in time, are compatible with the due care of a prudent businessman. The directors shall be under the same obligation in regard to payments to shareholders if these have led to the company becoming illiquid, unless this was not recognisable whilst observing the due care of a prudent businessman. Applying this rule to value extraction schemes means that directors have to reimburse to the company all payments which have been made to the shareholder after the point in time where the company was either unable to pay its debts or was overindebted. This is not a remedy against contracts with a hollowing effect (as contracts are not payments) yet a precaution against further diminishing the estate to the detriment of the general body of creditors.

b) Share capital protection

German company law provides also for rules on protecting the capital of the company which are relevant for fighting value extraction schemes. German GmbHs are characterised by the requirement of a fixed share capital with an amount of at least 25,000 € (§ 5 GmbHG).[13] Shareholders have to pay the capital in money or real value, depending on the details in the charter. Once the capital is paid, § 30 GmbHG interdicts the repayment of the assets necessary to maintain the company's share capital to the shareholders. Assets are necessary for maintaining the capital if the payment leads to insolvency (overindebtedness) or an adverse balance sheet.[14] § 30 GmbHG does not cover payments which are covered by a full claim to counter-performance against the shareholder (§ 30(1)(2) GmbHG). However, in the context of value extraction schemes this prerequisite is mostly not met, since the shareholder, by definition, receives excessive or unusually high salaries, management fees, interest rates etc.

If § 30 GmbH is violated, § 31 GmbH orders that the shareholder has to pay the money back. In addition, the directors who have made the payments are personally liable if the money cannot be clawed back from the shareholder (§ 43(3) GmbHG).

3. General civil law

The *Bundesgerichtshof* applies further § 826 BGB,[15] a tort law provision according to which a person who, in a manner which infringes *boni mores* (i.e. is contrary to public policy), intentionally inflicts damage on another person is liable to the other person to make compensation for the damage. The application of this rather narrowly shaped rule is the end of a long journey

Notes

12 Cf. above at d.
13 I will omit the possibility of the so-called '*Unternehmergesellschaft*' which requires a fixed share capital of EUR 1 only, cf. § 5a GmbHG.
14 BGH, 26.6.2018 – II ZR 65/16 = NJW-RR 2018, 1054; 21.3.2017 – II ZR 93/16 = BGHZ 214, 258 = NJW-RR 2017, 1069.
15 See below at fn. 17.

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through the landscape of value extraction schemes.[16] Realising that neither §§ 30, 31 GmbHG (which lead to claw back of accountable assets or payments but not to compensation of damages) nor transactions avoidance law (which cannot be applied if the value extraction scheme was so thorough that insolvency proceedings cannot be opened for lack of sufficient assets, § 26 InsO) suffices, the BGH tried to find other solutions. The court first applied company law, especially the law of groups of companies, holding the shareholder liable for inadequate influence in a 'qualified de facto group of companies'.[17] However, this solution did not find the necessary support and neither did the idea to found the 'piercing of the corporate veil' on company law, leading to personal liability of the shareholder in a limited company (deviant from § 13(2) GmbHG).[18] Finally, in 2007, case law ended up in tort law and established the legal figure of 'existence-crushing intrusion' (*existenzvernichtender Eingriff*, destruction of the company) of the shareholder into the company, which is now generally accepted.[19]

However, § 826 BGB is narrowly constructed and narrowly applied by the BGH. In order to establish 'infringement of *boni mores*', the court requires existence-crushing by 'plundering' which appears as self-service instead of creditor-service. Necessary is (1) an act of a majority shareholder (or several shareholders acting in concert or a shareholder-shareholder with dominating influence in the company), (2) deprivation of assets or defeat of earning opportunities (3) without respecting that the company's assets are recoverable assets for the creditors (e.g. by paying an adequate compensation or having another justification) and (4) spoiling the company's ability to pay their debts by causing or deepening substantive insolvency.[20] On the subjective side, § 826 BGB requires intent yet dolus eventualis suffices. Where these prerequisites are met, the company has a claim against the shareholder which stands beside claims arising from §§ 30, 31 GmbHG[21] or §§ 43, 64 GmbHG and which is normally executed by the company's Insolvency Practitioner yet can also be seized by single creditors if no insolvency proceedings have been opened.

Examples are rare. Typically, shareholders confronted with existence-crushing intrusion did not only hold all or at least the majority of shares but were also directors of the company. In the leading case, such a shareholder had received assets from the company as security for a shareholder loan and had terminated a lease contract between the company and himself by replacing it through a management contract. The BGH found the security ownership compensated by the loan and the termination of the lease contract justified by the company's default to pay the lease as well as compensated by the management contract. However, the court pondered an existence-crushing intrusion if the company's compensation provided for in the management contract was so low that insolvency was unavoidable. In other cases, the BGH did not accept an existence-crushing intrusion for founding the company with insufficient capital ('Cinderella corporation'),[22] selling the company's assets in the run of liquidation[23] or collecting the company's receivables while using the collected money for paying off creditors.[24] § 826 BGB was applied, however, where the shareholder had (as a director) waived a claim of the company against the shareholder himself,[25] or had sold the assets of the company to a sister company without adequate compensation.[26]

4. General aspects

At the end of the first part of this discussion, some general remarks are due.

The first one concerns the person entitled to enforce the claims or rights against the shareholder. Before the opening of insolvency proceedings, claims against the shareholder are claims of the company, yet can be seized by creditors. After the opening of insolvency proceedings all claims of the company are collected by the Insolvency Practitioner. In both cases, the entitled person has to go to court if the shareholder refuses voluntary satisfaction.

The second remark regards the limitation period for the rights or claims in question. Under §§ 195, 199

Notes

16 See for details Tan Cheng Han/Wang Jiangyu/Christian Hofmann, *Piercing the Corporate Veil; Historical, Theoretical and Comparative Perspectives* (NUS Law Working Paper 2018/25) 30-44; Sebastian Mock, 'Groups of companies', in Martin Schmidt-Kessel (ed.), *German National Reports on the 20th International Congress of Comparative Law* (Mohr-Siebeck, Tübingen 2018) 307-396 at pp. 378-380.

17 BGH, 29.3.1993 – II ZR 265/91 = BGHZ 122, 123 = NJW 1993, 1200; see on this decision Sebastian Mock, 'The Incorporation Process and Limitations to Limited Liability', in Marco Ventoruzzo/Pierre-Henri Conac/Gen Goto/Sebastian Mock/Mario Notari/Arad Reisberg, *Comparative Corporate Law* (West Academic Publishing, St. Paul, 2015) 172-174.

18 BGH, 17.9.2001 – II ZR 178/99 = BGHZ 149, 10 = NJW 2001, 3622.

19 BGH, 16.7.2007 – II ZR 3/04 = BGHZ 173, 246 = NJW 2007, 2689; see on this decision Mock (above fn. 17), p. 174-176.

20 BGH, 18.6.2013 – II ZR 217/12 = GmbHR 2013, 1321; 21.2.2013 – IX ZR 52/10 = NJW-RR 2013, 1321.

21 For details, see BGH, 15.9.2014 – II ZR 442/13 = GmbHR 2015, 644.

22 BGH, 28.4.2008 – II ZR 264/06 = BGHZ 176, 204 = NJW 2008, 2437.

23 BGH, 23.4.2012 – II ZR 252/10 = BGHZ 193, 96 = NZI 2012, 517.

24 BGH, 2.6.2008 – II ZR 104/07 = NJW-RR 2008, 1417.

25 BGH, 9.2.2009 – II ZR 292/07 = BGHZ 179, 344 = NJW 2009, 2127.

26 BGH, 21.2.2013 – IX ZR 52/10 = NJW-RR 2013, 1321; see also BGH, v. 8.2.2018 – IX ZR 103/17 = NJW 2018, 2404.

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BGB the limitation period is three years, starting with the end of the year during which the claim emerged and the company new of the facts and the person of the debtor.

5. General assessment

In summarising whether and how precisely the various performances (contracts as well as payments) connected to a value extraction scheme can be challenged in Germany, the following can be said:

Except for general remedies of transactions avoidance law (§§ 130-132 InsO), an unusual high salary for the shareholder acting as a director can be clawed-back according to §§ 133, 134 InsO, 30, 31 GmbHG as far as the excessive part of the salary is concerned. The contract can be challenged under § 133 InsO (in some circumstances with the effect that the complete salary has to be paid back). Directors can be held liable for damages under § 43 GmbHG (unless they act according to a direction of the shareholders meeting) and shareholders can be held liable for damages under the requirements of § 826 BGB (existence-crushing intrusion).

The same rules apply to a management fee for a shareholder not acting as a director, to a sale and lease back for excessive remuneration and to an unusually high interest rate for a loan granted by the shareholder. In addition it should be stressed, that all payments on shareholder loans during the last year prior to (or after) the application for insolvency proceedings are challengeable under § 135(1)No. 2 InsO. Charges for such a loan are – with a look-back period of 10 years – challengeable under § 135(1)No. 1 InsO. Where assets were bought from the company by a shareholder for an unusually low price, such transactions are voidable as transactions at an undervalue (§ 134 InsO) and as intentionally fraudulent transactions (§ 133 InsO). Directors can be held liable for damages under § 43 GmbHG (unless they act according to a direction of the shareholders meeting), the shareholder can be held liable for damages under the requirements of § 826 BGB (existence-crushing intrusion).

All in all, it seems to me that the problem of value extraction schemes is sufficiently addressed in German law.

III. The CERIL project

How far national laws support the reversal of value extraction schemes is also the research question considered by a working group of the Conference on European Restructuring and Insolvency Law (CERIL),[27] which I have the honour to chair and which consists of 19 members from 17 jurisdictions. The project has not been finished yet but so far I have received national reports from nine jurisdictions, namely Czech Republic, Denmark, Germany, Italy, Portugal, Slovakia, Slovenia, Spain and Sweden. A first analysis of these reports supports the thesis that in all these jurisdictions value extraction schemes can be challenged through transactions avoidance law, particularly through rules on transactions at an undervalue and on intentionally fraudulent transactions, providing for aggravation to the disadvantage of closely connected parties by extension of suspect periods or by rebuttable presumptions for certain prerequisites such as mental elements or detriment to the general body of creditors. Additional remedies can be found in company law, particularly in the rules on directors' liability. Interestingly, all national reporters feel that with some members of the working group seeing the decisive problem more in acquiring the necessary information about the relevant facts than in pursuing the claims resulting from these facts.

IV. Conclusion

In sum, German law – and the same can be said for many other jurisdictions – provides Insolvency Practitioners with a wide range of legal instruments for tackling value extraction schemes sufficiently. Transactions avoidance law, assisted by company and tort law, proves to be very helpful. This holds particularly true for rules on transactions at an undervalue, intentionally fraudulent transactions and shareholder loans.

Notes

27 CERIL is an independent and non-profit organisation made up of practitioners, researchers, and judges working in the areas of restructuring and insolvency; cf. <http://www.ceril.eu/> accessed 9 January 2019.

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