German Insolvency Law

Schultze & Braun

German Insolvency Law in a Nutshell

Legal Framework

Insolvency law in Germany is governed by the Insolvency Code (Insolvenzordnung), which has been in force since 1 January 1999. The new law replaced the Bankruptcy Code of 1877 and was designed to shift the emphasis from liquidation to reorganisation.

However, the Insolvency Code is the result of nearly 20 years of dispute. The clear debtor focus of the first drafts became somewhat diluted, and now it is fair to say that the law has turned out to be a compromise. Major tools to promote reorganisation are: the insolvency plan (an equivalent to the Chapter 11 procedure in the US Bankruptcy Code); provisions imposing an automatic stay; the increased avoiding powers of the insolvency administrator or trustee and the right to terminate contracts. Furthermore, secured creditors with security on equipment, inventory and accounts receivable have to contribute 9 % of the proceeds from the realisation of their collateral to the estate. The administrator is in charge of the sale.

As noted above, upon filing for insolvency the law imposes an automatic stay. Furthermore all transactions up to three months prior to filing are avoided. In general the law protects the debtor from individual claims to allow the reorganisation to proceed. All these provisions in the code enable the administrator to keep the assets of an enterprise together in order to encourage the rescue of the business. In addition to the Insolvency Code there are further provisions which entitle employees of the company to three months pay if their employer files for insolvency. This usually enables a provisional administrator to continue operations for three months, because he does not have to pay wages.

German law recognises foreign insolvency procedures provided such recognition does not violate public policy. German law would therefore automatically recognise a Chapter 11 procedure in the US relating to a US company with assets in Germany. However, this does not hinder local creditors from initiating secondary proceedings in Germany, limited to assets located in Germany. In such cases, the German court appoints an additional administrator who only administers these assets.

Rescue Procedures

Overview

Under the insolvency process the most common way to rescue a business is a sale, with the approval of the secured creditors, of all or part of the assets to a new legal entity. This commonly used method was developed under the regime of the previous law. In addition to this method, the option of an insolvency plan has now been created. This offers a settlement to the creditors other than by way of liquidation and it needs the approval of the creditors, which can also be achieved by a cram down. So far there have been relatively few plans, but the acceptance of these new provisions is increasing.

Obstacles

Employee rights are a major obstacle in a rescue attempt. Employees do not get priority for their claim to outstanding salary, but they can insist that their employment continue, or that it be transferred with the assets of the insolvent company to a new legal entity. If a business has an opportunity to be reorganised and the reorganisation fails, it is, in many cases, because the necessary restructuring of the work force turned out to be impossible or too expensive. Other reasons for the failure of a business rescue are often beyond the reach of the legislator.

Insolvency Plan

In a formal rescue, the restructuring plan or insolvency plan may be prepared by the debtor or by the insolvency administrator. The creditors can also instruct the insolvency administrator to prepare an insolvency plan.

The plan has to contain a descriptive part outlining the debtor's business, the reasons for its failure and a proposal for saving the business. The creative part of the plan sets out the steps which are necessary to reorganise the business. The plan might reduce claims of creditors, diminish the rights of secured creditors or sell assets of the debtor. Unlike the Chapter 11 procedure in the US, the German Insolvency Code does not support debt equity swaps because shareholders can not be affected by the plan, nor can the court order such a swap.

The plan will also divide the creditors into groups. Even though the law stipulates that the members of the groups have to have common interests, it is realistic to assume that the author of the plan has considerable flexibility when assigning the creditors to certain groups.

The plan needs the approval of all groups, but the court can overrule a dissenting group if it can be established that this group's position is not worsened by the plan and that the group participates fairly in the available assets. The provisions are comparable to the cram down provisions of the US Bankruptcy Code.

Out of Court Restructuring – Risks for Managing Directors

Informal rescue procedures are rather difficult and risky under German law when commenced too late. The managing director of a corporation has to file for insolvency without undue delay but no later than three weeks after he learns that the corporation is either overindebted or unable to pay its debts as they fall due. In cases with numerous creditors this limited negotiating time is simply not enough to achieve an out of court settlement.

Considering the three-week period, in many cases there might be good arguments for a managing director to assert that the corporation was not overindebted, because there is flexibility in valuing assets and liabilities, i.e. in an overindebted situation you are allowed to use fair market values rather than book values and certain subordinated debts do not have to be treated as liabilities. Things are much more difficult when the business becomes unable to pay its debts. Under these circumstances there is very little room to argue that the company is not insolvent and the obligation to file is immediate if no new funds can be secured.

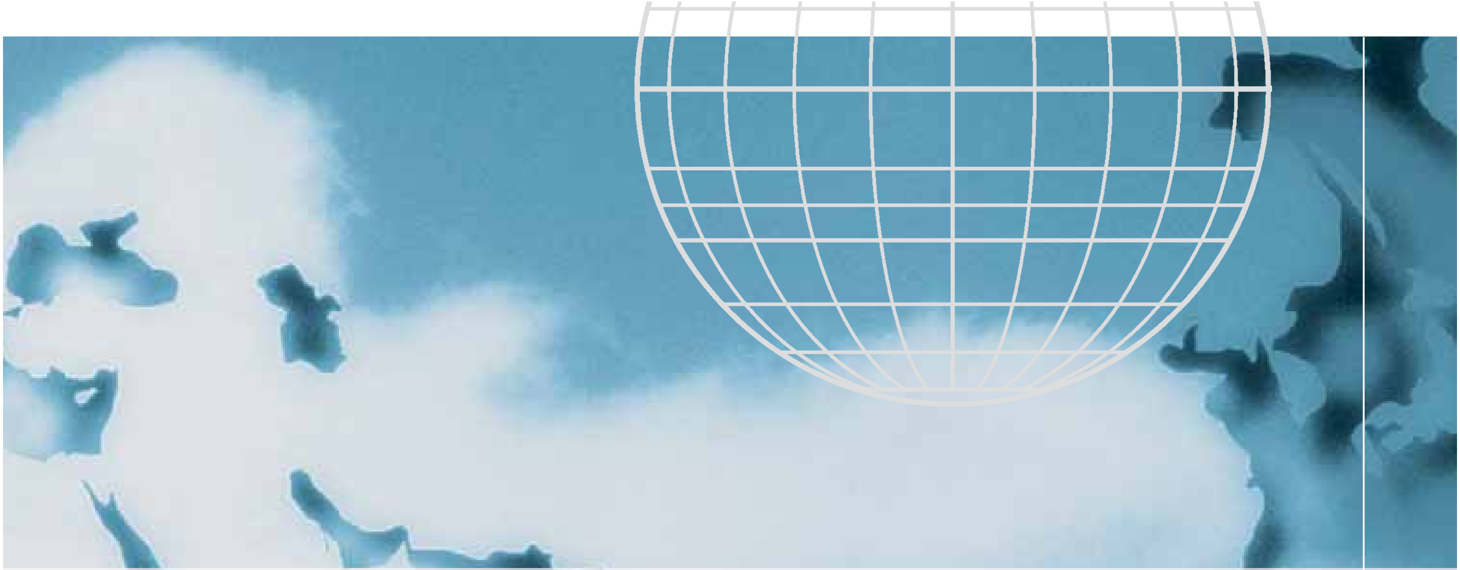
However it might work if negotiations with a few key creditors are sufficient to rescue the business.

The risks for managing directors are quite high. Breach of the duty to file can be punished with imprisonment. The managing director will also be held personally liable for all payments the corporation makes once it has become overindebted or illiquid, unless these payments can be considered as proper business behaviour. Inadequate bookkeeping or reckless business behaviour is punishable if the corporation goes into insolvency. Personal liability also exists for social security payments, withholding tax and VAT.

It is not a viable defence for the managing director to point out that he did not act to the detriment of the creditors.

Funding the Rescue – Inside and Outside Insolvency

Funding an insolvent company that has not filed for insolvency can be risky for the creditor. The creditor must ensure that collateral accepted for fresh money does not fall within the avoiding powers of the insolvency administrator. There is another risk, however. There have been decisions by German courts in which banks were required to indemnify third party creditors who had relied on the financial ability of the debtor. In these cases, the banks had financed insolvent companies solely for their own benefit. The money provided was inadequate to keep the debtor alive and only meant as interim financing, given with the intention of improving the banks' position, e.g. to allow the insolvent company to collect a large payment. Banks should also make sure that they do not assume control of the debtor's business, because this might also render them liable for the company's debts.



Under insolvency, DIP financing is often provided by German banks which already have exposure to the debtor. Banks are often prepared to finance the administrator, because they do not want to risk the administrator closing down the business. Unlike in the US there are no German banks specialising in DIP financing. German banks consider DIP financing more as a necessary evil than a form of business they are willing to promote.

These loans will be treated as debts of the estate (administrative claims) if they are granted after the opening of the procedure. They have to be repaid in full, even before secured creditors are considered. These loans are often collateralised by assigning accounts receivable generated by continuing the business in insolvency, or by assigning inventory which has been acquired post-petition and is therefore not subject to a pre-petition assignment.

When to File

We have already discussed the risks for managing directors if they breach their duty to file for insolvency. For this group there is no real question when to file. However, parent companies and creditors to German corporations should weigh the following criteria when making the decision on whether or not to file.

The Procedure

The insolvency procedure starts with a petition to the insolvency court either by the debtor or by a creditor. The court will usually appoint a provisional administrator who will determine on behalf of the court if there is cause for insolvency and if the unencumbered assets will cover the costs of the procedure. The administrator will also use the period of provisional administration to find an investor in the business and either sell the assets or prepare an insolvency plan to save the enterprise where this is feasible. Creditors from Anglo-Saxon jurisdictions often find that their influence over the procedure is not comparable to what they are used to, because German law does not have the equivalent of receivership. In particular, the courts are often unwilling to listen to the creditors' views as to whom to appoint as administrator.

The appointment of a provisional administrator will leave management in place, but in reality the provisional administrator will make the major decisions and watch the actions of management very carefully. As mentioned above, the courts will usually make orders to safeguard the assets of the debtor by making transactions of the debtor contingent upon approval of the provisional administrator.

Once the provisional administrator has determined there is cause for insolvency (overindebtedness, insolvency, or, if the debtor submits a filing, imminent insolvency) and that the unencumbered assets will pay for the costs of the procedure, he recommends that the court open the insolvency procedure. In most cases the court will follow the recommendation of the provisional administrator and in most cases the provisional administrator will be appointed as the administrator. With the appointment of an insolvency administrator the debtor loses the right to dispose of its assets. This right is bestowed on the administrator.

Under the new Insolvency Code there is also the option for the court to allow the debtor to stay in possession of its assets. So far courts have been rather reluctant to grant this right. This may be because courts are mistrustful, or because not many debtors pursue this option during insolvency proceedings due to the fact that it is related to provisions regarding insolvency plans and there are not too many plan proceedings.

The Perspective of the Shareholder

Considering the options from the perspective of a shareholder, the formal procedure will allow the shareholder to refuse further funding of the business. The formal procedure can thus be a very cost-effective way to disinvest or to reorganise by buying the assets from the administrator, which is possible with the consent of the creditors or by preparing an insolvency plan. However, there are several points to be observed.

When a company files for insolvency, the shareholder immediately loses control of the business. Even though the managing director stays in place under provisional administration, the court will usually make management's decisions contingent upon the approval of the provisional administrator. Even under provisional administration the administrator will take control of the business. The administrator acts independently of the shareholders, and will scrutinise the transactions between parent and subsidiary prior to filing for insolvency. He will investigate if the share capital has been paid in and if there have been any repayments of shareholder loans prior to insolvency. These shareholder loans are treated as equity from the moment the subsidiary faces a crisis. All repayments up to two years prior to filing are treated as a repayment of share capital and have to be reimbursed to the company. Shareholder loans, and even claims against the subsidiary, cannot usually be collected in a German insolvency. Further risks for the shareholder are the powers of the administrator to avoid antecedent actions, which are discussed below. These legal risks need to be evaluated before a shareholder decides to disinvest or reorganise the company by an insolvency procedure.

However, the insolvency administrator will have a better chance of laying off the company's work force than would be the case outside insolvency. Even though labour contracts are not automatically terminated in insolvency, the administrator can take advantage of shorter termination periods and limited social compensation plans. Furthermore it is easier for an administrator to negotiate than for a shareholder, who might have much deeper pockets than an insolvent estate.

The main disadvantage from the perspective of the shareholder is probably the unpredictability of the procedure. The administrator might not be interested in promoting a reorganisation plan prepared by the debtor or on behalf of the shareholder. Because the administrator is selected by the court and will have had no prior involvement in the case, it is extremely difficult to achieve a prepackaged sale of the business. Thus there is the risk of losing a great deal of value (especially in a people businesses and in fast moving environments), while the administrator settles into his role and decides on his strategy. Other investors might look for an opportunity to take over the business for a much lower price and so the price the shareholder has to pay to regain control of the business could be much higher than originally envisaged.

The Perspective of the Creditor

From the creditor's perspective the formal procedure might be inevitable if there are doubts about the credibility or even honesty of management, or about their ability to turn around the business. Depending on the collateral situation of an individual creditor he could face little to no risk in insolvency, which might make it much more attractive to use the insolvency procedure to limit the rights of shareholders or replace management. Creditors might also use insolvency as a tactical option, if the debtor has given little or no collateral (i.e. if the loans are guaranteed by the parent) and then starts using assets to secure loans to the benefit of individual creditors. In these cases, insolvency has the advantage that the avoiding powers of the administrator can reverse these transactions. In the absence of these circumstances, the creditor is also faced with the risk of not being able to predict the outcome of the procedure. Insolvency might lead to the end of the business, and creditors may have their collateral sold at break-up value rather than at going-concern value. The creditors also have no say in who will be appointed administrator, and this adds to the uncertainty.

In making their decision whether to file or not, creditors have to take a very close look at the voiding powers of the administrator. Among the major changes to the new law are the increased avoiding powers of the administrator.

The power to avoid a transaction depends on whether the transaction was an exchange for value, how close the other party was to the debtor, if the other party knew about the insolvency, and how much time had elapsed between the transaction and the filing.

A transaction can be avoided if it was an exchange for value, if the other party knew about the insolvency and the transaction was concluded three months or less prior to filing for insolvency.

A transaction that was not an exchange for value, in other words if the other party had no right to receive the value at all or not at that time (e.g. the claim was not due or he received another asset than the one due), can be avoided if it happened one month prior to filing, with no further conditions. It also can be avoided if it was completed up to three months prior to filing, if the debtor was insolvent or if the other party knew that the transaction was to the detriment of other creditors. The first provision is especially dangerous for banks who regularly offset their own claim using money coming into the debtor's account. If the account is not overdrawn or the loan is not called, most courts would hold that the creditors are not entitled to offset. They would then have to pay the estate the amounts received up to one month prior to filing. So far German courts have held that a bank may offset if it has an assignment of accounts receivable. If this is not the case the bank might have to reimburse collections three months prior to filing.

Transactions that occurred up to ten years prior to filing can be avoided if the debtor acted intentionally to the detriment of creditors and if the other party knew that insolvency was actual or imminent.

Transfers of title by gift can be avoided if they happened up to four years prior to filing.

It should be noted that for asset-based lenders, knowledge and understanding of these new provisions is of the utmost importance if they do not want to risk losing their collateral. This is especially true during the initial structuring of the collateral. Mistakes made in this phase of the engagement are often impossible to rectify once the debtor is close to filing. The provisions are especially important when the crisis at the debtor is apparent and lenders are being asked for fresh money or are trying to maximise their recovery.

The Key Players in Insolvency

The Debtor

The debtor can be a partnership (BGB-Gesellschaft, Offene Handelsgesellschaft), a limited-liability partnership (Kommanditgesellschaft), a limited-liability company corporation (Gesellschaft mit beschränkter Haftung), a stock corporation (Aktiengesellschaft) or an individual. When discussing the effects of the filing we have already looked at the personal risks involved and the loss of control for current management.

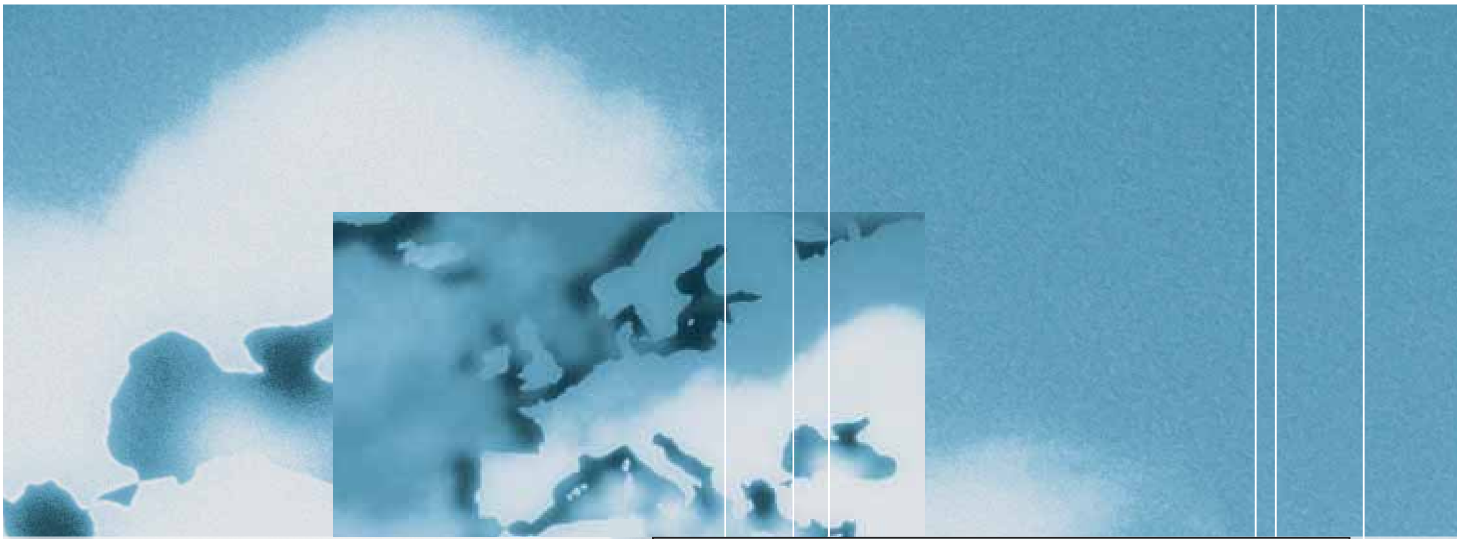
The Administrator/Trustee

As mentioned above, the formal rescue or liquidation will be conducted by a court-appointed insolvency administrator. The German court usually chooses from the list of local administrators, and there is no formal way for debtors, shareholders or creditors to influence the initial appointment of the provisional administrator or the administrator. For companies where many jobs are at stake, the court might listen to suggestions by certain large creditors or interest groups such as trade unions. However, in many cases these attempts may just trigger the very opposite effect. The creditors have the right to appoint their own administrator in the first creditors' meeting. This right has little practical impact. Given the fact that provisional administration can take two to three months, and also assuming that the first creditors' meeting may occur as late as two months after the opening of proceedings, it makes little sense for creditors to appoint a new administrator. With any restructuring, time is of the essence and after four to five months of insolvency proceedings, if the administrator has not saved the business, the chances that a new administrator will be more successful are often speculative at best.

It should also be noted that in Germany insolvency administration is almost completely in the hands of smaller law firms who are listed with the court. It is only recently that mergers between existing practitioners are bringing larger resources into the insolvency profession in Germany.

The Creditors

Outside insolvency procedures, an unsecured creditor must seek a court ruling allowing the enforcement of the claim, an often rather lengthy process. In an insolvency procedure the unsecured creditor has to lodge his claim. The insolvency administrator either confirms the claim or disputes it. In the latter case, the debtor has to litigate against the administrator to achieve recognition of the claim. In very many insolvency procedures, however, the quota paid to unsecured creditors is so low that these efforts are often futile. The formalities in lodging the claim are minimal. Usually the administrator sends the necessary forms. Deadlines are usually set by the court, but a late filing does not cause the creditor to lose the claim. A claim can be lodged until the final meeting of creditors, but the creditor has to pay any additional cost incurred by the administrator as a result of the delay in filing the claim.



There are several types of creditors that need to be distinguished:

- ➤ Creditors of the estate (administrative claims)
- ➤ Creditors entitled to separate satisfaction
- ➤ Secured creditors
- ➤ Unsecured creditors
- ➤ Subordinated creditors

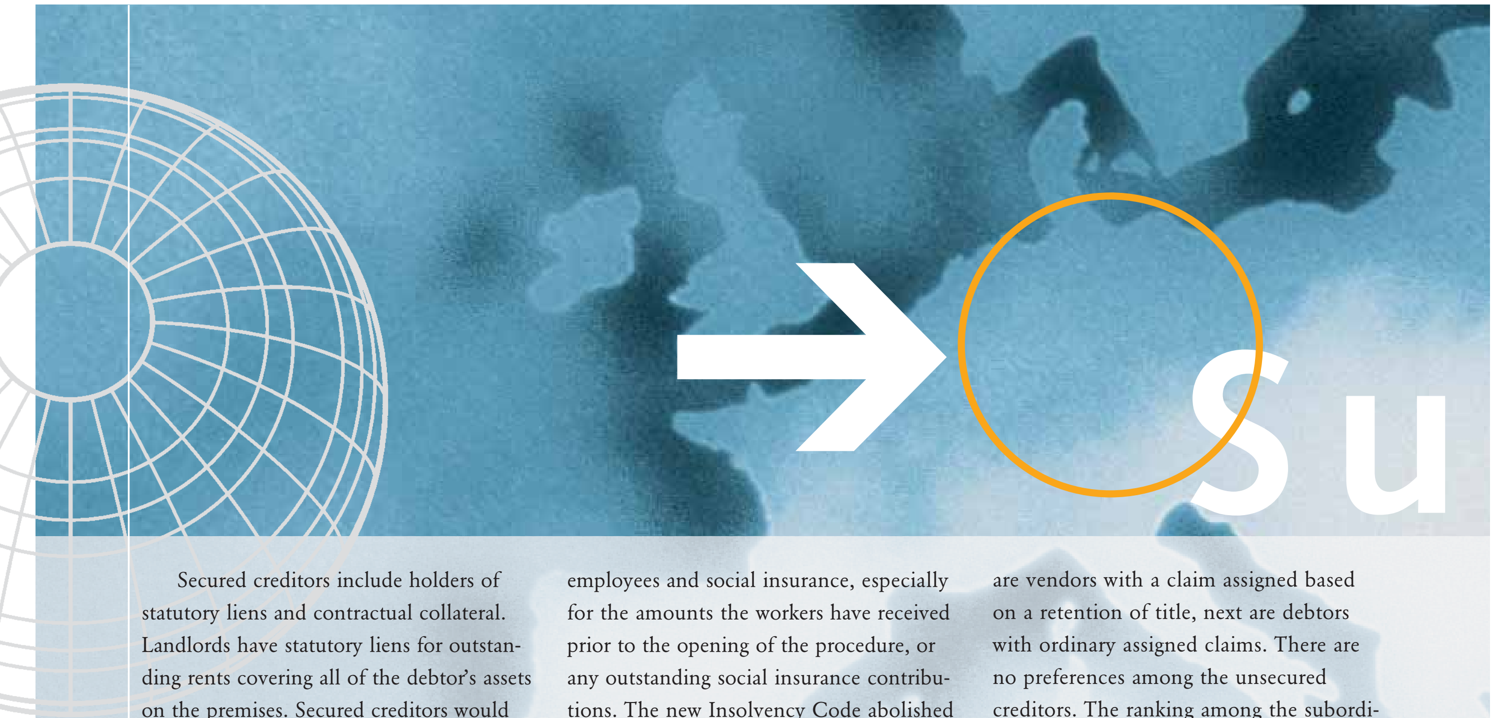
For secured creditors the type of security will determine how the security is enforced. The administrator will sell plant and equipment and inventory and collect accounts receivable even if these assets have been assigned to certain creditors. Furthermore, the secured creditors will in most cases have to pay 9 % of realisations to the estate. In many cases insolvency administrators will try to negotiate a higher percentage, which they often achieve by threatening to close down the debtor's business. Creditors with reservation of title do not participate in the insolvency procedure. They will usually recover their assets or be paid in full.

Creditors with a lien on real estate can force the sale of the real estate or claim rental income. The result of a forced sale is often considerably lower as compared to a going-concern sale. In most cases the creditor and the administrator will reach an agreement allowing the transaction to proceed without having to go through enforced sale.

Ranking can be quite difficult in individual cases, especially with secured creditors.

Creditors of the estate are creditors who hold a claim against the estate in insolvency by dealing with the administrator, i.e. by supplying goods or services or by giving loans to the administrator. This includes covering the administrator's fees, as well as court fees. These creditors must be paid in full. It is one of the most difficult and risky tasks of insolvency administration to make sure that these claims can be paid.

Creditors entitled to separate satisfaction are creditors who can claim that an asset in the possession of the debtor is actually their property. An obvious example is landlords in a lease situation, but it would also cover vendors who sold subject to retention of title. These creditors do not take part in the insolvency procedure insofar as their claim is covered by their right to separate satisfaction. Otherwise, they take part for the balance of their full claim and the value of the goods delivered under reservation of title. This excess part of the claim depends upon the terms and conditions of delivery as to whether these creditors are unsecured or secured. The creditors could also be secured if they took an assignment on goods manufactured using the supplied item or accepted an assignment of the claims arising from the sale of the delivered item (see above).



Secured creditors include holders of statutory liens and contractual collateral. Landlords have statutory liens for outstanding rents covering all of the debtor's assets on the premises. Secured creditors would also include those creditors with reservation of title who extended the reservation of title to WIP, finished goods or accounts receivable, as well as asset-based lenders with assignments on plant and equipment, inventory and accounts receivable. Within this group of secured creditors the landlord's lien would rank the highest, next would be the creditors with a claim assigned based on retention of title and last would be creditors with other assignments. Note again, sales will be made by the administrator, and he will render a 9 % charge against the values realised.

Unsecured creditors are all creditors who did not manage to secure their claim or those with claims in excess of the value of the collateral. It would also include employees and social insurance, especially for the amounts the workers have received prior to the opening of the procedure, or any outstanding social insurance contributions. The new Insolvency Code abolished all preferences among the unsecured creditors. Neither employees nor social security are entitled to any preferential payments.

Subordinated creditors are creditors who have a claim which is subordinated by law or by contract. The first include interest for the period of the insolvency procedure, costs the creditors incurred during the procedure, fines, claims out of gifts. The latter include creditors who have willingly subordinated their claim. Certain liabilities to shareholders are subordinated by law. The ranking of the subordinated creditors are in the same order as discussed above. There is little to no practical merit to this ranking, since payments on subordinated claims are rarely made.

To summarise as a general rule the order in which the creditors receive payments: creditors of the estate rank first, creditors with retention of title will recover their asset or receive payment for the asset. Among the secured creditors the landlord's lien ranks the highest, next are vendors with a claim assigned based on a retention of title, next are debtors with ordinary assigned claims. There are no preferences among the unsecured creditors. The ranking among the subordinated has little impact.

In most cases secured creditors will be landlords, vendors and banks. Landlords will have statutory liens. Vendors will make use of retention of title clauses which allows them to retain title until their claim has been paid in full. They also get an assignment on goods manufactured by making use of the delivered article and an assignment of the claim generated by the sale of the delivered article. Banks will usually have liens on land and also assignments over plant and equipment, inventory and accounts receivable.

Whereas lenders, such as banks, usually play a very active part in the insolvency procedures, this is often not the case with suppliers. If there are any, trade credit insurers will represent the vendors. In some cases, however, suppliers organise themselves into pools.

As mentioned above, the creditors have the power to elect a new insolvency administrator at the first meeting of creditors. The court can also dismiss the insolvency administrator either after a petition by the creditors' committee or the creditors' meeting. These petitions are often filed, but they have little chance of being successful unless the administrator is seriously inadequate.

The most effective weapon creditors have is Article 60 of the Insolvency Code. According to this provision the insolvency administrator is personally liable if he intentionally or negligently causes damage to creditors or other parties involved in the procedure. The liability of the insolvency administrator is quite severe and the threat of this personal liability makes the administrator very prudent.

It should not be forgotten, however, that in German insolvency law disputes between the administrator and creditors, especially secured creditors, are common. Insolvency administrators will go a long way to try to find reasons to void the collateralisation of loans. This might make a creditor dissatisfied with the conduct of the administrator, but under normal circumstances it would not give cause for a court to replace the administrator, nor would it give grounds for an action to recover damages.

European Insolvency Regulation

The European Council Regulation on Insolvency Proceedings came into force in 2002. This regulation, which contains 47 articles, contains the framework for cross-border insolvency within the European Union, excepting Denmark, but including the newly joined Eastern European countries. The goal of the regulation is to enable efficient and effective cross-border-insolvency work.

Initial experience has shown the regulation can also be a tool in cross-border group insolvencies. Although one goal of the regulation is to avoid forum shopping, in many cases there might be different views as to where the 'centre of main interest (COMI)' of a company is located. This offers opportunities for joint and coordinated group insolvencies in different member states under a single jurisdiction.

Summary None of the parties involved in an insolvency would consider it to be a pleasant experience, except maybe for the insolvency practitioner, who makes a living from it. Nevertheless, it is probably fair to say that the system in Germany works. It needs to be stressed, however, that you have to play the game according to the local rules and this should be the prevailing perspective at a very early stage of any involvement in a German business, be it as a shareholder or as a creditor. Mistakes made when structuring a transaction, either an investment or a loan, can often not be rectified once the subsidiary or the debtor has moved into the insolvency zone. Only familiarity with and strict observance of the insolvency rules will protect foreign parties from damage.

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