SCHULTZE & BRAUN **INSOLVENCY LAW**

Security management for partners and shareholders: Opportunities to avoid insolvency

The situation of the company in crisis

The main problem of a company in financial crisis is usually the lack of liquid funds. If the company is itself incapable of creating liquid funds and the partner/shareholder is also unwilling or incapable to do so, the addressee of the credit request will usually be the funding credit institution or the bank pool. In legal terms, the credit institutions are permitted under certain circumstances (which apply in the [potential] borrower's crisis) to provide the necessary liquid funds by way of a loan. This is done in the manner of a bridging loan and/or a reorganisation loan.[1]

But loan negotiations often fail because the usual collateral bank security (e.g., security interests in land, security for debts by lien on inventory and on tangible assets, assignments) and other, less common collateral bank security interests (patents, trademarks, pledging shares in the company) have already been created or are not available as collaterals. In these situations, banks will be very reluctant to grant a blank loan without any collateral security. Asserting (subsequent) excess collateral against individual credit institutions which have already received security interests also tends to be futile. These are situations in which complicated issues of valuation would need to be discussed which, considering the company's situation characterised by the pressure of time, can usually not be resolved under mutual understanding and at short notice.

Appointment of a security trustee

If the partners/shareholders themselves are unwilling or unable to provide the necessary liquid funds from the private sector, a viable option is to transfer the company shares (of the borrowing company or a third party company) in favour of the credit institution onto a security trustee. This security trustee will act on behalf of the partners/shareholders and holds the shares (real contract in favour of third parties) for the funding institutions. In this concept, it is expressly laid down in the trustee agreement that there is no directive relationship between the credit institution and the security trustee.[2]

The trustee is irrevocably instructed by the partner(s)/shareholder(s) to sell the shares in the company under certain clearly defined conditions with the aim of finding an investor If the security trustee sells the company shares and achieves proceeds from the sale, he will be entitled and obliged by way of a security arrangement to pay the proceeds to the funding institution(s) and to pay any excess proceeds to the partner(s)/shareholder(s).

Benefits of this construct for the funding credit institutions

This construct has various advantages for the credit institutions which may motivate them to grant new loans:

---

[1] Details hereto in Obermüller, *Insolvenzrecht in der Bankpraxis*, 5th edition 1997, p. 504ff.

[2] This is necessary so that the shares in the company cannot be attributed to the credit institutions and loans and security interests will not become capital-replacing.

- The search for an investor can be done professionally, a neutral third party acting as trustee (e.g. a lawyer) guarantees the professional implementation.

- By providing new funds, an investor can rescue the company and hence the credit commitment by the credit institutions.

- A signal is sent to the credit institutions to the effect that the partners/shareholders are serious about their readiness to sell.[3]

- Security has been created in formal terms; no blank credit needs to be granted.

- The transfer to a trustee may help to restitute the take-over capability of the company(s), which in individual cases may also increase their value (indicated for complicated structures of group of companies, constituted by over-emphasising the tax aspects).

Benefits for the partners/shareholders
At first glance, the partners/shareholders suffer a disadvantage with the trustee concept, because they transfer their shares in the company to a trustee and because it is primarily the funding institutions which are the beneficiaries of any sales proceeds. Nonetheless, they will be better situated than in the otherwise inevitable insolvency of the company:

- In insolvency, the insolvency administrator often asserts claims against the partners/shareholders from the capital maintenance regulations.

- If the partners/shareholders have already provided collateral security from the private sector, the security case attaches in the event of insolvency. The security creditors will begin to utilise these security interests.

- The partner/shareholders receive at least the excess proceeds which must be paid out to them after settling the secured credit claim for the credit institution as beneficiary of the trustee agreement.

There are, therefore, very good reasons to try and rescue the company by coming to arrangements with the credit institutions and a trustee.

Trusteeship and pledging company shares
If the company shares in question have already been pledged, the credit institution is already entitled to claim some proceeds from the utilisation. This does not mean, however, that a trustee construct must be ruled out (and is also non-detrimental observing the freedom of direction and instruction). Although the company shares can only be transferred to the trustee encumbered by the credit institution's lien, there are nonetheless some good reasons for the credit institutions to accept such an arrangement:

---

[3] The view is wide-spread among banks that partners/shareholders are not always capable of properly realising the seriousness of the company's financial situation, or that they are unwilling to cooperate constructively in the sale of the shares to an investor.

- The conventional bank form involving the pledging of company shares allows the security interests to be utilised in the security case only in the narrower sense, e.g., in case of the company's insolvency. At this point in time, the company shares are normally of no value any more. The trustee agreement allows more flexible arrangements.

- The company shares may be utilised by private contract, and not exclusively by the provisions of the Civil Code on the utilisation of liens.

- Utilisation is made by a (neutral) third party and not by the partner/shareholder. Depending on the selection of the trustee, the third party may enjoy greater trust by the banks than the partner/shareholder who, legitimately, pursues his own interests.

Insolvency stability of the trustee agreement
The question of whether the trustee agreement stands in insolvency is, naturally, of paramount interest. This whole issue complex may be disregarded only if the partner/shareholder is not himself threatened by the insolvency of his company or if the credit institution is merely interested in selling the shares to an investor and not in participating in the utilisation proceeds.[4]

On principle, trustee agreement qualify as agency agreement under § 116 InsO.[5] Pursuant to § 116 InsO (and taking account of the reference to § 115 InsO), this would mean that the agency agreement would expire as soon as insolvency proceedings over the assets of the trustor (partner/shareholder) are instituted. The company shares transferred to the trustee or any proceeds received herefrom must be handed over to the insolvency administrator of the partner's/ shareholder's assets.

However, this does not apply in the event a security arrangement exists. Security trusteeship is always secure in insolvency.[6] In the event of insolvency, the security trustee would hold a separation claim regarding the trust property (company shares). To the extent the company shares have at this point in time as yet not been utilised, there is (with some exception) no more value inherent in the shares. Investors will be more likely to acquire individual items of the company's assets (so-called asset deals) rather than shares of an insolvent company. An exception may be construed only if the company may be reorganised during insolvency, particularly with the help of an insolvency plan.[7] Once the insolvency plan procedure has been successfully concluded, the company shares may again be made valuable.

Property acquisition tax
It should be noted that the transfer of company shares to a security trustee can trigger property acquisition tax. This risk exists, in particular, if the company's property includes real estate property. Depending on the company's legal structure, the provisions of the property acquisition tax laws attach to the consolidation of shares upon one acquirer (trustee) or to the transfer itself

---

[4] If it is only a question of safeguarding the sale of the company shares, another option would be to provide the trustee with the irrevocable power of disposal.
[5] Cf. e.g. Kießner, in: Nerlich/Römernann, *Insolvenzordnung*, commentary, November 2000, § 116 InsO, mn 19.
[6] See Kießner, ibid. mn 21; Bork, „Die Doppeltruehand in der Insolvenz", NZI 1999, p. 337ff (general opinion); the general principles of the insolvency contesting and avoidance rights should, however, be noted. These also apply to the transfer to a trustee.
[7] See also Braun/Uhlenbruck, *Unternehmensinsolvenz*, 1997, p. 423ff.

(or the obligation to do so). For precautionary reasons it is advisable to limit the transfer to 90% of the company shares.

Summary

The fiduciary transfer of company shares to a trustee can, in some instances, be the last chance on the level of partners/shareholders to procure new funds from credit institutions. As a rule, other security interests tend to be no longer available in the financial situation of a company to be reorganised. The opportunity both for the credit institutions and the partners/shareholders lies in the timely transfer of the company shares to an investor. If successful, the credit institution rescues its credit commitment, whereas the partners/shareholders avoid claims raised against them by the insolvency administrator and by security creditors.

Dr. Rainer Riggert