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# KNOWLEDGE NUGGETS

THE QUALIFIED SUBORDINATION DECLARATION –  
OPPORTUNITIES AND RISKS

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## I. WHY THIS TOPIC IS IMPORTANT

Shareholder loans are a proven tool for corporate financing, particularly in small and medium-sized “Mittelstand” enterprises. If a company encounters financial difficulties, these loans—like any other third-party loans—can become a problem (as liabilities on the balance sheet, they can significantly contribute to over-indebtedness within the meaning of Section 19 of the German Insolvency Code (InsO) and, if applicable, trigger an obligation to file for insolvency). To avoid this, a so-called qualified subordination (*qualifizierter Rangrücktritt*) is often declared with respect to the loan at issue.

According to case law issued by the Federal Court of Justice (BGH), a qualified subordination constitutes a debt modification agreement which, when validly agreed upon, establishes a moratorium on enforcement; that is, the creditor is not entitled to demand fulfillment of its claim as long as the company is in crisis. Conversely, in relation to the other creditors, the claim constitutes liable capital and no longer needs to be recognized as a liability in connection with an over-indebtedness analysis.

But caution is advised: Merely labeling the declaration a “subordination” is not sufficient. According to the BGH, certain minimum substantive requirements must be met for the subordination declaration to have the desired effect. Otherwise, the claim remains subject to recognition as a liability, and the company may (continue to be) over-indebted.

The legal consequences of an erroneous subordination declaration can be severe. If a required insolvency filing is not made due to supposedly eliminated over-indebtedness, there is a risk of civil or even criminal liability for delaying the required insolvency filing. Furthermore, incorrectly worded subordination declarations can also lead to serious tax consequences, as the wording of the subordination may result in a tax-detrimental derecognition of the loan liability from the tax balance sheet.

## II. MINIMUM REQUIREMENTS FOR A VALID QUALIFIED SUBORDINATION DECLARATION

For a subordination to eliminate the obligation to recognize the liability and prevent over-indebtedness, the following substantive requirements must be met:

1. There must be an agreement between the relevant creditor and the debtor.
2. The creditor must not be able to demand satisfaction of its claim prior to the opening of insolvency proceedings if the payment would threaten to cause the company to become over-indebted or illiquid.

3. The subordination must remain in effect even after the commencement of insolvency proceedings and must provide for a ranking of the claim that is junior to the rank stipulated in § 39 para. 1 no. 5 InsO (§ 39 para. 2 InsO).
4. Outside of insolvency proceedings, the claim must only be satisfied from future profits, liquidation surpluses, or other free assets. The possibility of satisfaction from other free assets is a decisive factor in the tax treatment of the qualified subordination.
5. A subordination that is only limited in time does not eliminate the obligation to recognize the claim as a liability.
6. Pursuant to § 39 para. 3 InsO, in addition to the principal claim, the agreed subordination also covers interest and other ancillary claims.

Finally, it should be noted that the subordination agreement constitutes a contract for the benefit of the totality of the creditors and, thus, requires the cooperation of all creditors upon the onset of insolvency; that is, an agreement between the creditor and the debtor to terminate the subordination is only permissible if the debtor is no longer insolvent or if the insolvency has been resolved.

## III. RECOMMENDATIONS

- **Use of wording that meets the requirements of the Federal Court of Justice (BGH):** The clause stipulating the qualified subordination should expressly provide that the creditor may demand satisfaction of its claims only after all company creditors have been satisfied and only concurrently with, but in priority to, the shareholders’ claims for return of capital contributions.
- **Ensure pre-insolvency applicability:** The agreement must clarify that the subordination applies both before and after the opening of insolvency proceedings.
- **Express prohibition on payment in the event of imminent insolvency:** The clause should expressly stipulate that the subordination applies “as long as and to the extent that a partial or full satisfaction of the subordinated claim would result in or threaten to result in the debtor’s over-indebtedness or illiquidity within the meaning of insolvency law.”
- **Coverage of all claims:** The agreement should explicitly cover all claims arising from the loan—principal, interest, and repayment, including all accrued interest and costs.
- **Written documentation:** Although there is no formal requirement, the agreement should be set forth in writing and carefully archived to provide evidence in the event of a dispute.
- **Legal and tax advice:** Have the specific terms of the qualified subordination agreement reviewed by specialized attorneys to ensure compliance with current case law of the Federal Court of Justice (BGH) and with the requirements of the tax authorities.

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