Milbank

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Client Alert

Proposed Legislation to avoid COVID-19-related Insolvencies in Germany

1. Proposed New Legislation - Modification of the German Insolvency Regime

The German Federal Government has resolved upon a draft bill for the mitigation of the consequences of the SARS-CoV2-Virus (COVID-19) pandemic (the **"Proposed Legislation"**). One of the goals of the Proposed Legislation is to prevent insolvencies of companies which encounter financial difficulties as a result of the ongoing COVID-19 pandemic.

The Proposed Legislation goes well beyond the earlier announcement made by the German Federal Department of Justice which suggested that the envisaged amendments to be made to the German Insolvency Code would generally follow the previous reliefs granted, in particular the reliefs granted to mitigate the effects of the floods in Germany in 2016.[1] In stark contrast thereto, the Proposed Legislation would comprehensively modify the German insolvency regime and address nearly all insolvency-related obligations and restrictions which insolvent debtors typically encounter and which would frustrate the affected companies' going concern status and their ability to continue trading.

It is planned that the Proposed Legislation will be enacted very soon given the urgency caused by the severe impact of the COVID-19 pandemic on businesses. For that reason, the German legislator will make use of a fast-track process in deviation from the usual procedure for the enactment of draft bills. In addition, the Proposed Legislation provides for an enactment with retroactive effect on and from 1 March 2020.

The modifications to be introduced by the Proposed Legislation will relate to the following key elements of the German insolvency regime:

- Suspension of the directors' obligation to file for insolvency (see below, paragraph 2.1 (*Obligation of Directors to File for Insolvency*));
- Limitation of creditors' entitlement to file for insolvency (see below, paragraph 2.2 (*Creditors' Entitlement to File for Insolvency*));
- Suspension of the restrictions to the discharge pre-existing liabilities (see below, paragraph 3.1 (*Discharge of Pre-existing Liabilities*));
- Privileging new shareholder and third-party financings by means of:
  - suspending equitable subordination of shareholder loans (see below, paragraph 4.1 (*Equitable Subordination*));
  - preventing lender liability risks in the context of turnaround financings (see below, paragraph 4.2 (*Claw-back Rights*)); and
  - limiting claw-back of repayments and collateralisation (see below, paragraph 4.3 (*Lender Liability*)).

2. Insolvency Filing

2.1 Obligation of Directors to File for Insolvency

(a) Current Regime

In case of illiquidity (*Zahlungsunfähigkeit*) or over-indebtedness (*Überschuldung*), each managing director (*Geschäftsführer*) has the obligation to file for insolvency without undue delay (*unverzüglich*), but in any event not later than three weeks after the managing director's knowledge of the relevant insolvency reason.

[1] Article 3a of the law of 26 July 2016 (Federal Law Gazette I, 2016, no. 37, page 1838).

Illiquidity (*Zahlungsunfähigkeit*) means the debtor's inability to pay its debts when they fall due. Pursuant to the jurisprudence of the German courts, there are certain *de minimis* exceptions. Generally, a liquidity gap of up to 10 per cent. of the amount of debts due at any given point in time is, in the absence of aggravating circumstances, generally regarded as insufficient to establish illiquidity. In addition, German courts apply a three-week test, i.e. if there is, despite a current illiquidity, a positive outlook to regain liquidity within three weeks, there is also no requirement to file for insolvency due to illiquidity.

Over-indebtedness (*Überschuldung*) means that the debtor's liabilities (irrespective of their maturity date and whether they are actual or contingent) exceed the value of the debtor's assets (the value of such assets being determined based on liquidation values). However, the debtor is not deemed over-indebted if there is a positive going concern prognosis (*positive Fortführungsprognose*). Simply put, this is the case if it is more likely than not that the debtor will be able to meet its payment obligations at least within the current and following business year.

The knowledge of the relevant insolvency reason, i.e. illiquidity or over-indebtedness, by the managing director is hardly ever relevant in practice. It is assumed that a managing director has actual knowledge of the financial situation of his company since each managing director has the ongoing obligation to monitor the company's finances.

Non-compliance with the insolvency filing obligation may result in personal liability of the directors and constitutes a criminal offence.

Impending illiquidity (*drohende Zahlungsunfähigkeit*) does not, in contrast to illiquidity or over-indebtednes, trigger any obligation to file for insolvency but gives the managing directors a right to file (subject to the required internal approvals by the responsible corporate bodies). Impending illiquidity means that the occurrence of illiquidity within the current and following business year is more likely than not.

(b) Proposed Modification

Under the Proposed Legislation, the insolvency filing obligation is suspended until 30 September 2020. Such suspension of the insolvency filing obligation does not apply if:

(i) the insolvency is not caused by the COVID-19 pandemic; or
(ii) there are no prospects of overcoming an existing illiquidity.

As it would be inherently difficult for the debtor to evidence that none of such exceptions applies, the Proposed Legislation provides for two reliefs in this respect for the benefit of the debtor: First, the Proposed Legislation provides for a statutory presumption that the company has become insolvent as a consequence of the COVID-19 pandemic and that the company has prospects of overcoming its illiquidity, if the debtor was not illiquid as at 31 December 2019. Second, even if the debtor was illiquid as at 31 December 2019, and hence the aforementioned presumption does not apply, the burden of proof as to the fact that the insolvency is not caused by the COVID-19 pandemic and/or that there are no prospects of overcoming an existing illiquidity lies with the party claiming a violation of the statutory filing obligation (e.g. a creditor of the debtor or the insolvency administrator). Consequently, the suspension of the insolvency filing obligation would only be inapplicable in exceptional cases where it is more or less evident that the insolvency is not caused by the COVID-19 pandemic or that there are no prospects of overcoming an existing illiquidity. The reasoning of the Proposed Legislation stresses that a rebuttal of the statutory presumption is subject to very strict requirements.

The Proposed Legislation will authorise the Federal Ministry of Justice and Consumer Protection to extend the suspension of the obligation to file for insolvency until 31 March 2021 by way of an ordinance without the consent of the German Federal Council (*Bundesrat*) should such an extension be required due to ongoing demand for available public aid, ongoing financing obstacles or other circumstances.

2.2 Creditors' Entitlement to File for Insolvency

(a) Current Regime

Upon an illiquidity or over-indebtedness of a debtor, each of its creditors has the right to file for insolvency of the debtor. An impending illiquidity does not entitle a creditor to file.

(b) Proposed Modification

The Proposed Legislation will, within three months after the Proposed Legislation has entered into force, only permit creditor filings if the insolvency reason has already existed on 1 March 2020.

Similar to the suspension of the directors' insolvency filing obligation, the Federal Ministry of Justice and Consumer Protection will be authorised to extend the limitation of creditor filings until 31 March 2021 by way of an ordinance without the consent of the German Federal Council should such extension be required due to ongoing demand for available public aid, ongoing financing obstacles or other circumstances.

3. Other Insolvency-related Obligations and Restrictions

Once a debtor becomes illiquid or over-indebted, the current insolvency regime provides for a shift in directors' duties towards the preservation of the insolvency estate and the protection of existing and future creditors of the debtor.

3.1 Discharge of Pre-existing Liabilities

(a) Current Regime

Following the occurrence of illiquidity or over-indebtedness (*Insolvenzreife*), directors are no longer entitled to permit any discharge of liabilities which already existed prior to the occurrence of such illiquidity or over-indebtedness. This not only prohibits the payment on any such pre-existing liabilities, but captures all means of discharge such as, for example, set-off, netting and reduction of debit balances by receipt of payments into an account which has a negative balance. Non-compliance with these restrictions may result in a personal liability of the relevant directors.

A discharge of a pre-existing liability is only permitted to the extent such discharge is, from a creditors' perspective, compatible with the due diligence of an orderly and conscientious director. Since this exception is interpreted rather strictly by the pertinent case law of the German Federal Court of Justice (*Bundesgerichtshof*), the applicability of this exception needs to be thoroughly analysed on a case-by-case basis.

(b) Proposed Modification

The Proposed Legislation will deem payments that are made in the ordinary course of business to be compatible with the due diligence of an orderly and conscientious director. This applies in particular to payments made to maintain or resume business operations or to implement a turnaround concept.

Consequently, any such payments would be permissible without the directors facing the risk of a personal liability and ultimately requiring the directors to file for insolvency.

3.2 Incurrence of New Liabilities

(a) Current Regime

Following the occurrence of illiquidity or over-indebtedness (*Insolvenzreife*), directors are in principle no longer entitled to permit the incurrence of further obligations, including by means of placement of further orders, if and to the extent it cannot be presumed that the company will be able to discharge these new obligations.

Even if the incurrence of further obligations was generally compatible with the due diligence of an orderly and conscientious director, the director nevertheless must not deceive the respective counterparty of the transaction. It is generally considered fraudulent behavior if a party enters into an agreement and, in doing so, deceives the counterparty about its inability to fulfill its obligations thereunder. Such behavior may give rise to criminal liability.

Therefore, in order to prevent such risk of criminal liability (and personal liability for any losses incurred by the counterparty), the director should disclose the fact that the company is currently in the state of illiquidity and/or over-indebtedness so that

the counterparty is in a position to knowingly accept the default risk prior to such counterparty entering into the agreement or providing the relevant goods and services. Such disclosure could, of course, discourage the other party from entering into the agreement or require the company to make advance payments or post collateral which may further impair the debtor's ability to continue trading.

(b) (No) Proposed Modification

The Proposed Legislation does not explicitly address the entry into new transactions, but such new transactions would be facilitated if one takes the view that the incurrence of the respective further liabilities is allowed to the same — now broader — extent as the discharge of liabilities will be permissible under the Proposed Legislation (outlined in paragraph 3.1 (*Discharge of Pre-existing Liabilities)* above). In addition, however, the debtor must have the financial means (and the intention) to make such discharge (or disclose its potential inability to do so) in order to avoid fraudulent behavior as described above.

4. Privileging new Shareholder and Third-Party Financings

4.1 Equitable Subordination

(a) Current Regime

German insolvency law provides that claims for the repayment of loans granted by a shareholder and claims resulting from legal acts which have an equivalent commercial effect as such shareholder loans are subject to equitable subordination to all non-subordinated creditors of the respective debtor in any German insolvency proceedings of such debtor. Consequences of equitable subordination are in general:

- Equitably subordinated claims can usually not be filed as an insolvency claim.
- Security granted for the benefit of equitably subordinated debt and payments on such equitably subordinated debt are subject to a claw-back right of the insolvency administrator, if such security was granted or payment was made within a certain period of time prior to the insolvency filing.
- Creditors who were granted any type of security by the debtor's shareholder (or by an equivalent person whose claims would be equitably subordinated) can only receive payments from the insolvent debtor to the extent such creditors have failed to receive payments through the enforcement of the relevant security granted by the shareholder.

(b) Proposed Modification

The Proposed Legislation intends that in any insolvency proceedings that will be filed on or before 30 September 2023, the equitable subordination regime outlined above will not apply to any new shareholder loans which were extended during the time the directors' insolvency filing obligations were suspended (see above, sub-paragraph (b) (*Proposed Modification*) of paragraph 2.1 (*Obligation of Directors to File for Insolvency*)).

With respect to loans granted by KfW (*Kreditanstalt für Wiederaufbau*), its financing partners or by other institutions in the context of government aid programmes to mitigate the effects of the COVID-19 pandemic, the equitable subordination regime outlined above will not apply even if the loan is granted after the end of the period during which the insolvency filing obligations were suspended.

This constitutes a major change in German insolvency law and is intended to motivate shareholders to grant loans to their respective companies.

4.2 Claw-back Rights

(a) Current Regime

Under German insolvency law, the insolvency administrator (or in case of debtor-in-possession proceedings, the custodian) may challenge (*anfechten*) transactions, performances or other acts that are deemed detrimental to the insolvency creditors

and which were effected prior to the opening of formal insolvency proceedings. Generally, if transactions, performances or other acts are successfully challenged by the insolvency administrator, any amounts or other benefits derived from such challenged transaction, performance or act will be clawed-back to the insolvency estate.

(b) Proposed Modification for New Loans

The Proposed Legislation privileges new loans which are extended during the time the directors' insolvency filing obligations are suspended (see above, sub-paragraph (b) (*Proposed Modification*) of paragraph 2.1 (*Obligation of Directors to File for Insolvency*)). Any repayment of such loan on or before 30 September 2023 and the granting of security to collateralise such loans are deemed not to be detrimental to the creditors and will therefore not be subject to claw-back.

The same is supposed to apply to the repayment of shareholder loans and payments in respect of claims arising from legal transactions that are considered to be equivalent to shareholder loans. However, the granting of any security granted in respect of such shareholder loans or equivalent transactions will not be privileged and remains subject to the current regime.

It should be noted that it is the legislator's intention that such privileges of the Proposed Legislation only apply to new financings which provide additional liquidity to the relevant debtor. Therefore, the mere novation or prolongation (or commercially equivalent transactions) of existing loans will not be privileged under the Proposed Legislation.

Loans extended by KfW (*Kreditanstalt für Wiederaufbau*), its financing partners or by other institutions as part of the government aid programmes made available to support businesses affected by the COVID-19 pandemic are covered by the privileges outlined above, too. However, to facilitate the implementation of these government aid programmes, such loans will benefit from these privileges irrespective of such loan being extended or collateralised during the period in which the insolvency filing obligations were suspended (see above, sub-paragraph (b) (*Proposed Modification*) of paragraph 2.1 (*Obligation of Directors to File for Insolvency*)) and irrespective of the repayment taking place on or before 30 September 2023.

(c) Proposed Modification for Legal Acts granting a Security or Discharge

The Proposed Legislation also privileges legal acts (*Rechtshandlungen*) granting or allowing a counterparty of an insolvent debtor a security or discharge to which such counterparty was entitled in such form and at such time. Generally, such legal acts are (despite the entitlement of the counterparty) subject to claw-back if the relevant legal act occurred within a certain period of time prior to the filing for insolvency (or thereafter). Pursuant to the Proposed Legislation, such legal acts shall no longer be subject to claw-back in any subsequent insolvency proceedings, unless the counterparty was aware that the restructuring efforts and financing efforts of the debtor were not appropriate to redress the existing illiquidity of the debtor.

4.3 Lender Liability

(a) Current Regime

Lenders granting loans to a company in a state of crisis may be exposed to tort liability vis-à-vis the company's other creditors ("**Lender Liability**") if such loans merely delayed the company's insolvency filing (or in the words of the German Federal Court of Justice (*Bundesgerichtshof*): *"merely prolonged the futile struggle for survival"*) and the delay caused a depletion in the value recovery of other creditors. Lender Liability presupposes that the lender acted contrary to public policy (*contra bonos mores, sittenwidrig*).

As a consequence, any new financing in German turnaround situations is only made available on the basis of a restructuring opinion which complies with the standards imposed by the German Federal Court of Justice (*Bundesgerichtshof*) for restructuring opinions and confirms that a successful turnaround of the debtor is more likely than not (usually according to the IDW S6 standard).

(b) Proposed Modification

New loans extended and the taking of security during the period in which the filing obligation was suspended (see above, sub-paragraph (b) (*Proposed Modification*) of paragraph 2.1 (*Obligation of Directors to File for Insolvency*)) are deemed not to be contrary to public policy (*contra bonos mores, sittenwidrig*). Therefore, the risk of Lender Liability should be eliminated

in relation to any such new financings irrespective of a restructuring opinion (e.g. according to the IDW S6 standard) confirming that a successful turnaround of the debtor is more likely than not.

Similar to the privilege under the modified claw-back regime (see above, sub-paragraph (b) of paragraph 4.2 (*Claw-back Rights*)), loans extended by KfW, its financing partners or by other institutions as part of the government aid programmes, will benefit from this privilege irrespective of such loan being extended or collateralised during the period in which insolvency filing obligations were suspended (see above, sub-paragraph (b) (*Proposed Modification*) of paragraph 2.1 (*Obligation of Directors to File for Insolvency*)).

5. Relief also for solvent companies

Companies which are not illiquid or over-indebted (*insolvenzreif*) also benefit from the Proposed Legislation since the Proposed Legislation extends the exclusion of equitable subordination (see above, sub-paragraph (b) (*Proposed Modification*) of paragraph 4.1 (*Equitable Subordination*)), the exclusion of claw-back rights (see above, sub-paragraphs (b) (*Proposed Modification for New Loans*) and (c) (*Proposed Modification for Legal Acts granting a Security or Discharge*) of paragraph 4.2 (*Claw-back Rights*)) and the elimination of lender liability for new financings (see above, sub-paragraph (b) (*Proposed Modification*) of paragraph 4.3 (*Lender Liability*)) also to solvent companies. The purpose of this further relief is to motivate lenders and other counterparties to provide additional financing and continue trading with the relevant companies.

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