COVID-19: UPDATE TO THE AMENDMENTS OF THE GERMAN INSOLVENCY ACT

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German Banking and Finance Alert

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Both the German federal government and various German federal states are pushing ahead with packages of measures to mitigate the as-yet-unforeseeable economic consequences of the COVID-19 pandemic.

This client information is intended to provide you with an overview of new law in force with respect to German Insolvency Law.

OVERVIEW

In order to mitigate the economic consequences of the COVID-19 pandemic, the legislator passed the COVID-19 Insolvency Suspension Act (*COVInsAG*; the "*Act*"), which came into force on 27 March with retroactive effect from 1 March 2020.

In the event of illiquidity (*Zahlungsunfähigkeit*) or overindebtedness (*Überschuldung*), the managers of a corporation or a partnership which does not have a natural person as a partner with unlimited liability are obliged to file an application for the opening of insolvency proceedings without delay but at the latest within three weeks.[1] An intentional or even negligent breach of this obligation is not only an offense but may also result in civil liability.[2] Furthermore, the managing directors are obliged to compensate for payments made after the occurrence of the company's illiquidity or overindebtedness unless these payments are also compatible with the diligence of a "prudent businessman" after this point in time, pursuant to applicable German corporate law (including § 64 sentences 1 and 2 German Limited Liability Act (*GmbHG*); § 92 para. 2 German Stock Corporation Act (*AktG*); § 177a; § 130a para. 1 German Commercial Code (*HGB*). Based on these regulations, there was the concern that due to the economic effects of the COVID-19 pandemic, a very large number of companies would have to apply for insolvency.

In addition, there are numerous restrictions and obstacles to the granting of restructuring loans and other financial assistance to companies in difficulties. Some of these restrictions and obstacles may even lead to liability of lenders (e.g., in the case of the granting of immoral (*sittenwidrig*) restructuring loans under § 826 BGB).

In order to mitigate the economic consequential damage caused by the COVID-19 pandemic, the legislator has therefore enacted the COVInsAG — among many other regulations. The aim of the law is to enable and facilitate the continuation of companies that have become insolvent or are experiencing economic difficulties as a result of the COVID-19 pandemic. The affected companies and their legal representatives shall be given time to take the necessary precautions to eliminate the reasons for insolvency, in particular, to take advantage of state aid for this purpose or to make financing or restructuring arrangements with creditors and capital providers. In addition, by limiting liability and rescission risks, the granting of restructuring loans are facilitated to ensure that business relations with these companies are not discontinued.

RESTRICTION OF INSOLVENCY FILING OBLIGATIONS AND OF INSOLVENCY APPLICATIONS BY CREDITORS

Under the COVInsAG, the obligation of managing directors to file for insolvency is suspended until 30 September 2020, provided that the insolvency is based on the consequences of the COVID-19 pandemic and provided that there are prospects of eliminating any existing insolvency.[3] Since it is very difficult to determine with hindsight whether these conditions are met or not, the legislator has introduced a rule of presumption: if the debtor was not illiquid on 31 December 2019, it is — rebuttably — assumed that the insolvency is based on the effects of the COVID-19 pandemic and that there are prospects of eliminating an existing insolvency.

According to the statement of reasons for the Act, however, in view of the purpose of the presumption, which is to effectively relieve the debtor from the difficulties of proof and prognosis, such a rebuttal can only be considered in those cases in which "*there can be no doubt that the COVID-19 pandemic was not the cause of the insolvency and that the elimination of an occurred insolvency could not succeed.*" In this respect, "*highest requirements*" had to be set. Against this background, the hurdles for a rebuttal of the legal presumption must be described as extremely high.

As long as the obligation to file for insolvency is suspended, payments which are made in the ordinary course of business; in particular, those payments which serve to maintain or resume business operations or to implement a restructuring concept shall be deemed to have been made with the diligence of a prudent and conscientious managerand shall therefore not result in any liability on the part of the managing directors.[4] The statement of reasons for the Act states that the implementation of a reorganisation concept also includes measures in the course of the reorientation of the business.

In addition to a suspension of the duty of the management to file for insolvency on its own account, insolvency applications by creditors are also restricted. Insolvency applications filed by creditors between 28 March 2020 and 27 June 2020 require that the reason for opening of insolvency proceedings already existed on 1 March 2020.[5] This regulation prevents for a period of three months that companies affected by the COVID-19 pandemic that were not yet insolvent on 1 March 2020 can be forced into insolvency proceedings by creditors. The regulation does not apply to application rights not governed by the Insolvency Code, such as rights of the German Financial Supervisory Authority (BaF-in) and other competent authorities.[6]

The Federal Ministry of Justice and Consumer Protection has been authorised to extend the suspension of the obligation to file for insolvency and the restriction of creditors' insolvency applications by statutory order without the consent of the *Bundesrat* until 31 March 2021 at the latest if this appears to be necessary due to continuing demand for available public assistance, ongoing financing difficulties or other circumstances.[7]

The regulation does not deal with the question of whether the management of a company makes itself liable to prosecution for committing fraud if it continues the business operations and continues to enter into obligations although it accepts that the company cannot pay this obligation. Similarly, there is no relief for the criminal and civil liability of management in the event of nonpayment of social security contributions[8] or taxes.[9]

LIMITATION OF LIABILITY AND RESCISSION RISKS TO FACILITATE RESTRUCTURING LOANS

The restriction of the managing director's obligations to file for insolvency and of insolvency applications by creditors is flanked by numerous restrictions on liability and rescissions, which are intended to facilitate the granting of restructuring loans and other financial assistance for the period during which the companies' obligation to file for insolvency is suspended (*Suspension Period*),[11] whereby it is not necessary for the company concerned to be subject to an actual obligation to file for insolvency by virtue of its legal form or because of the existence of grounds for insolvency.[12]

According to the statement of reasons for the Act, the presumptions and burden of proof regarding the existence of the conditions for suspending the obligation to file for insolvency benefit not only the management of the company but also its lenders.

1. Loans granted and collateral provided during the Suspension Period shall not be regarded as an immoral (*sittenwidrig*) contribution to the delay in filing for insolvency.

The liability of lenders for the granting of immoral restructuring loans (e.g., under § 826 BGB) is therefore excluded for these loans and collateral.

According to the statement of reasons for the Act, this privilege also covers nova-tions and renewals. However, these are only immoral in exceptional cases.

2. Repayment by 30 September 2023 of new loans granted during the Suspension Period and the provision of collateral to secure such loans during the Suspension Period can no longer be considered as a “discrimination of creditors” (*gläubigerbenachteili-gend*) and therefore cannot be contested.

According to the statement of reasons for the Act, *only fresh money loans* (including commercial loans and other forms of performance on credit terms) are covered by this privilege, *but not novated, extended, or deferred loans.* The same applies to economically comparable cases, such as back-and-forth payments. On the other hand, however, the privilege should also extend to “reasonable” interest payments.

3. Legal acts that have granted or enabled a contractual partner to obtain security or satisfaction of its claims that the contractual partner was able to claim in the manner and at the time are not contestable in subsequent insolvency proceedings, unless the contractual partner was aware that the restructuring and financing efforts of the company were not suitable for eliminating an insolvency which had occurred.

According to the statement of reasons for the Act, the burden of proof for the existence of such knowledge lies with the party wishing to invoke contestability. The company's contractual partner does not have to satisfy itself that the debtor is making suitable restructuring and financing efforts, and only proven positive knowledge of the absence of restructuring and financing efforts or of the obvious unsuitability of the restructuring and financing efforts would render the protection against avoidance void.

4. Furthermore, the following legal acts cannot be contested in subsequent insolvency proceedings unless the contractual partner was aware that the restructuring and financing efforts of the company were not suitable for eliminating an insolvency that had occurred:

- Performance in lieu of or on account of fulfillment;

- Payments by a third party on the instructions of the company;
- the provision of security other than that originally agreed, if this is not more valuable;
- the shortening of payment terms; and
- the granting of a facilitation of payment.

The regulation does not deal with the question of whether the management of a company may be liable to prosecution and thus also liable under civil law[13] on the grounds of preferential treatment of creditors[14] if it grants incongruent benefits such as benefits in lieu of performance, benefits on account of performance, or a security other than that originally agreed, provided that the company is insolvent and the management is aware of it.

Further relief applies to loans granted by KfW and its financing partners or by other institutions in the context of state aid programmes in connection with the COVID-19 pandemic. For these loans, the lender's liability for immoralities (*Sittenwidrigkeit*) and the avoidance of repayment or provision of collateral is excluded even if the loan is granted or secured only after the end of the Suspension Period or repayment is made after 30 September 2023.[15]

According to the statement of reasons for the Act, the additional privilege covers not only the parts of the financing provided by KfW but also the parts to be provided by third parties (e.g., the borrower's bank).

As a result of the facilitations for the granting of rehabilitation loans, these can now be granted in an accelerated procedure. The previously time-consuming and cost-intensive obtaining of redevelopment expert opinions, for example, according to the IdW S6 standard, is no longer necessary.

RESTRICTION OF THE SUBORDINATION OF SHAREHOLDER LOANS

In order to facilitate the provision of additional liquidity by shareholders of a company, new shareholder loans granted during the Suspension Period and claims arising from legal acts that are economically equivalent to such a loan are no longer subject to subordination in insolvency proceedings of the company if such proceedings have been applied for by 30 September 2023.

The granting of security for shareholder loans from the assets of the company is not privileged but has been excluded explicitly from this privilege.

However, it should be privileged if a shareholder uses its assets to secure a newly granted third-party loan during the Suspension Period, since the nonapplication of § 44a InsO regulating this case was expressly included in the wording of the law and the security in this case does not come from the company assets.

According to the statement of reasons for the Act, shareholder loans must be new loans (fresh money). In particular, the prolongation or new granting of a previously subordinated shareholder loan for the purpose or with the effect of a ranking upgrade is not covered.

The same is likely to apply to any other combination of creditor and shareholder positions, e.g., the acquisition of a share in the company by an existing creditor, the acquisition of an existing creditor position by a shareholder, or the simultaneous acquisition of a shareholder and creditor position, provided that this combination takes place without the injection of additional liquidity.

The repayment of privileged shareholder loans (including "reasonable" interest payments) is considered to be not disadvantageous to other creditors and is therefore no longer sub-ject to an insolvency challenge if this payment has been made by 30 September 2023.

It is unclear whether the repayment by the company of third-party loans secured by the shareholder is disadvantageous to creditors. If the exclusion of subordination for such shareholder collateral is affirmed, it would only be consistent if the repayment of such a third-party loan (and thus the release of the collateral provided by the shareholder) were also classified as not disadvantageous to creditors, provided that the repayment is made by 30 September 2023.

The regulation does not deal with the question of whether the managing directors of a company are liable to prosecution for bankruptcy[16] and thus also liable under civil law[17] if it repays a privileged shareholder loan. The possibility of such criminal liability was — if further requirements for the offence of bankruptcy are met — in principle affirmed by German courts.[18] However, if the statutory privilege are taken seriously, in our opinion, it will hardly be possible to make a criminal charge against the management if it makes a repayment of a shareholder loan that is permitted under civil law. Ultimately, however, the legal situation in this regard is unclear.

Please note that this overview does not constitute binding legal advice for individual cases, but is a nonbinding overview of the legislative initiative of the federal and state governments in connection with the COVID-19 pandemic (as of 8 April 2020).

FOOTNOTES

[1] § 15a para. 1 and para. 2 German Insolvency Act (*InsO*).
[2] § 823 para. 2 German Civil Code (*BGB*) in conjunction with § 15a InsO.
[3] § 1 COVInsAG.
[4] § 2 para. 1 no. 1 COVInsAG.
[5] § 3 COVInsAG.
[6] *See* § 46b para. 1 German Banking Supervisory Act, KWG, or § 312 para. 1 German Insurance Supervisory Act, VAG.
[7] § 4 COVInsAG.
[8] § 263 StGB.
[9] § 266a StGB.
[10] § 69 AO.
[11] § 2 para. 1 No. 2–4 COVInsAG.
[12] § 2 para. 2 COVInsAG.
[13] § 823 Para. 2 BGB.
[14] § 283c StGB.
[15] § 2 para. 1 no.1 COVInsAG.
[16] § 283, para. 1, no. 1 StGB.
[17] § 823 para. 2 BGB.
[18] *See* Federal Court of Justice, Neue Zeitschrift für Insolvenz- und Sanierungsrecht 2017, p. 542.

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